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ADVANCED MATERIALS GROUP INC  
Form 10QSB  
July 18, 2006

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

FORM 10-QSB

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934 FOR THE QUARTERLY PERIOD ENDED FEBRUARY 28, 2005

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT FOR THE  
TRANSITION PERIOD FROM TO

COMMISSION FILE NO. 0-16401

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ADVANCED MATERIALS GROUP, INC.  
(Exact name of registrant as specified in its charter)

NEVADA  
(State or other jurisdiction of  
incorporation or organization)

33-0215295  
(I.R.S. Employer  
Identification No.)

3303 LEE PARKWAY SUITE 105 DALLAS, TEXAS 75219  
(Address of principal executive offices) (Zip code)

(972) 432-0602  
(Registrant's telephone number, including area code)

-----  
N/A

(Former name, former address and former fiscal year,  
if changed since last report)

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: Common Stock, \$.001 par value,  
12,116,000 shares outstanding as of June 12, 2006.

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

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PART I - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

ADVANCED MATERIALS GROUP, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

THREE MONTHS ENDED

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	FEBRUARY 28, 2005	FEBRUARY 29
Net sales	\$ 1,967,066	\$ 2,015
Cost of sales	1,620,452	1,585
Gross profit	346,614	430
Operating expenses:		
Selling, general and administrative	476,297	397
Depreciation and amortization	50,144	50
Total operating expenses	526,441	447
Loss from operations	(179,827)	(17)
Other income (expense):		
Interest expense	(34,021)	(23)
Other, net	4,373	13
Total other expenses, net	(29,648)	(10)
Loss from operations before income taxes	(209,475)	(27)
Income tax expense	--	42
Net loss	\$ (209,475)	\$ (69)
Basic and diluted net loss per share	\$ (0.02)	\$ (
Basic and diluted weighted average common shares outstanding	10,516,026	9,226

See accompanying notes to consolidated financial statements

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ADVANCED MATERIALS GROUP, INC.  
CONSOLIDATED BALANCE SHEETS

	FEBRUARY 28, 2005	FEBRUARY 29, 2005
ASSETS		
Current assets:		
Cash and cash equivalents		\$ 15
Accounts receivable		1,02
Inventories, net		78
Prepaid expenses and other		18
Total current assets		2,15
Property and equipment, net		59
Other assets		

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Total assets	\$ 2,74
	=====
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	\$ 77
Accrued liabilities	24
Restructuring reserve, current	1
Notes payable - related parties	20
Line of credit	68
Current portion of term loan	9
Current portion of capital lease obligations	4
	-----
Total current liabilities	2,06
Capital lease obligations, net of current portion	1
Term loan, net of current portion	14
	-----
Total liabilities	2,21
	-----
Commitments and contingencies	
Stockholders' equity:	
Preferred stock-\$.001 par value; 5,000,000 shares authorized; no shares issued and outstanding	
Common stock-\$.001 par value; 25,000,000 shares authorized; 10,516,026 shares issued and outstanding at February 28, 2005 and November 30, 2004	1
Additional paid-in capital	8,03
Accumulated deficit	(7,51
	-----
Total stockholders' equity	53
	-----
Total liabilities and stockholders' equity	\$ 2,74
	=====

See accompanying notes to consolidated financial statements

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ADVANCED MATERIALS GROUP, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

	THREE
	-----
	FEBRUARY 28, 2
	-----
Cash flows from operating activities:	
Net loss	\$(209,475)
Adjustments to reconcile net loss to net cash used in operating activities	
Depreciation and amortization	111,365
Provision for obsolete inventory	--
Non-cash compensation	--
Changes in operating assets and liabilities:	
Accounts receivable	164,852
Inventories	(95,729)
Prepaid expenses and other	(23,675)
Accounts payable and accrued liabilities	191,168
Restructuring reserve	(6,328)

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Net cash provided by (used in) operating activities	132,178
Cash flows from investing activities:	
Purchases of property and equipment	(4,129)
Net cash used in investing activities	(4,129)
Cash flows from financing activities:	
Sale of common stock	--
Exercise of common stock options	--
Net borrowings (repayments) under line of credit	1,742
Repayments under term loan	(22,500)
Repayment of convertible debentures	--
Repayments of other long-term obligations	(8,591)
Increase in bank overdraft	--
Net cash used in financing activities	(29,349)
Net change in cash and cash equivalents	98,700
Cash and cash equivalents, beginning of period	55,289
Cash and cash equivalents, end of period	\$ 153,989
Supplemental disclosures of cash flow information	
Cash paid during the period for:	
Interest	\$ 34,020
Income taxes	\$ --

See accompanying notes to consolidated financial statements

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### ADVANCED MATERIALS GROUP, INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1) BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission and therefore do not include all information and footnotes necessary for a complete presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America.

The unaudited consolidated financial statements do, however, reflect all adjustments, consisting of only normal recurring adjustments, which are, in the opinion of management, necessary to state fairly the financial position as of February 28, 2005 and November 30, 2004 and the results of operations and cash flows for the related interim periods ended February 28, 2005 and February 29, 2004. However, these results are not necessarily indicative of results for any other interim period or for the year. It is suggested that the accompanying consolidated financial statements be read in conjunction with the Company's audited consolidated financial statements and accompanying notes thereto included in the Company's Annual Report on Form

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10-K for the fiscal year ended November 30, 2004.

The Company's consolidated financial statements have been presented on the basis that it is a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company has incurred continued net losses. At February 28, 2005, the Company had limited cash reserves and was not in compliance with certain financial covenant ratios pertaining to its line of credit, and therefore is in technical default under the compliance provisions of the line of credit and term loan. This violation was cured in October 2005. Management has implemented a plan to reduce expenses and improve sales. The Company has altered its focus and will now be concentrating on securing proprietary products primarily for the medical and consumer industry. The objective is to create advanced designs, using current materials. These products will be pursued through aggressive product development and the licensing of existing patented products or technology. These new products are expected to have higher profit margins and be less subject to competition. There can be no assurances that the Company will be successful in completing these critical tasks. If the Company is unable to successfully complete these critical tasks, it may be forced to significantly reduce, restructure or cease its operations and/or liquidate inventory at amounts below current carrying value to generate the necessary working capital to fund its operations, and if necessary, seek other remedies available to the Company including protection under the bankruptcy laws. As a result of these and other factors, the Company's independent certified registered public accounting firm, Katherine Fang, LLP, indicated in their report on the 2004 consolidated financial statements, that there is substantial doubt about the Company's ability to continue as a going concern.

The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

### Principles of Consolidation

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The consolidated financial statements include the accounts of Advanced Materials Group, Inc. and its wholly owned subsidiary, Advanced Materials, Inc. and Advanced Materials, Ltd. All significant intercompany accounts and transactions have been eliminated.

### Use of Estimates

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The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 materially from those estimates.

## 2) LOSS PER SHARE

The Company has adopted the provisions of Statement of Financial Accounting Standards No. 128, "Earnings per Share" ("SFAS 128"). SFAS 128 requires the presentation of basic and diluted net income per share. Basic earnings per share exclude dilution and are computed by dividing net income by the weighted average of common shares outstanding during the period. Diluted

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earnings per share reflect the potential dilution that would occur if securities or other contracts to issue common stock were exercised or converted into common stock. Potential common share equivalents including stock options and warrants have been excluded for the three-month periods ended February 28, 2005 and February 29, 2004, as their effect would be antidilutive.

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There were 2,556,000 and 2,423,500 potentially dilutive options and warrants outstanding at February 28, 2005 and February 29, 2004, respectively, that were not included in the computation of the net loss per share because they would be anti-dilutive.

### 3) STOCK BASED COMPENSATION

In December 2002, the Financial Accounting Standards Board issued SFAS No. 148, "Accounting for Stock-Based Compensation -- Transition and Disclosure", which amended FAS No. 123, "Accounting for Stock-Based Compensation." The new standard provides alternative methods of transition for a voluntary change to the fair market value based method for accounting for stock-based employee compensation. Additionally, the statement amends the disclosure requirements of FAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. In compliance with FAS No. 148, the Company has elected to continue to follow the intrinsic value method in accounting for its stock-based employee compensation plan as defined by APB No. 25.

The following table represents the effect on net income and earnings per share if the Company had applied the fair value based method and recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation", to stock-based employee compensation. For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. The Company's pro forma information follows:

	THREE MONTHS ENDED	
	FEBRUARY 28, 2005	FEBRUAR
Net loss available to common shareholders	\$ (209,475)	\$
Plus: Stock-based employee compensation expense included in reported net loss	--	
Less: Total stock-based employee compensation determined using fair value based method	(9,378)	
Pro forma net loss available to common stockholders	\$ (218,853)	\$
Net loss per common share - basic and diluted - as reported	\$ (0.02)	\$
Net loss per common share - basic and diluted - pro forma	\$ (0.02)	\$

### 4) INVENTORIES

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Inventories are stated at the lower of cost (determined on the first-in, first-out method) or market. Inventories consisted of the following:

	FEBRUARY 29, 2004	NOVEMBER 30, 2004
	(UNAUDITED)	
Raw Materials	\$ 451,157	\$ 451,157
Work-in-process	111,642	111,642
Finished Goods	244,099	244,099
	-----	-----
Less allowance for obsolete inventory	(20,218)	(20,218)
	-----	-----
	\$ 786,680	\$ 786,680

### 6) CONTINGENT LIABILITIES

Material legal proceedings to which the Company is a party are discussed in Part 1, Item 3, in the Company's latest Annual Report on Form 10-K and in Part II, Item 1 of this Form 10-QSB.

### ITEM 2 -MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

The following discussion should be read in conjunction with the unaudited consolidated financial statements and the related notes that appear elsewhere in this report.

This document contains forward-looking statements that involve risks and uncertainties that could cause the results of the Company and its consolidated subsidiaries to differ materially from those expressed or implied by such forward-looking statements. These risks include the timely development,

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production and delivery of new products; the challenge of managing asset levels, including inventory and trade receivables; the difficulty of keeping expense growth at modest levels while increasing revenues and other risks described from time to time in the Company's filings with the Securities and Exchange Commission, including but not limited to the Annual Report on Form 10-K for the year ended November 30, 2004 and in "Factors That Could Affect Future Results" below.

Forward-looking statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described herein as anticipated, believed, estimated or expected.

The Company's condensed consolidated financial statements have been presented on the basis that it is a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company incurred net losses of \$209,475 and \$69,000 in the three-month periods ended February 28, 2005 and February 29, 2004, respectively. At February 28, 2005, the Company had limited cash reserves and was not in compliance with certain financial covenant ratios pertaining to its line of credit, and



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therefore is in technical default under the compliance provisions of the line of credit and term loan. This violation was cured in October 2005. Management has implemented a plan to reduce expenses and improve sales. The Company has altered its focus and will now be concentrating on securing proprietary products primarily for the medical and consumer industry. The objective is to create advanced designs, using current materials. These products will be pursued through aggressive product development and the licensing of existing patented products or technology. These new products are expected to have higher profit margins and be less subject to competition. There can be no assurances that the Company will be successful in completing these critical tasks. If the Company is unable to successfully complete these critical tasks, it may be forced to significantly reduce, restructure or cease its operations and/or liquidate inventory at amounts below current carrying value to generate the necessary working capital to fund its operations, and if necessary, seek other remedies available to the Company including protection under the bankruptcy laws. As a result of these and other factors, the Company's independent certified registered public accounting firm, Katherine Fang, LLP, indicated in their report on the 2004 consolidated financial statements, that there is substantial doubt about the Company's ability to continue as a going concern.

### RESULTS OF OPERATIONS

#### FY 05 CURRENT THREE MONTHS VERSUS FY 04

Net sales for the quarter ended February 28, 2005 were \$1,967,066 versus \$2,015,000 for the same period of fiscal 2004, a decrease of \$47,934 or 2%. Revenues from the Singapore strategic manufacturing venture declined to \$109,814 in the three-month period ended February 28, 2005 from \$192,000 in the comparable period in 2004. Revenues from U.S. operations increased to \$1,857,252 in the first quarter of 2005 from \$1,823,000 in 2004.

The increase in sales for U.S. operations is due to both increased sales prices and higher sales volumes. The Company has recently begun to shift its primary focus to generating its own proprietary opportunities with both its existing customer base as well as new prospects in order to build a more competitive base of business in the United States. Management does not expect significant sales from the new opportunities in the next 6 to 12 months. Sales will continue to increase in the interim period as the Company refocuses its efforts due to increased volumes from existing customers.

Cost of sales for the quarters ended February 28, 2005 and February 28, 2004 were \$1,620,452 and \$1,585,000, respectively. Cost of sales as a percentage of net sales was 82% for the first quarter of fiscal 2005, compared to 79% for the first quarter of fiscal 2004. The Company's gross profit percentage was 18% in 2005 period, compared to 21% in the 2004 period. The major reason of the increase on the cost of sales is lead by the increase on the raw materials. Increase on costs of sales leads to the lower gross profit. Another factor affect the cost of sales is the oil price increase which leads increase on the raw materials and freight.

Selling, general and administrative expenses for the first quarter of fiscal 2005 and 2004 were \$476,297 and \$397,000, respectively, an increase of \$79,297 or 20%. The increase is affected by the following factors: headquarter relocation, company financial system upgrade and the abnormal legal expenses associated with the IRAS tax issue discussed.

Interest expense for the first quarter of fiscal 2005 and 2004 was \$34,021 and \$23,000, respectively. Interest expense relates primarily to bank borrowings and is not expected to fluctuate significantly in the near future.

Net loss for the first quarter of fiscal 2005 was \$209,475, compared to a net loss of \$69,000 for the first quarter of fiscal 2004. Basic and diluted loss per

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share for the first quarter of fiscal 2005 was \$.02 per share, compared to a net loss of \$0.01 per share for the first quarter of fiscal 2004.

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### LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were \$153,989 at February 28, 2005, compared with \$55,289 at November 30, 2004. Operating activities provided \$132,178 of cash during the first quarter of fiscal 2005, compared with using \$33,000 in the corresponding period of fiscal 2004. The cash provided by operating activities in the first quarter of 2005 resulted primarily from a decrease in accounts receivable, and an increase in accounts payable and accrued liabilities, offset by an increase in inventory of \$164,852 and \$191,168 and \$95,729, respectively.

Capital expenditures were \$4,129 for the three months ended February 28, 2005, compared to \$1,000 for the corresponding period in fiscal 2004. The Company has instituted a Company-wide program to reduce non-essential capital expenditures that are not specifically focused on revenue growth.

The Company uses short- and long-term borrowings to supplement internally generated cash flow. Activity related to short- and long-term borrowings in the three-months ended February 28, 2005 resulted in cash used in financing activities of \$29,349.

### FACTORS THAT COULD AFFECT FUTURE RESULTS

**BANKING** - The Company has incurred losses from operations. The Company has incurred continued net losses. At February 28, 2005, the Company had limited cash reserves and was not in compliance with certain financial covenant ratios pertaining to its line of credit, and therefore is in technical default under the compliance provisions of the line of credit and term loan. This violation was cured in October 2005. The curing of this default along with the revised terms of the lending agreement result in reduced administrative and borrowing fees.

**COMPETITION** - The Company encounters aggressive competition in all areas of its business. It has numerous competitors, ranging from several comparable-size companies to many relatively small companies. The majority of the competitors are private, closely held companies. There is also the risk that a supplier to the Company could become a competitor. The Company competes primarily on the basis of performance, price, quality and customer service. Product life cycles are short, with numerous small one-time customer orders. To remain competitive, the Company must be able to quickly develop new products and enhance existing products in response to customer demands. In some of its markets, the Company may not be able to successfully compete against current and future competitors, and the competitive pressures faced could harm the Company's business and prospects.

**NEW PRODUCT INTRODUCTIONS** - If the Company cannot continue to rapidly develop and manufacture innovative products that meet customer requirements for performance, price, quality and customer service, it may lose market share and future revenue and earnings may suffer. The process of developing new products and corresponding manufacturing processes is complex and uncertain. The customer decision-making process can be lengthy and some raw materials have extremely long lead times. These circumstances often lead to long delays in new product introductions. After a product is developed, the Company must be able to manufacture sufficient volumes quickly at low enough costs. To do this it must accurately forecast volumes and mix of products. Customer orders have also been subject to dramatic swings from customer provided forecasts. Thus, matching customers' demand and timing for particular products makes the process of

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planning production and managing inventory levels increasingly difficult.

**SHORT PRODUCT LIFE CYCLES** - The short life cycles of many of the Company's products pose a challenge to the Company's ability to effectively manage the transition from existing products to new products. If the Company does not manage the transition effectively, future revenue and earnings could suffer. Among the factors that make a smooth transition from current products to new products difficult are delays in the customer decision-making process, development of manufacturing processes, long lead times for the delivery of raw materials and variations in product costs. The Company's future revenues and earnings could also suffer due to the timing and introduction of new product offerings that compete directly or indirectly with its customers' products and new product offerings by its competitors.

**RELIANCE ON SUPPLIERS** - The Company's manufacturing operations depend on its suppliers' ability to deliver quality raw materials and components in time for the Company to meet critical manufacturing and distribution schedules. The Company sometimes experiences a short supply of certain raw materials as a result of supplier out-of-stock situations or long manufacturing lead times. If shortages or delays exist, the Company's future operating results could suffer. Furthermore, it may not be able to secure enough raw materials at reasonable prices to manufacture new products in the quantities required to meet customer demand. Sudden or large raw materials price increases could also cause future operating results to suffer if the Company is not able to increase its sales prices to account for the materials price increases.

**EARTHQUAKE** - The corporate offices and manufacturing division in California are located near major earthquake faults. The ultimate impact on the Company and its general infrastructure is unknown, but operating results could be materially affected in the event of a major earthquake. The Company is predominantly uninsured for losses and interruptions caused by earthquakes.

**ENVIRONMENTAL** - Some of the Company's operations use substances regulated under various federal, state and international laws governing the environment. It is the Company's policy to apply strict standards for environmental protection to sites inside and outside the U.S., even when not subject to local government regulations. The Company has not been notified of any environmental infractions.

**PROFIT MARGIN** - The Company's profit margins vary somewhat among its products. Consequently, the overall profitability in any given period is partially dependent on the product and customer mix reflected in that period's net sales.

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**STOCK PRICE** - The Company's stock price, like that of any other small-cap company, can be volatile. Some of the factors that can affect the stock price are:

- o The Company's, its customer's or its competitor's announcement of new or discontinued products,
- o Quarterly increases or decreases in earnings,
- o Changes in revenue or earnings estimates by the investment community, and
- o Speculation in the press or investment community.

General market conditions and domestic or international macroeconomic factors unrelated to the Company's performance may also affect the stock price. For these reasons, investors should not rely on recent trends to predict future stock prices or financial results. In addition, following periods of volatility in a company's securities, securities class action litigation against a company is sometimes instituted. This type of litigation could result in substantial costs and the diversion of management time and resources.

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EARNINGS FLUCTUATIONS - Although management believes the Company has products and resources needed for successful results, it cannot reliably predict future revenue and margin trends. Actual trends may cause it to adjust its operations, which could cause period-to-period fluctuations in earnings.

### ITEM 3 - CONTROLS AND PROCEDURES

The Company's Chief Executive Officer (the Company's principal executive officer and principal financial officer), has evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the period ended February 28, 2005, the period covered by this Quarterly Report on Form 10-QSB. Based upon that evaluation, the Company's principal Chief Executive Officer has concluded that the disclosure controls and procedures were effective as of February 28, 2005 to provide reasonable assurance that material information relating to the Company is made known to the CEO.

There were no changes in the Company's internal control over financial reporting that occurred during the period ended February 28, 2005 that have materially affected, or are reasonable likely to materially affect, the Company's internal control over financial reporting.

### PART II - OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS.

NONE

#### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

NONE

#### ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

At February 28, 2005, the Company was not in compliance with certain financial covenant ratios pertaining to its line of credit, and therefore is in technical default under the compliance provisions of the line of credit and term loan. In September of 2005, the Company renegotiated the terms of these debt instruments, reducing the line of credit from \$3.75 million to \$1.5 million and extending the term of the term loan through October 1, 2006 with monthly principal payments of \$7,500 and the remainder due on October 1, 2006. Under the new agreement, the line of credit and term loan bear interest at Prime plus 1.5% and Prime plus 2.0%, respectively. As a result of the new agreement, the Company was able to cure its debt covenant violations.

#### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

NONE

#### ITEM 5. OTHER INFORMATION.

NONE

#### ITEM 6. EXHIBITS

(a) Exhibits.

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EXHIBIT NO.	DESCRIPTION
31.1	Certifications Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: July 18, 2006

ADVANCED MATERIALS GROUP, INC.

By: /s/ William G. Mortensen  
-----  
William G. Mortensen  
President and Chief Financial Officer

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