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PROFILE TECHNOLOGIES INC  
Form 10QSB  
February 08, 2007

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-QSB

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended December 31, 2006

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-21151

PROFILE TECHNOLOGIES, INC.  
-----

(Name of Small Business Issuer in Its Charter)

Delaware  
-----

(State or other jurisdiction of  
incorporation or organization)

91-1418002  
-----

(I.R.S. Employer  
Identification No.)

2 Park Avenue, Suite 201  
-----

11030  
-----

Manhasset, New York  
(Address of principal executive offices)

(Zip Code)

(516) 365-1909  
-----

(Issuer's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:  
Common Stock, \$0.001 par value

Check whether the issuer: (1) filed all reports required to be filed by  
Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such  
shorter period that the registrant was required to file such reports), and (2)  
has been subject to such filing requirements for the past 90 days.  
Yes  No

Indicate by check mark whether the registrant is a shell company (as  
defined in Rule 12b-2 of the Exchange Act). Yes  No

State the number of shares outstanding of each of the issuer's classes of common  
equity, as of the latest practicable date: 12,627,278 shares of common stock as  
of February 6, 2007.

Transitional Small Business Disclosure Format (check one): Yes  No

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PART I -- FINANCIAL INFORMATION

Item 1. Financial Statements.

PROFILE TECHNOLOGIES, INC.  
Balance Sheet  
(unaudited)

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December 31,  
2006

Assets		-----
Current assets:		
Cash	\$	502,640
Prepaid expenses and other current assets		9,049
		-----
Total current assets		511,689
Equipment, net of accumulated depreciation of \$547,566		12,104
Deferred financing fees		700
Other assets		1,550
		-----
Total assets	\$	526,043
		=====
Liabilities and Stockholders' Deficit		
Current Liabilities:		
Accounts payable	\$	140,483
Notes payable to stockholders		57,500
Current portion of convertible debt		82,500
Deferred wages		732,054
Accrued professional fees		204,150
Accrued interest		1,952
Other accrued expenses		12,644
		-----
Total current liabilities		1,231,283
Long-term convertible debt, net of unamortized discount of \$66,690		510
Stockholders' deficit:		
Common stock, \$0.001 par value. Authorized 25,000,000 shares; issued and outstanding 12,577,278 shares		12,577
Additional paid-in capital		13,416,783
Accumulated deficit		(14,135,110)
		-----
Total stockholders' deficit		(705,750)
Commitments, contingencies and subsequent events		
		-----
Total liabilities and stockholders' deficit	\$	526,043
		=====

See accompanying notes to financial statements.

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	For the three months ended December 31,		For the
	2006	2005	2006
Revenue	\$ --	\$ --	\$ --
Cost of revenues	--	--	--
Gross profit	--	--	--
Operating expenses:			
Research and development	125,233	189,766	314,7
General and administrative	865,573	175,138	976,9
Total operating expenses	990,806	364,904	1,291,6
Loss from operations	(990,806)	(364,904)	(1,291,6
Interest expense	3,013	30,675	6,0
Net loss	\$ (993,819)	\$ (395,579)	\$ (1,297,7
Basic and diluted net loss per share	\$ (0.08)	\$ (0.05)	\$ (0.
Weighted average shares outstanding used to calculate basic and diluted net loss per share	12,554,950	8,674,869	12,505,6

See accompanying notes to financial statements.

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PROFILE TECHNOLOGIES, INC.  
Statements of Cash Flows  
(unaudited)

Cash flows from operating activities:

Net loss

Adjustments to reconcile net loss to net cash used in operating activities:

    Depreciation and amortization

    Accreted discount on convertible debt

    Amortization of convertible debt discount included in interest expense

    Accrued interest on convertible debt converted to equity

    Accrued interest on notes payable to stockholders converted to equity

    Amortization of debt issuance costs

    Equity issued for services to consultants

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Equity issued for services to employees and board of directors

Changes in operating assets and liabilities:

Prepaid expenses and other current assets

Other assets

Accounts payable

Deferred wages

Accrued professional fees

Accrued interest

Other accrued expenses

Net cash used in operating activities

Cash flows from financing activities:

Common stock issuance costs

Allocated proceeds from issuance of common stock

Allocated proceeds from issuance of warrants attached to issuance of common stock

Proceeds from issuance of notes payable to stockholders

Proceeds from exercise of stock options and warrants

Net cash provided by financing activities

Increase (decrease) in cash

Cash at beginning of period

Cash at end of period

Supplemental disclosure of cash flow information:

Cash paid for interest

Convertible debt and related accrued interest converted into 50,000 and 440,740 shares of common stock during the six months ended December 31, 2006 and 2005, respectively

Notes payable to stockholder converted into 1,456,508 shares of common stock during the six months ended December 31, 2005

Accrued interest on notes payable to stockholder converted into 61,492 shares of common stock during the six months ended December 31, 2005

See accompanying notes to financial statements.

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PROFILE TECHNOLOGIES, INC

December 31, 2006

Notes to Financial Statements (Unaudited)

### 1. Description of Business

Profile Technologies, Inc. (the "Company"), was incorporated in 1986 and commenced operations in fiscal year 1988. The Company is in the business of inspecting pipelines for corrosion and has developed a patented, non-destructive and non-invasive, high speed scanning process, using electro magnetic waves to remotely inspect buried, encased and insulated pipelines for corrosion. The Company is now actively marketing its inspection services for encased and insulated pipelines; however, over the next four to six months, the Company intends to perform additional development work prior to marketing its services

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for direct buried pipe.

### 2. Basis of Presentation

The unaudited interim financial statements and related notes of the Company have been prepared pursuant to the instructions to Form 10-QSB. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted pursuant to such instructions. The preparation of financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses. On an on-going basis, the Company evaluates its estimates, including contract revenue recognition and impairment of long-lived assets. Actual results and outcomes may differ materially from these estimates and assumptions.

The financial statements and related notes should be read in conjunction with the audited financial statements and notes thereto included in the Company's annual report on Form 10-KSB for the year ended June 30, 2006. The information furnished reflects, in the opinion of management, all adjustments, consisting of only normal recurring items, necessary for fair presentation of the results of the interim periods presented. Interim results are not necessarily indicative of results for a full year.

### 3. Liquidity

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. The Company incurred cumulative losses of \$14,135,110 through December 31, 2006, and had negative working capital of \$719,594 as of December 31, 2006. Additionally, the Company has expended a significant amount of cash in developing its technology and patented processes. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management recognizes that in order to meet the Company's capital requirements, and continue to operate, additional financing, including seeking industry-partner investment through joint ventures or other possible arrangements, will be necessary. The Company is evaluating alternative sources of financing to improve its cash position and is undertaking efforts to raise capital. If the Company is unable to raise additional capital or secure revenue contracts and generate positive cash flow, it is unlikely that the Company will be able to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

### 4. Summary of Significant Accounting Policies

#### Cash

Cash includes highly liquid investments with original maturities of three months or less. On occasion, the Company has amounts deposited with financial institutions in excess of federally insured limits.

#### Fair Value of Financial Instruments

The Company has the following financial instruments: cash, accounts payable, notes payable to stockholders, and convertible debt. The carrying value of these instruments, other than the convertible debt, approximates fair value based on their liquidity. The fair value of the convertible debt was determined as the excess of the proceeds over the fair value of the warrants.

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### Deferred Financing Fees

The Company records costs incurred related to debt financings as deferred financing fees and amortizes, on a straight-line basis, the costs incurred over the life of the related debt. The amortization is recognized as interest in the financial statements. Upon conversion into equity or extinguishment of the related debt, the Company recognizes any unamortized portion of the deferred financing fees as interest expense.

### Contract Revenue Recognition

The Company recognizes revenue from service contracts using the percentage of completion method of accounting. Contract revenues earned are measured using either the percentage of contract costs incurred to date to total estimated contract costs or, when the contract is based on measurable units of completion, revenue is based on the completion of such units. This method is used because management considers total cost or measurable units of completion to be the best available measure of progress on contracts. Because of the inherent uncertainties in estimating costs, it is at least reasonably possible that the estimates used may change in the near term.

Anticipated losses on contracts, if any, are charged to earnings as soon as such losses can be estimated. Changes in estimated profits on contracts are recognized during the period in which the change in estimate is known.

Cost of revenues include contract costs incurred to date as well as any idle time incurred by personnel scheduled to work on customer contracts.

The Company records claims for additional compensation on contracts upon revision of the contract to include the amount to be received for the additional work performed. Contract costs include all direct material and labor costs and those indirect costs related to contract performance, such as indirect labor, supplies, tools and repairs, and depreciation costs. Selling, general, and administrative costs are charged to expense as incurred. Service contracts generally extend no more than six months.

### Research and Development

Research and development costs are expensed when incurred. During the three months ended December 31, 2006 and 2005, the Company incurred \$125,233 and \$189,766 on research and development activities. During the six months ended December 31, 2006 and 2005, the Company incurred \$314,722 and \$246,866 on research and development activities.

### Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of

The Company reviews long-lived assets, such as equipment and intangibles, for impairment at least annually or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

### Valuation of Warrants and Options

The Company estimates the value of warrants and option grants using a Black-Scholes pricing model based on management assumptions regarding the warrant and option lives, expected volatility, and risk free interest rates.

### Use of Estimates

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The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### Recently Issued Accounting Standards Not Yet Adopted

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, Accounting for Uncertainties in Income Taxes, ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for financial statements as of January 1, 2007. The Company has not yet determined the impact of applying FIN 48.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("SFAS 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements but does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company has not yet determined the impact of applying SFAS No. 157.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108). Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. The Company does not expect any material impact from applying SAB 108.

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### Vendor Concentration

#### Consultant Scientist Fees

The Company relies on the expertise of two consultant scientists to facilitate the development and testing of the Company's hardware and software. These scientists are also instrumental in compiling and interpreting the data captured during the testing of the hardware and software. The loss of the specialized knowledge provided by the scientists could have an adverse effect on the ability of the Company to successfully market its hardware and software. During the three and six months ended December 31, 2006, the Company incurred cash fees payable to the scientists of \$45,695 and \$131,989, which are included in research and development expense in the Company's Statements of Operations. During the three and six months ended December 31, 2005, the Company incurred cash fees payable to the scientists of \$74,042 and \$100,538, which are included in research and development expense in the Company's Statements of Operations.

As partial compensation for services rendered, on November 13, 2006, the Company granted the scientists stock options to purchase a total of 100,000 shares of common stock at an exercise price of \$0.86 per share, expiring November 12, 2016. The 100,000 stock options had a fair value at the date of grant of \$77,000, which is included in research and development expense in the Company's Statements of Operations for the three and six months ended December



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31, 2006.

As partial compensation for services rendered, on July 13, 2006, the Company granted one of the scientists a stock option to purchase 100,000 shares of common stock at an exercise price of \$1.05 per share, expiring July 12, 2011. The 100,000 stock options had a fair value at the date of grant of \$89,000, which is included in research and development expenses in the Company's Statements of Operations for the three and six months ended December 31, 2006.

As partial compensation for services rendered, on December 12, 2005, the Company granted one of the scientists a stock option to purchase 50,000 shares of common stock at an exercise price of \$1.12 per share, expiring December 12, 2010. The 50,000 stock options had a fair value at the date of grant of \$50,500, which is included in research and development expense in the Company's Statements of Operations for the three and six months ended December 31, 2005.

Total cash and equity compensation expense incurred for settlement of services rendered by the scientists totaled \$122,695 and \$297,989 , or approximately 98% and 95%, of research and development expense for the three and six months ended December 31, 2006.

Total cash and equity compensation expense incurred for settlement of services rendered by the scientists totaled \$124,542 and \$151,038, or approximately 66% and 61%, of research and development expense for the three and six months ended December 31, 2005.

As of December 31, 2006, the Company owed the scientists a total of \$69,693, which is included in accounts payable at December 31, 2006.

### 5. Stock Based Compensation

Prior to January 1, 2006, the Company accounted for stock-based awards under the intrinsic value method, which followed the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. The intrinsic value method of accounting resulted in compensation expense for stock options to the extent that the exercise prices were set below the fair market price of the Company's stock at the date of grant.

As of January 1, 2006, the Company adopted SFAS No. 123(R) using the modified prospective method, which requires measurement of compensation cost for all stock-based awards at fair value on date of grant and recognition of compensation over the service period for awards expected to vest. The fair value of stock options is determined using the Black-Scholes valuation model, which is

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consistent with the Company's valuation techniques previously utilized for options in footnote disclosures required under SFAS No. 123, Accounting for Stock Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation--Transition and Disclosure. Such value is recognized as expense over the service period. To date, all stock option grants have been fully vested upon grant.

The application of SFAS 123(R) had the following effect on net loss as reported:

Three Months Ended  
December 31,

Six Months  
December

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	2006 -----	2005 -----	2006 -----
Net loss:			
As reported	\$ (993,819)	\$ (395,579)	\$ (1,297,724)
Plus: stock-based employee compensation expense included in reported net loss	--(1)	--	--(1)
Less: stock based compensation expense determined under fair value based method for all employee awards	--(1)	(352,000)	--(1)
	-----	-----	-----
Net loss	\$ (993,819)	\$ (747,579)	\$ (1,297,724)
	=====	=====	=====
Net loss per share			
Basic and diluted - as reported	\$ (0.08)	\$ (0.05)	\$ (0.10)
Basic and diluted - pro forma	\$ (0.08) (1)	\$ (0.09)	\$ (0.10) (1)

(1) The Company applied SFAS No. 123(R) for the three and six months ended December 31, 2006, therefore net loss as reported and basic and diluted net loss per share as reported are the same as the Company's pro forma net loss and pro forma basic and diluted net loss per share as determined in accordance with SFAS No. 123(R).

6. Net Loss Per Share

Basic net loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing the net loss by the weighted average number of common and dilutive common equivalent shares outstanding during the period. As the Company had a net loss attributable to common shareholders in each of the periods presented, basic and diluted net loss per share are the same.

Excluded from the computation of diluted net loss per share for the three and six months ended December 31, 2006, because their effect would be antidilutive, are stock options and warrants to acquire 12,481,417 shares of common stock with a weighted-average exercise price of \$0.99 per share. Also excluded from the computation of diluted net loss per share for the three and six months ended December 31, 2006 are 300,000 shares of common stock that may be issued if investors exercise their conversion right under the Debentures related to the 2003 Offering as discussed in Note 8 because their effect would be antidilutive.

Excluded from the computation of diluted net loss per share for the three and six months ended December 31, 2005, because their effect would be antidilutive, are stock options and warrants to acquire 9,343,018 shares of common stock with a weighted-average exercise price of \$1.16 per share. Also excluded from the computation of diluted net loss per share for the three and six months ended December 31, 2005 are 366,000 shares of common stock that may be issued if investors exercise their conversion right under the Debentures related to the 2003 Offering as discussed in Note 8 because their effect would be antidilutive.

For the three and six months ended December 31, 2006 and 2005, additional potential dilutive securities that were excluded from the diluted net loss per share computation are the exchange rights discussed in Note 9 that could result in options to acquire up to 223,000 shares of common stock with an exercise price of \$1.00 per share at December 31, 2006 and 2005.

For purposes of earnings per share computations, shares of common stock that are issuable at the end of a reporting period are included as outstanding.

7. Related Parties

Notes Payable - Stockholders

In April 2002, the Company issued a non-interest bearing bridge note payable to an officer of the Company in the amount of \$7,500. The note is payable in full when the Company determines it has sufficient working capital to do so. On September 29, 2002, the officer who was owed the \$7,500 died.

The Company entered into various loan agreements with Murphy Evans, President, a director and stockholder of the Company. On March 6, 2003, the Company's Board of Directors approved the Loan Amendment and Promissory Note (the "Amended Evans Loan") between the Company and Murphy Evans. The Amended Evans Loan aggregated all previous debt and superseded and replaced all of the terms of the previous loans with Mr. Evans, including any conversion features. The Amended Evans Loan bore interest on the aggregate principal balance at a rate of 5% per annum, payable on June 30 and December 31 of each year, with the principal balance due and payable in full on December 31, 2003. The Amended Evans Loan was exempt from registration under Section 4(2) of the Securities Act.

In January 2006, Mr. Evans converted the entire then outstanding principal and accrued interest on the Amended Evans Loan pursuant to the terms of the 2005 Offering as defined below.

Interest expense related to the Amended Evans Loan was \$7,136 and \$15,870 for the three and six months ended December 31, 2005.

In September 2002, the Company entered into two non-interest bearing bridge loans in the respective principal amounts of \$40,000 and \$10,000 (the "Stockholder Loans") payable to two stockholders of the Company. The terms of the Stockholder Loans provide for payment at such time as the Company determines it has sufficient working capital to repay the principal balances of the Stockholder Loans. The Stockholder Loans are convertible into 57,142 and 14,286 equity units, respectively, at any time prior to re-payment. Each equity unit is comprised of one share of the Company's common stock, with a detachable 5-year warrant to purchase one additional share at an exercise price of \$1.05 per share. Neither stockholder has converted either Stockholder Loan into equity units.

The following is a summary of notes payable to stockholders as of December 31, 2006:

Deceased Officer Note	\$ 7,500
Stockholder Loans	50,000
	-----
Total	\$57,500
	=====

8. Convertible Debt

On June 19, 2003, the Board of Directors approved the offering (the "2003 Offering") of \$1,000,000 in convertible debentures (the "Debentures"). The

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Debentures are convertible into that number of shares of the Company's common stock equal to the amount of the converted indebtedness divided by \$0.50 per share. The Debentures bear interest at a rate of 5% per annum, payable quarterly. Delinquent interest payments bear interest at a rate of 12% per annum. The Company is required to redeem each Debenture on the 5th anniversary of the date of the Debenture. The Company may, in its discretion, redeem any Debenture at any time prior to the mandatory redemption date of the Debenture by providing no less than 60 days' prior written notice to the holder of the Debenture. Certain events of default will result in the Debentures being redeemable by the Company upon demand of the holder.

Upon the purchase of, and for each \$0.50 of the Debenture's principal amount, the Company issued to each investor a warrant (the "Warrant") to purchase one (1) share of the Company's common stock at an exercise price of \$0.75 per share. The Warrants are exercisable at any time prior to the 5th anniversary date of the redemption of the Debenture.

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Warrants issued in connection with the 2003 Offering were recorded based on their relative fair value as compared to the fair value of the debt at issuance. The relative fair value of the warrants was recorded as paid-in capital. The intrinsic value of the Debentures results in a beneficial conversion feature, recorded as a discount against the Debentures, which reduces the book value of the convertible debt to not less than zero. The Company amortizes the discount using the effective interest method over the five-year life of the Debentures.

During the quarter ended March 31, 2005, the Board of Directors terminated the 2003 Offering. As of the closing date of the 2003 Offering, the Company had raised \$503,000 from the 2003 Offering.

During the three and six months ended December 31, 2006, one investor exercised their conversion right under the terms of the Debentures. Accordingly, the carrying value of the convertible debt was reclassified as equity upon conversion. The discount related to this Debenture was previously expensed as interest expense during the quarter ended June 30, 2004 when the Company was deemed to be in default with respect to the interest payment terms.

During the three and six months ended December 31, 2005, one and five investors, respectively, exercised their conversion right under the terms of the Debentures. Accordingly, the carrying value of the convertible debt was reclassified as equity upon conversion. Since the convertible debt instruments include a beneficial conversion feature, the remaining unamortized discount of \$19,993 and \$189,954 at the conversion date was recognized as interest expense during the three and six months ended December 31, 2005.

As of December 31, 2006, accrued interest on the Debentures was \$1,952. The Company recorded interest expense related to the accretion of the discount on the Debentures of \$197 and \$321 for the three and six months ended December 31, 2006. The Company recorded interest expense related to the accretion of the discount on the Debentures and amortization of the convertible debt discount as a result of the conversions discussed above of \$20,026 and \$190,011 for the three and six months ended December 31, 2005. As of December 31, 2006 the carrying value of the long-term portion of the Debentures was \$510, net of unamortized debt discount of \$66,990.

### 9. Deferred Wages and Accrued Professional Fees

To reduce cash outflows, certain of the Company's employees, officers, consultants, and directors have agreed to defer a portion of their salaries and professional fees until the Company has sufficient resources to pay the amounts

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owed or to exchange such amounts into options as described below. At December 31, 2006, the Company has accrued \$936,204 related to the deferred payment of salaries and professional fees of which \$732,054 is included under deferred wages and \$204,150 in accrued professional fees. On March 18, 2002, the Board approved a conversion right on all deferred wages and accrued professional fees deferred as of March 18, 2002 (the "Conversion Right"). Pursuant to the Conversion Right, employees, officers, consultants, and directors may elect to convert \$1.00 of fees owed to them as of March 18, 2002 for an option to purchase two shares of the Company's common stock, at an exercise price of \$1.00 per share for a term of five years. Of the total \$936,204 deferred salaries and professional fees, the amount subject to the Conversion Right is \$111,500, resulting in the potential issuance of 223,000 options under the terms mentioned above. No conversions have occurred to date. At March 18, 2002, there was no intrinsic value associated with these exchange rights. As such, no additional compensation cost was recorded.

### 10. Common Stock and Warrants

On January 19, 2005, the Board of Directors approved the offering (the "2005 Offering") of 2,000,000 units (the "Units") to accredited investors for a total offering price of \$1,000,000. Each Unit consists of one share of common stock and a warrant to acquire common stock. On November 21, 2005, the Board of Directors approved an increase in the number of Units offered in the 2005 Offering to 6,000,000 Units, for a total offering price of \$3,000,000. The purchase price of one Unit is \$0.50. Each Unit consists of one share of common stock and a warrant to purchase one share of common stock at an exercise price of \$0.75. The warrants are exercisable at any time prior to the fifth anniversary from the date of their issuance.

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The 2005 Offering was terminated on June 9, 2006. As of the closing date of the 2005 Offering, the Company had raised \$1,801,000 from the 2005 Offering.

The Company engaged a brokerage firm to help in the fund raising efforts of the 2005 Offering. Pursuant to the terms of the agreement with the brokerage firm, the Company paid the brokerage firm a ten percent cash commission on all funds that the brokerage firm helped raise. During the three and six months ended September 30, 2005, the Company incurred \$19,700 and \$71,350 of fees that were paid in cash to the brokerage firm. The brokerage firm and the Company also agreed that the Company would issue warrants to purchase a total of 439,600 shares of common stock at an exercise price of \$0.60. The warrants are exercisable for up to five years from the date of issuance, which is the date the proceeds were received under the 2005 Offering. Of the total 439,600 warrants that the brokerage firm received, 39,400 were earned during the three months ended December 31, 2005 as a result of the funds raised by the brokerage firm during that period. Accordingly, during the three months ended December 31, 2005, the Company recorded \$39,006 as a reduction to paid-in capital for the fair value of the 39,400 warrants. The fair value of the warrant grants were estimated using the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility of 376.16%, risk-free interest rate of 4.14%, expected lives of five years, and a 0% dividend yield.

Of the total 439,600 warrants that the brokerage firm received, 142,700 were earned during the six months ended December 31, 2005 as a result of the funds raised by the brokerage firm during that period. Accordingly, during the six months ended December 31, 2005, the Company recorded \$107,184 as a reduction to paid-in capital for the fair value of the 142,700 warrants. The fair value of the warrants issued to the brokerage firm during the six months ended December 31, 2005 were estimated using the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility ranging from 353.30%

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to 376.15%, risk-free interest rates ranging from 4.14% to 4.35%, expected lives of five years, and a 0% dividend yield.

### 11. Stock Options and Warrants

#### Stock Options

##### Stock Option Grants

On November 13, 2006, the Board approved the issuance of stock options exercisable for a total of 575,000 shares of common stock pursuant to the 1999 Stock Option Plan to certain directors, officers, employees and four consultants of the Company. The stock options are fully vested upon grant and are exercisable until November 12, 2016. The exercise price of the stock options granted to insiders owning or controlling more than ten percent of the Company's common stock was \$0.95, which is ten percent over the closing bid price of the Company's common stock as quoted on the Over the Counter Bulletin Board on the grant date, November 13, 2006. The exercise price of the stock options granted to non-insiders was \$0.86. On November 13, 2006, the date of grant, the Company recognized \$77,000 as research and development expense related to the fair value of 100,000 of the stock options and \$365,750 as general and administrative expense related to the fair value of 475,000 of the stock options. The fair value of the stock option grants were estimated using the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility of 142%, risk-free interest rate of 4.60%, expected lives of five years, and a 0% dividend yield.

On July 13, 2006, the Board approved an option grant to a consultant to purchase 100,000 shares of the Company's common stock at an exercise price of \$1.05 per share. The option was granted in consideration for work the consultant is performing for the Company and was not granted pursuant to the 1999 Stock Option Plan. The option was fully vested upon grant and is exercisable until July 13, 2011. The Company recognized \$89,000, at the time of grant, as research and development expense for the fair value of the option grant. The fair value of the option grant was estimated using the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility of 160%, risk-free interest rate of 5.04%, expected life of five years, and a 0% dividend yield.

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##### Stock Option Cancellations

On November 13, 2006, the Board cancelled 30,000 stock options that were originally granted on December 9, 2002 with an exercise price of \$0.55 per share.

##### Stock Option Exercises

On October 18, 2006, a non-employee Board member exercised stock options to purchase shares of the Company's common stock. The following is a summary of the stock options exercised on October 18, 2006 by the non-employee Board member:

	Number of Shares of Common Stock Acquired	Exercise Price of Stock Option
	-----	-----
Stock Option	20,000	\$1.05
Stock Option	10,000	\$0.55
Stock Option	20,000	\$0.70

A summary of stock option-related activity follows:

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	Shares available for grant (1)	Options outstanding Number of shares (2)	Weighted average exercise price
	-----	-----	-----
Balance at June 30, 2006	115,000	2,700,000	\$ 1.18
Increase in authorized stock options available for grant	2,000,000		
Grants	(575,000)	675,000	0.91
Cancellations	30,000	(30,000)	0.55
Exercises	50,000	(50,000)	0.81
Expirations	110,000	(110,000)	1.05
	-----	-----	
Balance at December 31, 2006	1,730,000	3,185,000	\$ 1.14
	=====	=====	

(1) Consists of stock options available for grant under the Company's 1999 Stock Option Plan.

(2) Consists of stock options outstanding under the Company's 1999 Stock Option Plan and stock options outstanding that were granted outside of the 1999 Stock Option Plan.

Warrants

Warrant Grants

On November 13, 2006, the Board approved the issuance of warrants exercisable for a total of 450,000 shares of common stock to certain directors and officers of the Company. The warrants are fully vested upon grant and are exercisable until November 12, 2016. The exercise price of the warrants was \$0.86, which is the closing bid price of the Company's common stock as quoted on the Over the Counter Bulletin Board on the grant date, November 13, 2006. During the three months ended December 31, 2006, the Company recognized \$346,500 as

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general and administrative expense related to the fair value of the warrants. The fair value of the warrants grants were estimated using the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility of 142%, risk-free interest rate of 4.60%, expected lives of five years, and a 0% dividend yield.

Warrant Cancellations

On November 13, 2006, the Board cancelled the following warrants: 5,000 warrants at an exercise price of \$0.55 per share, 150,000 warrants at an exercise price of \$1.05 per share, 190,000 warrants at an exercise price of \$1.125 per share, and 80,000 warrants at an exercise price of \$3.00 per share.

Warrant Exercises

On October 18, 2006, a non-employee Board member exercised a warrant to purchase 20,833 shares of the Company's common stock at an exercise price of \$1.00 per share.

A summary of warrant-related activity follows:

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	Number of warrants outstanding	Weighted average exercise price
	-----	-----
Outstanding at June 30, 2006	9,943,418	\$ 0.97
Grants	450,000	0.86
Cancellations	(425,000)	1.44
Exercises	(20,833)	1.00
Expirations	(651,168)	1.00
	-----	
Outstanding at December 31, 2006	9,296,417	\$ 0.94
	=====	

### 12. Subsequent Events

Subsequent to December 31, 2006, two investors exercised their conversion right, pursuant to the terms of the 2003 Offering and converted Debentures in the combined principal amount of \$25,000 pursuant to the terms of the 2003 Offering. Accordingly, the Company issued 50,000 shares of common stock in accordance with the terms of the 2003 Offering.

### Item 2. Management's Discussion and Analysis or Plan of Operations.

#### Plan of Operations

In recent years, the Company has focused on the buried pipe market in the United States. It has redesigned and improved the hardware underlying its EMW Inspection Process. It has also performed lab and field testing of this new hardware and has developed computer models to better predict and interpret field conditions.

The Company has filed a patent application covering the work of its consulting scientists during the last several years. It has recently received a Notice of Allowance from the patent office in this matter.

The Company is now actively marketing a cased pipe inspection service; however, there can be no assurance that contracts for this service will be obtained. Failure to obtain such contracts could have a serious and material effect on the business and financial condition of the Company.

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The Company also continues to work on direct buried (uncased) pipe inspections. Additional work needs to be done to adjust the Company's hardware and software to account for the effects of varying soil conditions before the Company can actively market a direct buried pipe inspection service.

While the Company has, in the past, inspected only for external corrosion, it has recently filed a patent application covering the adaptation of its technology for internal pipe inspections. However, significant design, fabrication and testing must be done before the Company will be able to offer internal pipe inspection services.

Capital will be expended to support operations until the Company can generate sufficient cash flows from operations. In order for the Company to generate cash flows from operations, the Company must obtain revenue generating contracts. Management is currently directing the Company's activities towards obtaining service contracts, which, if obtained, will necessitate the Company attracting, hiring, training and outfitting qualified technicians. If service contracts are obtained, it will also necessitate additional field test equipment



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purchases in order to provide the services. The Company expects that if revenue contracts are secured, working capital requirements will increase. The Company will incur additional expenses as it hires and trains field crews and support personnel related to the successful receipt of commercial contracts. Additionally, the Company anticipates that cash will be used to meet capital expenditure requirements necessary to develop infrastructure to support future growth.

The Company has expended a significant amount of cash in developing its technology and patented processes. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management recognizes that in order to meet the Company's capital requirements, and continue to operate, additional financing, including seeking industry-partner investment through joint ventures or other possible arrangements, will be necessary within the next twelve months. The Company is evaluating alternative sources of financing to improve its cash position and is undertaking efforts to raise capital. If the Company is unable to raise additional capital or secure revenue contracts and generate positive cash flow, it is unlikely that the Company will be able to continue as a going concern.

### Liquidity and Capital Resources

#### Deferred Wages and Accrued Professional Fees

To reduce cash outflows, certain of the Company's employees, officers, consultants, and directors have agreed to defer a portion of their salaries and professional fees until the Company has sufficient resources to pay the amounts owed or to exchange such amounts into options as described below. At December 31, 2006, the Company has accrued \$936,204 related to the deferred payment of salaries and professional fees of which \$732,054 is included under deferred wages and \$204,150 in accrued professional fees. On March 18, 2002, the Board approved a conversion right on all deferred wages and accrued professional fees deferred as of March 18, 2002 (the "Conversion Right"). Pursuant to the Conversion Right, employees, officers, consultants, and directors may elect to convert \$1.00 of fees owed to them as of March 18, 2002 for an option to purchase two shares of the Company's common stock, at an exercise price of \$1.00 per share for a term of five years. Of the total \$936,204 deferred salaries and professional fees, the amount subject to the Conversion Right is \$111,500, resulting in the potential issuance of 223,000 options under the terms mentioned above. No conversions have occurred to date. At March 18, 2002, there was no intrinsic value associated with these exchange rights. As such, no additional compensation cost was recorded.

#### Convertible Debt

On June 19, 2003, the Board of Directors approved the offering (the "2003 Offering") of \$1,000,000 in convertible debentures (the "Debentures"). The Debentures are convertible into that number of shares of the Company's common stock equal to the amount of the converted indebtedness divided by \$0.50 per share. The Debentures bear interest at a rate of 5% per annum, payable quarterly. Delinquent interest payments bear interest at a rate of 12% per annum. The Company is required to redeem each Debenture on the 5th anniversary of the date of the Debenture. The Company may, in its discretion, redeem any Debenture at any time prior to the mandatory redemption date of the Debenture by

providing no less than 60 days' prior written notice to the holder of the Debenture. Certain events of default will result in the Debentures being redeemable by the Company upon demand of the holder.

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Upon the purchase of, and for each \$0.50 of the Debenture's principal amount, the Company issued to each investor a warrant (the "Warrant") to purchase one (1) share of the Company's common stock at an exercise price of \$0.75 per share. The Warrants are exercisable at any time prior to the 5th anniversary date of the redemption of the Debenture.

Warrants issued in connection with the 2003 Offering were recorded based on their relative fair value as compared to the fair value of the debt at issuance. The relative fair value of the warrants was recorded as paid-in capital. The intrinsic value of the Debentures results in a beneficial conversion feature, recorded as a discount against the Debentures, which reduces the book value of the convertible debt to not less than zero. The Company amortizes the discount using the effective interest method over the five-year life of the Debentures.

During the quarter ended March 31, 2005, the Board of Directors terminated the 2003 Offering. As of the closing date of the 2003 Offering, the Company had raised \$503,000 from the 2003 Offering.

During the three and six months ended December 31, 2006, one investor exercised their conversion right under the terms of the Debentures. Accordingly, the carrying value of the convertible debt was reclassified as equity upon conversion. The discount related to this Debenture was previously expensed as interest expense during the quarter ended June 30, 2004 when the Company was deemed to be in default with respect to the interest payment terms.

During the three and six months ended December 31, 2005, one and five investors, respectively, exercised their conversion right under the terms of the Debentures. Accordingly, the carrying value of the convertible debt was reclassified as equity upon conversion. Since the convertible debt instruments include a beneficial conversion feature, the remaining unamortized discount of \$19,993 and \$189,954 at the conversion date was recognized as interest expense during the three and six months ended December 31, 2005.

As of December 31, 2006, accrued interest on the Debentures was \$1,952. The Company recorded interest expense related to the accretion of the discount on the Debentures of \$197 and \$321 for the three and six months ended December 31, 2006. The Company recorded interest expense related to the accretion of the discount on the Debentures and amortization of the convertible debt discount as a result of the conversions discussed above of \$20,026 and \$190,011 for the three and six months ended December 31, 2005. As of December 31, 2006 the carrying value of the long-term portion of the Debentures was \$510, net of unamortized debt discount of \$66,990.

### Other Commitments

The Company's other contractual obligations consist of commitments under an operating lease and repayment of loans payable to certain stockholders.

As of December 31, 2006, the Company had outstanding loans payable to certain stockholders with principal amounts, in the aggregate, equal to \$57,500. The terms of the various notes are described above under "Note 7: Related Parties: Notes Payable - Stockholders."

The Company's research and development facility is located in Ferndale, Washington. Pursuant to an operating lease that expires on January 31, 2007, the Company leases 1,800 square feet of space from a non-affiliate at a monthly cost of approximately \$2,107. In October 2006, the Company provided written notification to the landlord of the Ferndale property that it would not be renewing the operating lease in January 2007. As of December 31, 2006, the Company has future minimum lease payments of approximately \$2,107, representing the last month's rent for January 2007.

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### Off Balance Sheet Arrangements

The Company has no off-balance sheet arrangements.

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### FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-QSB contains "forward-looking statements." These forward-looking statements can generally be identified as such because the context of the statement will include words such as the Company "believes," "anticipates," "expects" or words of similar import. Similarly, statements that describe the Company's projected future results, future plans, objectives or goals or future conditions or events are also forward looking statements. Actual results are inherently difficult to predict. Any such forward-looking statements are subject to the risks and uncertainties that could cause actual results of operations, financial condition, acquisitions, financing transactions, operations, expenditures, expansion and other events to differ materially from those expressed or implied in such forward-looking statements. Any such forward-looking statements would be subject to a number of assumptions regarding, among other things, future economic, competitive and market conditions generally. Such assumptions would be based on facts and conditions as they exist at the time such statements are made as well as predictions as to future facts and conditions, the accurate prediction of which may be difficult and involve the assessment of events beyond the Company's control.

The forward-looking statements contained in this report are based on current expectations that involve a number of risks and uncertainties. Such forward-looking statements are based on assumptions that the Company will obtain or have access to adequate financing to continue its operations, that the Company will market and provide products and services on a timely basis, that there will be no material adverse competitive or technological change with respect to the Company's business, demand for the Company's products and services will significantly increase, that the Company will be able to secure additional fee-for-services or licensing contracts, that the Company's executive officers will remain employed as such by the Company, that the Company's forecast accurately anticipate market demand, and that there will be no material adverse change in the Company's operations, business or governmental regulation affecting the Company or its customers. The foregoing assumptions are based on judgments with respect to, among other things, future economic, competitive and market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the Company's control. Although the Company believes the expectations reflected in the forward-looking statements are reasonable, the Company cannot guarantee future results, levels of activity, performance or achievements.

### Item 3. Controls and Procedures.

#### Evaluation of Disclosure Controls and Procedures

##### (a) Evaluation of Disclosure Controls and Procedures

The term "disclosure controls and procedures" is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). This term refers to the controls and procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized, and reported within the required time periods. The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. They have

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concluded that, as of that date, the Company's disclosure controls and procedures were effective at ensuring that required information will be disclosed on a timely basis in the Company's reports filed under the Exchange Act.

### (b) Changes in Internal Control over Financial Reporting

No change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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## PART II -- OTHER INFORMATION

### Item 1. Legal Proceedings.

The Company is not aware of any legal proceedings contemplated by any governmental authority or any other party involving the Company or its properties. As of the date of this report, no director, officer or affiliate is a party adverse to the Company in any legal proceeding or has an adverse interest to the Company in any legal proceedings. The Company is not aware of any other legal proceedings pending or that have been threatened against the Company or its properties.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

#### Convertible Debt

On June 19, 2003, the Board of Directors approved the offering (the "2003 Offering") of \$1,000,000 in convertible debentures (the "Debentures"). The Debentures are convertible into that number of shares of the Company's common stock equal to the amount of the converted indebtedness divided by \$0.50 per share. Upon the purchase of, and for each \$0.50 of the Debenture's principal amount, the Company issued to each investor a warrant (the "Warrant") to purchase one (1) share of the Company's common stock at an exercise price of \$0.75 per share. The Warrants are exercisable at any time prior to the 5th anniversary date of the redemption of the Debenture. The 2003 Offering is exempt from registration under Section 4(2) of the Securities Act.

On October 18, 2006, an investor exercised their conversion right, pursuant to the terms of the 2003 Offering and converted a Debenture in the principal amount of \$25,000 pursuant to the terms of the 2003 Offering. Accordingly, the Company issued 50,000 shares of common stock in accordance with the terms of the 2003 Offering.

#### Stock Options

On November 13, 2006, the Board approved the issuance of stock options exercisable for a total of 575,000 shares of common stock pursuant to the 1999 Stock Option Plan to certain directors, officers, employees and four consultants of the Company. The stock options are fully vested upon grant and are exercisable until November 12, 2016. The exercise price of the stock options granted to insiders owning or controlling more than ten percent of the Company's common stock was \$0.95, which is ten percent over the closing bid price of the Company's common stock as quoted on the Over the Counter Bulletin Board on the grant date, November 13, 2006. The exercise price of the stock options granted to non-insiders was \$0.86. These securities were issued in reliance on exemptions from registration provided by Section 4(2) of the Securities Act.

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### Warrants

On November 13, 2006, the Board approved the issuance of warrants exercisable for a total of 450,000 shares of common stock to certain directors and officers of the Company. The warrants are fully vested upon grant and are exercisable until November 12, 2016. The exercise price of the warrants was \$0.86, which is the closing bid price of the Company's common stock as quoted on the Over the Counter Bulletin Board on the grant date, November 13, 2006. These securities were issued in reliance on exemptions from registration provided by Section 4(2) of the Securities Act.

### Item 3. Defaults Upon Senior Securities.

None.

### Item 4. Submission of Matters to a Vote of Shareholders.

The Annual Meeting of Stockholders (the "Annual Meeting") of the Company was held on November 13, 2006.

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At the Annual Meeting, 7,224,243 shares were present in person or by proxy. The following is a summary and tabulation of the matters that were voted upon at the Annual Meeting:

#### Proposal I.

The election of a board of directors to serve a term of one year or until their respective successors are elected and qualified.

	Votes For -----	Votes Withheld -----
Henry E. Gemino	7,127,352	96,891
Murphy Evans	7,127,294	96,949
Charles Christenson	7,109,407	114,836
William A. Krivsky	7,137,693	86,550

#### Proposal II.

To approve an amendment to the Company's Certificate of Incorporation to increase the number of authorized common shares from 25,000,000 to 35,000,000.

Votes For -----	Against -----	Abstain -----
7,034,665	188,578	1,000

#### Proposal III.

To approve amendments to the Company's 1999 Stock Plan to increase the maximum period of time for which stock options are exercisable from five years to ten years and to increase the aggregate number of shares of common stock which may be issued pursuant to the 1999 Stock Plan from 500,000 to 3,500,000.

Votes For -----	Against -----	Abstain -----	Not Voted -----
5,003,942	122,000	1,900	2,096,401

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### Item 5. Other Information.

None.

### Item 6. Exhibits.

The following exhibits are filed with or incorporated by reference into this report:

Exhibit No. -----	Description of Exhibit -----
Exhibit 3.1	Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form SB-2 filed with the Commission on May 10, 1996).
Exhibit 3.2	Bylaws of the Company (incorporated by reference to Exhibit 3.3 to the Company's Registration Statement on Form SB-2 filed with the Commission on May 10, 1996).
Exhibit 3.3	Amendment to Certificate of Incorporation (incorporated by reference to Exhibit A to the Company's Definitive Proxy Statement filed with the Commission on October 28, 2002).
Exhibit 3.4	Amendment to Certificate of Incorporation (incorporated by reference to Appendix A to the Company's Preliminary Proxy Statement filed with the Commission on September 13, 2006).
Exhibit 10.1	Loan Agreement dated March 6, 2003, by and between the Company and Murphy Evans (incorporated by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-QSB filed with the Commission on May 15, 2002).
Exhibit 10.2	Loan Amendment and Promissory Note dated March 6, 2003, by and between the Company and Murphy Evans (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-QSB filed with the Commission on May 20, 2003).
Exhibit 10.3	Lease Agreement dated January 26, 2001 by and between the Company and Fatum LLC (incorporated by reference to Exhibit 10.4 to the Company's Annual Report on Form 10-KSB filed with the Commission on October 12, 2004).
Exhibit 10.4	Lease Extension dated February 26, 2003 by and between the Company and Fatum LLC (incorporated by reference to Exhibit 10.5 to the Company's Annual Report on Form 10-KSB filed with the Commission on October 12, 2004).
Exhibit 10.5	Royalty Agreement (incorporated by reference to Exhibit 10.1 to the Company's Registration Statement on Form SB-2 filed with the Commission on May 10, 1996).
Exhibit 10.6	Assignment of Patent Rights (incorporated by reference to Exhibit 10.2 to the Company's Registration Statement on Form SB-2 filed with the Commission on May 10, 1996).
Exhibit 10.7	1999 Stock Option Plan (incorporated by reference to Exhibit 10.9 to the Company's Annual Report on Form 10-KSB filed

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with the Commission on October 12, 2004).

- Exhibit 10.8 First Amendment to the 1999 Stock Option Plan (incorporated by reference to Appendix B to the Company's Preliminary Proxy Statement filed with the Commission on September 13, 2006).
- Exhibit 31.1 Rule 13a-14(a)/15d-14(a) Certification of Henry E. Gemino, as Chief Executive Officer and Chief Financial Officer of the Company. \*
- Exhibit 31.2 Rule 13a-14(a)/15d-14(a) Certification of Philip L. Jones, as Chief Operating Officer and Executive Vice President of the Company. \*
- Exhibit 32.1 Certification under Section 906 of the Sarbanes-Oxley Act of 2002 by Henry E. Gemino, as Chief Executive Officer and Chief Financial Officer of the Company. \*
- Exhibit 32.2 Certification under Section 906 of the Sarbanes-Oxley Act of 2002 by Philip L. Jones, as Chief Operating Officer and Executive Vice President of the Company. \*

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\*Filed herewith.

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EXHIBIT INDEX

- Exhibit 31.1 Rule 13a-14(a)/15d-14(a) Certification of Henry E. Gemino, as Chief Executive Officer and Chief Financial Officer of the Company.\*
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\*Filed herewith.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PROFILE TECHNOLOGIES, INC.  
(Registrant)

Date: February 8, 2007

/s/ Henry E. Gemino

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Henry E. Gemino  
Chief Executive Officer and  
Chief Financial Officer