

PGMI, INC.  
Form 10QSB  
May 22, 2006

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

---

**FORM 10-QSB**

---

(Mark One)

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

**For the quarterly period ended March 31, 2006**

**OR**

**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 000-32195**

**PGMI, INC.**

(Exact name of Registrant as specified in its charter)

**Utah**

(State or other jurisdiction of  
incorporation or organization)

**87-0319410**

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

**5912 Bolsa Avenue, Suite 108, Huntington Beach, California**

(Address of principal executive offices)

**92649**

(Zip Code)

**(714) 895-7772**

(Registrant's telephone number, including area code)

**HAPS USA, INC.**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports); and (2) has been subject

Edgar Filing: PGMI, INC. - Form 10QSB

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 .

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| <b>Class</b>               | <b>Number of Shares Outstanding</b>               |
|----------------------------|---|
| Common Stock, no par value | 20,600,646 shares of common stock as May 22, 2006 |

Transitional Small Business Disclosure Format (Check one):

Yes  No .

---

PGMI, INC.

TABLE OF CONTENTS

**PART I - FINANCIAL INFORMATION**

|                |  |
|----------------|--|
| <u>Item 1.</u> | <u>Financial Statements:</u><br><u>Consolidated Balance Sheet at March 31, 2006 (unaudited)</u><br><br><u>Consolidated Statements of Operations and Comprehensive Income (Loss) for the three and nine months ended March 31, 2006 and 2005 (unaudited)</u><br><br><u>Consolidated Statements of Cash Flows for the nine months ended March 31, 2006 and 2005 (unaudited)</u><br><br><u>Notes to Consolidated Financial Statements</u> |
| <u>Item 2.</u> | <u>Management's Discussion and Analysis or Plan of Operations</u>  |
| <u>Item 3.</u> | <u>Controls and Procedures</u>   |

**PART II - OTHER INFORMATION**

|                |   |
|----------------|---|
| <u>Item 1.</u> | <u>Legal Proceedings</u>  |
| <u>Item 2.</u> | <u>Changes in Securities and Small Business Issuer Purchases of Equity Securities</u> |
| <u>Item 3.</u> | <u>Defaults Upon Senior Securities</u>  |
| <u>Item 4.</u> | <u>Submission of Matters to a Vote of Security Holders</u>                            |
| <u>Item 5.</u> | <u>Other Information</u>  |
| <u>Item 6.</u> | <u>Exhibits</u>   |

**SIGNATURES**

*The terms we, us, our, the Company, and PGMI, as used in this Report on Form 10-QSB refers to PGMI, Inc., a Utah Corporation, and its wholly-owned subsidiary, Marugin International, Inc., a corporation formed under the laws of Japan.*

**PART I - FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**PGMI, INC. AND SUBSIDIARIES**

**(FORMERLY HAPS USA, INC.)**

**Index to Consolidated Financial Statements:**

Consolidated Balance Sheet as of March 31, 2006 (Unaudited)

Consolidated Statements of Operations and Comprehensive Income (Loss) for the three and nine months ended March 31, 2006 and 2005 (Unaudited)

Consolidated Statement of Shareholders' Equity for the nine months ended March 31, 2006 (Unaudited)

Consolidated Statements of Cash Flows for the nine months ended March 31, 2006 and 2005 (Unaudited)

Notes to Consolidated Financial Statements (Unaudited)

**PGMI, INC. AND SUBSIDIARIES****(FORMERLY HAPS USA, INC.)****CONSOLIDATED BALANCE SHEET**

|  | <b>March 31, 2006</b> |
|--|-----------------------|
|  | <b>(Unaudited)</b>    |
| <b>ASSETS (Note 5)</b>   |                       |
| Current assets:  |                       |
| Cash   | \$ 12,138,789         |
| Time deposits  | 1,719,836             |
| Inventories  | 634,229               |
| Cash surrender value of life insurance   | 618,046               |
| Deferred income taxes  | 130,751               |
| Prepaid expenses and other (Note 4)  | 567,232               |
| Total current assets   | 15,808,883            |
| Property and equipment, net (Note 3)   | 40,074,817            |
| Deferred income taxes  | 1,472,625             |
| Deposits and other assets (Note 4)   | 2,754,425             |
| Total assets   | \$ 60,110,750         |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                       |
| Current liabilities:   |                       |
| Accounts payable   | \$ 1,567,548          |
| Accrued liabilities (Note 4)   | 636,140               |
| Current portion of long-term debt (Note 5)   | 7,761,935             |
| Current portion of capital lease obligations   | 1,703,512             |
| Current portion of loan payable to shareholders  | 91,845                |
| Total current liabilities  | 11,760,980            |
| Long-term debt, net of current portion (Note 5)  | 35,168,203            |
| Capital lease obligations, net of current portion  | 3,551,152             |
| Non-current accrued liabilities (Note 4)   | 1,575,465             |
| Loan payable to shareholders, net of current portion   | 596,990               |
| Total liabilities  | 52,652,790            |
| Commitments and contingencies (Note 6)   |                       |
| Shareholders' Equity (Note 7):   |                       |
| Preferred stock, no par value, 150,000,000 shares authorized:  |                       |
| Class A convertible preferred stock, 6,000,000 shares designated, 5,040,053 shares issued and outstanding    | 2,333,683             |
| Class B convertible preferred stock, 5,000,000 shares designated, no shares issued and outstanding           |                       |
| Class C convertible preferred stock, 1,200,000 shares designated, no shares issued and outstanding           |                       |
| Class E convertible preferred stock, 116,595,760 shares designated, 97,059,998 shares issued and outstanding | 2,115,915             |
| Common stock, no par value, 750,000,000 shares authorized, 20,560,646 shares issued and outstanding          | 105,892               |
| Restricted retained earnings   | 106,966               |
| Unrestricted retained earnings   | 2,658,794             |
| Accumulated other comprehensive income   | 136,710               |
| Total shareholders' equity   | 7,457,960             |
| Total liabilities and shareholders' equity   | \$ 60,110,750         |

See accompanying notes to these consolidated financial statements



## PGMI, INC. AND SUBSIDIARIES

(FORMERLY HAPS USA, INC.)

## CONSOLIDATED STATEMENTS OF OPERATIONS AND

## COMPREHENSIVE INCOME (LOSS)

|   | For the Three Months Ended |                | For the Nine Months Ended |                |
|---|----------------------------|----------------|---------------------------|----------------|
|   | March 31, 2006             | March 31, 2005 | March 31, 2006            | March 31, 2005 |
|   | (unaudited)                | (unaudited)    | (unaudited)               | (unaudited)    |
| <b>REVENUES:</b>  |                            |                |                           |                |
| Gaming (Note 8)   | \$ 6,536,236               | \$ 6,548,366   | \$ 17,337,892             | \$ 15,959,243  |
| Food, beverage and other                                      | 483,450                    | 326,714        | 1,320,141                 | 1,250,500      |
| Total revenues  | 7,019,686                  | 6,875,080      | 18,658,033                | 17,209,743     |
| <b>COST OF REVENUES:</b>                                      |                            |                |                           |                |
| Salaries and wages  | 1,057,961                  | 1,129,803      | 3,481,814                 | 3,578,319      |
| Depreciation  | 2,721,808                  | 2,967,045      | 6,428,673                 | 6,176,661      |
| Facilities and other  | 1,297,080                  | 1,595,183      | 3,855,530                 | 4,539,174      |
| Impairments (Note 3)  | 410,932                    | 757,730        | 1,271,413                 | 1,560,011      |
| Total cost of revenues  | 5,487,781                  | 6,449,761      | 15,037,430                | 15,854,165     |
| Gross profit  | 1,531,905                  | 425,319        | 3,620,603                 | 1,355,578      |
| <b>OPERATING EXPENSES:</b>                                    |                            |                |                           |                |
| Marketing and advertising                                     | 210,093                    | 346,647        | 704,988                   | 818,327        |
| General and administrative                                    | 942,715                    | 1,180,973      | 2,317,378                 | 2,462,708      |
| Total operating expenses                                      | 1,152,808                  | 1,527,620      | 3,022,366                 | 3,281,035      |
| Operating income (loss)                                       | 379,097                    | (1,102,301)    | 598,237                   | (1,925,457)    |
| <b>OTHER INCOME (EXPENSE):</b>                                |                            |                |                           |                |
| Reverse acquisition fees                                      |                            |                | (2,333,683)               |                |
| Interest income   | 23                         | 56             | 461                       | 1,790          |
| Interest expense  | (525,298)                  | (489,153)      | (1,379,729)               | (1,257,903)    |
| Other income  | 544,541                    | 376,645        | 766,923                   | 967,984        |
| Other expense   |                            | (527)          | (114)                     | (4,904)        |
| Total other income (expense), net                             | 19,266                     | (112,979)      | (2,946,142)               | (293,033)      |
| Income (loss) before provision (benefit) for income taxes     | 398,363                    | (1,215,280)    | (2,347,905)               | (2,218,490)    |
| Provision (benefit) for income taxes (Note 9)                 | 236,505                    | (339,850)      | 183,966                   | (729,316)      |
| <b>NET INCOME (LOSS)</b>                                      | \$ 161,858                 | \$ (875,430)   | \$ (2,531,871)            | \$ (1,489,174) |
| Change in foreign currency translation                        | (28,967)                   | (399,035)      | (532,281)                 | 92,155         |
| <b>COMPREHENSIVE INCOME (LOSS)</b>                            | \$ 132,891                 | \$ (1,274,465) | \$ (3,064,152)            | \$ (1,397,019) |
| Basic income (loss) per common share (Note 2)                 | \$ 0.01                    | \$ N/A         | \$ (0.31)                 | \$ N/A         |
| Basic income (loss) per common share (Note 2)                 | \$ 0.00                    | \$ N/A         | \$ (0.31)                 | \$ N/A         |
| Weighted average number of equivalent common shares (Note 2): |                            |                |                           |                |
| Basic   | 20,338,324                 | N/A            | 8,287,058                 | N/A            |



Edgar Filing: PGMI, INC. - Form 10QSB

|          |             |     |           |     |
|----------|-------------|-----|-----------|-----|
| Dilutive | 530,838,579 | N/A | 8,287,058 | N/A |
|----------|-------------|-----|-----------|-----|

See accompanying notes to these consolidated financial statements

## PGMI, INC. AND SUBSIDIARIES

(FORMERLY HAPS USA, INC.)

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY  
(Unaudited)

| (Note 7)  | Class A Convertible Preferred Stock |              | Class E Convertible Preferred Stock |              | Common Stock |            | Restricted Retained Earnings | Unrestricted Retained Earnings | Accumulated Other Comprehensive Income | Totals       |
|---|-------------------------------------|--------------|-------------------------------------|--------------|--------------|------------|------------------------------|--------------------------------|--|--------------|
|   | Shares                              | Amount       | Shares                              | Amount       | Shares       | Amount     |                              |                                |  |              |
| Beginning balances,   |                                     |              |                                     |              |              |            |                              |                                |  |              |
| Class E Preferred shares issued to PGMI, Inc. shareholders in reverse acquisition |                                     | \$           | 97,059,998                          | \$ 2,115,915 |              | \$         | \$ 106,966                   | \$ 5,296,557                   | \$ 668,991                             | \$ 8,188,429 |
| Shares retained by existing shareholders after reverse acquisition, as restated   | 3,153,923                           |              |                                     |              | 18,848,746   |            |                              | (105,892)                      |  | (105,892)    |
| Class A Preferred shares issued for reverse acquisition transaction fee           | 2,121,530                           | 2,333,683    |                                     |              |              |            |                              |                                |  | 2,333,683    |
| Conversion of Class A Preferred shares into common stock                          | (235,400)                           |              |                                     |              | 1,177,000    |            |                              |                                |  |              |
| Foreign currency translation  |                                     |              |                                     |              |              |            |                              |                                | (532,281)                              | (532,281)    |
| Common stock issued for settlements of accounts payable                           |                                     |              |                                     |              | 534,900      | 105,892    |                              |                                |  | 105,892      |
| Net loss  |                                     |              |                                     |              |              |            |                              | (2,531,871)                    |  | (2,513,871)  |
| Balances March 31, 2006   | 5,040,053                           | \$ 2,333,683 | 97,059,998                          | \$ 2,115,915 | 20,560,646   | \$ 105,892 | \$ 106,966                   | \$ 2,658,794                   | \$ 136,710                             | \$ 7,457,960 |

See accompanying notes to these consolidated financial statements

**PGMI, INC. AND SUBSIDIARIES**

(FORMERLY HAPS USA, INC.)

## CONSOLIDATED FINANCIAL STATEMENTS OF CASH FLOWS

|   | For the Nine Months<br>Ended<br>March 31, 2006<br>(Unaudited) | For the Nine Months<br>Ended<br>March 31, 2005<br>(Unaudited) |
|---|---|---|
| <b>Cash flows from operating activities:</b>                                    |   |   |
| Net loss  | \$ (2,531,871)  | \$ (1,489,174)  |
| Adjustments to reconcile net loss to net cash provided by operating activities: |   |   |
| Depreciation, amortization and accretion expense                                | 6,798,853   | 6,497,920   |
| Impairment of property and equipment  | 1,271,413   | 1,560,011   |
| Gain on interest swap contracts   | (629,377)   | (292,392)   |
| Merger related expenses   | 2,333,683   |   |
| Changes in operating assets and liabilities:                                    |   |   |
| Inventories   | (80,789)  | (293,151)   |
| Deferred income taxes   | 182,475   | (730,825)   |
| Prepaid expenses and other  | 257,730   | 95,493  |
| Accounts payable  | (396,855)   | (2,473,222)   |
| Accrued liabilities   | (336,410)   | 329,458   |
| Net cash provided by operating activities                                       | 6,868,852   | 3,204,118   |
| <b>Cash flows from investing activities:</b>                                    |   |   |
| Capital expenditures  | (5,611,582)   | (7,072,266)   |
| Time deposits and restricted cash   | (979,868)   | 5,688,827   |
| Other assets  | (592,283)   | (568,322)   |
| Net cash used in investing activities   | (7,183,733)   | (1,951,761)   |
| <b>Cash flows from financing activities:</b>                                    |   |   |
| Payments on capital lease obligations   | (1,511,582)   | (331,256)   |
| Borrowings of long-term debt  | 12,136,985  | 9,673,669   |
| Payments on long-term debt  | (5,685,941)   | (9,231,650)   |
| Payments on loan payable to shareholders  | (23,460)  | (75,892)  |
| Net cash provided by financing activities                                       | 4,916,002   | 34,871  |
| Foreign currency effect on cash   | (419,327)   | (59,960)  |
| <b>Net increase in cash</b>   | <b>4,181,794</b>  | <b>1,227,268</b>  |
| Cash, beginning of period   | 7,956,995   | 6,163,096   |
| Cash, end of period   | \$ 12,138,789   | \$ 7,390,364  |
| <b>Non-cash investing and financing transactions:</b>                           |   |   |
| Purchases of equipment under capital leases                                     | \$ 201,668  | \$ 4,611,646  |
| Increase in property and equipment from asset retirement obligations            |   | 801,893   |
| Accounts payable settled in Common Stock  | \$ 105,892  |   |
| <b>Cash paid for :</b>  |   |   |
| Interest  | \$ 1,274,235  | \$ 1,654,570  |
| Income taxes  |   |   |

See accompanying notes to these consolidated financial statements

**PGMI, INC. AND SUBSIDIARIES**

Edgar Filing: PGMI, INC. - Form 10QSB

(FORMERLY HAPS USA, INC.)

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 - ORGANIZATION AND BUSINESS**

*Organization*

PGMI, Inc., formerly HAPS USA, Inc. ( PGMI or the Company ), on December 9, 2005, pursuant to an Agreement and Plan of Reorganization dated October 27, 2005 (the Agreement ) by and among HAPS USA, Inc. ( HAPS ) and PGMI, Inc. acquired all of the issued and outstanding shares of PGMI in exchange for an aggregate of 97,059,998 shares of HAPS Class E Preferred Stock. Each share of Class E preferred stock is convertible into five shares of HAPS common stock, commencing on the date which is three years from the date of their original issuance (or December 9, 2008). As a result of this transaction, PGMI is a wholly-owned subsidiary, and the PGMI stockholders own approximately 91.5% of HAPS voting stock, on a fully-diluted basis. At the time of acquisition, HAPS had no revenues and no assets or liabilities. It was considered a blank-check company prior to the acquisition. The acquisition of PGMI by HAPS will be accounted for as a reverse acquisition, whereby the assets and liabilities of PGMI are reported at their historical cost. The effects of shareholders equity are reported as a recapitalization. No goodwill was recorded in connection with the reverse acquisition. The reverse acquisition resulted in a change in reporting entity of PGMI for accounting and reporting purposes. In March 2006 the Company changed its name from HAPS USA, Inc. to PGMI, Inc.

The unaudited pro forma balance sheet data is not significant because of the lack of operating assets and liabilities of HAPS. The pro forma results of operations, assuming the acquisition was completed at the beginning of the reporting period, would have caused our net losses to increase, but not materially, because of the limited operating losses reported by HAPS.

*Business*

The Company operates thirteen (13) stores and 4,796 pachinko machines as of March 31, 2006, which offer pachinko (Japanese pinball) gaming entertainment. All stores, except two, are located in the Nagano prefecture. In July 2004 and March 2005, the Company opened its two largest stores with 560 machines each. In July 2005, the Company closed its smallest store which operated 138 machines. The closing did not have a significant impact on the Company's financial statements. In addition, the Company receives income from cigarettes, non-alcoholic beverages and sundry items, as well as one small batting cage and a bowling alley. Japanese law regulates Pachinko gaming and the local police enforce laws. Pachinko gaming is one of the largest business segments in Japan.

**NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Financial Statement Preparation*

The accompanying unaudited consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities Exchange Commission ( SEC ) regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America. Refer to the Company's audited consolidated financial statements for the year ended June 30, 2005 included on form 8-K filed with the SEC on December 9, 2005 for additional information.

The unaudited consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, which are, in the opinion of management, necessary for a fair presentation of results for the interim periods presented. Preparing financial statements requires management to make estimates and assumptions that affect the amounts that are reported in the consolidated financial statements and accompanying disclosures. Although these estimates are based on management's best knowledge of current events and actions that the Company may undertake in the future, actual results may be different from these estimates. The results of operations for the three and nine months ended March 31, 2006, are not necessarily indicative of the results to be expected for any future period or the full fiscal year.

*Going Concern Considerations*

The Company has incurred losses during the nine months ended March 31, 2006 and 2005. The Company has significant amounts of debt and has a high debt to equity ratio. These factors raise substantial doubt about the Company's ability to continue as a going concern. Management has refinanced certain of its debts to reduce amounts due within 12 months. As a result, as of March 31, 2006, the Company has a working capital totaling \$4,047,903 versus a working capital deficit as of December 31, 2005 of \$733,857. Furthermore, management has reduced operating expenses in an effort to restore profitability. As a result, the Company generated net income of \$161,858 during the three months ended March 31, 2006. Management plans to continue to monitor its operating expenses, as it opens new stores in fiscal 2007. Management believes the Company will continue its growth and generate positive cash flows from operations to fund its daily operations and service its debt obligations. There are no assurances that we will be successful in our plans. No adjustments have been made to the carrying value of assets or liabilities as a result of the uncertainty about obtaining cash required to pay obligations as they come due.

*Per Share Information*

The Company presents basic earnings per share (EPS) and diluted EPS on the face of all statements of operations. Basic EPS is computed as net loss divided by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur from common shares issue able through stock options, warrants, and other convertible securities that are exercisable during or after the reporting period. In the event of a net loss, such incremental shares are not included in EPS since their effects are anti-dilutive.

The following table sets forth the computation of diluted weighted average shares outstanding for the three months ended March 31, 2006:

|  |             |
|--|-------------|
| Weighted average shares of common stock outstanding - basic    | 20,338,324  |
| Effect of convertible preferred stock:                         |             |
| Class A  | 25,200,265  |
| Class E  | 485,299,990 |
| Weighted average shares of common stock outstanding - dilutive | 530,838,579 |

The computation of diluted earnings per share for the three months ended March 31, 2006, includes the effects of Class A and Class E convertible preferred stock. Such amounts were not included in the computation of basic earnings per share since the Class A and Class E convertible preferred stock do not participate in the earnings, dividends or undistributed earnings of the Company. There were no adjustments required to net income for the three months ended March 31, 2006 for the computation of dilutive earnings per share.

The following is a table of common stock equivalents for the three months ended March 31, 2005, and the nine months ended March 31, 2006 and 2005, that were not considered in the calculation of diluted net loss per share as the effects would have been anti-dilutive.

|  | For the Three Months<br>March 31,<br>2005 | For the Nine Months Ended<br>March 31,<br>2006 | March 31,<br>2005 |
|--|---|--|-------------------|
| Effects of class A convertible preferred |   | 25,200,265                                     |                   |
| Effects of class E convertible preferred | 485,299,990                               | 485,299,990                                    | 485,299,990       |



Edgar Filing: PGMI, INC. - Form 10QSB

|  |             |             |             |
|--|-------------|-------------|-------------|
| Shares not used in the calculation of diluted<br>EPS | 485,299,990 | 510,500,255 | 485,299,990 |
|--|-------------|-------------|-------------|

**NOTE 3 - PROPERTY AND EQUIPMENT**

At March 31, 2006, property and equipment consisted of the following:

|  |    |              |
|--|----|--------------|
| Land                                     | \$ | 14,217,612   |
| Buildings and improvements               |    | 25,311,336   |
| Leasehold improvements                   |    | 14,417,687   |
| Pachinko machines and computer equipment |    | 23,702,168   |
| Construction in progress                 |    | 1,451,161    |
|  |    | 79,099,964   |
| Less accumulated depreciation            |    | (39,025,147) |
|  | \$ | 40,074,817   |

*Machine Impairments*

During the nine months ended March 31, 2006 and 2005, the Company impaired and retired pachinko and pachislot machines prior to the end of their useful lives resulting in losses of \$1,271,413 and \$1,560,011, respectively. During the three months ended March 31, 2006 and 2005, the Company impaired and retired pachinko and pachislot machines prior to the end of their useful lives resulting in losses of \$410,932 and \$757,730, respectively.

*Depreciation*

Depreciation expense charged to operations related to property and equipment during the nine months ended March 31, 2006 and 2005 was \$6,522,391 and \$6,333,646, respectively. Depreciation expense charged to operations related to property and equipment during the three months ended March 31, 2006 and 2005 was \$2,754,037 and \$3,022,201, respectively.

*Construction in Progress*

During the nine months ended March 31, 2006, the Company entered into various contracts to build three (3) new stores which are planned to be open during the first and second quarters of fiscal year ending June 30, 2007. During the nine months ended March 31, 2006, the Company incurred costs of \$1,451,161 with respect to such planned new stores.

**NOTE 4 CERTAIN BALANCE SHEET ITEMS***Assets*

Edgar Filing: PGMI, INC. - Form 10QSB

At March 31, 2006, prepaid expenses and other consisted of the following:

|                            |    |         |
|----------------------------|----|---------|
| Prepaid interest - current | \$ | 375,486 |
| Prepaid rent               |    | 102,554 |
| Advance to employees       |    | 45,242  |
| Professional fees          |    | 20,000  |
| Prepaid income taxes       |    | 14,155  |
| Other                      |    | 9,7955  |
|                            | \$ | 567,232 |

At March 31, 2006, deposits and other assets consisted of the following:

|                                |    |           |
|--------------------------------|----|-----------|
| Deposits                       | \$ | 1,033,344 |
| Unamortized interest swap cost |    | 638,787   |
| Debt issue costs               |    | 695,433   |
| Long-term saving accounts      |    | 218,105   |
| Prepaid interest non-current   |    | 134,171   |
| Other                          |    | 34,585    |
|                                | \$ | 2,754,425 |

*Accrued Liabilities*

At March 31, 2006, accrued liabilities consisted of the following:

|                               |    |         |
|-------------------------------|----|---------|
| Sales tax payable             | \$ | 359,367 |
| Salaries and related benefits |    | 144,460 |
| Deferred revenue              |    | 92,261  |
| Professional fees             |    | 30,000  |
| Other                         |    | 10,052  |
|                               | \$ | 636,140 |

At March 31, 2006, non-current accrued liabilities consisted of the following:

|                              |    |           |
|------------------------------|----|-----------|
| Asset retirement obligations | \$ | 1,189,089 |
| Interest swap liabilities    |    | 198,520   |
| Benefit plan obligation      |    | 187,856   |
|                              | \$ | 1,575,465 |

During the nine months ended March 31, 2006, the Company's interest swap liabilities decreased by \$667,635.

During the three months ended March 31, 2006, the Company's interest swap liabilities decreased by \$495,848. Those decreases were because of favorable changes in the three-month TIBOR (Tokyo Interbank Offer Rate), and the related gain is included in other income in the accompanying consolidated statement of operations.

**NOTE 5 - LONG-TERM DEBT***Long-Term Debt*

Long-term debt at March 31, 2006, consisted of the following:

|  |    |           |
|--|----|-----------|
| Loans payable to commercial bank, payable monthly in principal and interest installments ranging from \$7,074 to \$42,412, interest at 2.875%-3.125% per annum, due 2006 through 2014, secured by land and buildings, guaranteed by officers | \$ | 3,442,223 |
|--|----|-----------|

Edgar Filing: PGMI, INC. - Form 10QSB

|  |               |
|--|---------------|
| Loans payable to commercial bank, payable monthly in principal and interest installments ranging from \$3,037 to \$70,744, interest at 2.30%-3.05% per annum, due 2006 through 2012, secured by land and buildings, guaranteed by officers.  | 5,782,099     |
| Loans payable to lease company, payable monthly in principal and interest installments of \$25,447 and \$45,116, interest at 2.47% and 3.6% per annum, due 2006 through 2012, secured by building, guaranteed by officers.   | 3,664,852     |
| Notes payable to commercial bank, lump sum due in February 2007, interest only at 2.5% per annum, secured by land and buildings, guaranteed by officers.   | 9,745,727     |
| Bond payable to commercial bank, payable semiannually in principal of \$424,124, coupon interest at 0.9% per annum, due 2006 through 2011, with a lump-sum payment of \$848,248 in March 2011, unsecured. See interest swap agreements discussed below.                            | 4,677,268     |
| Bond payable to commercial bank, payable semiannually in principal of \$480,770, coupon interest at 1.54% per annum, due 2006 through 2013, with a lump-sum payment of \$637,000 in March 2013, unsecured. See interest swap agreements discussed below.                           | 6,378,093     |
| Bond payable to commercial bank, payable semiannually in principal of \$318,093, coupon interest at 0.21% per annum at first interest payment and TIBOR + 0.1% at thereafter, guarantee fee at 1.1%, due 2006 through 2012, with a lump-sum payment of \$106,031 in December 2012. | 4,252,062     |
| Loans payable to commercial bank, payable monthly in principal and interest installments from \$4,241 to \$28,247, interest at 2.75% and 3.75% per annum, due 2006 through 2012, unsecured, guaranteed by officers.  | 2,776,427     |
| Loan payable to commercial bank, payable monthly in principal and interest installments of \$4,920, interest at 4.5% per annum, due 2006 through 2008, unsecured, guaranteed by officers.  | 125,011       |
| Loans payable to commercial bank, payable monthly in principal and interest installment of \$28,272, interest at 3.5% per annum, due 2006 through 2010, unsecured, guaranteed by officers.   | 1,389,038     |
| Loans payable to commercial bank, monthly in principal and interest installment of \$25,447, interest at 2.425% per annum, due 2006 through 2007, unsecured, guaranteed by officers.   | 527,256       |
| Loans payable to commercial bank, payable monthly in principal and interest installment of \$42,521 interest at 2.625% per annum, due July 2006, unsecured.  | 170,082       |
| Total long-term debt   | 42,930,138    |
| Less current portion of long-term debt   | (7,761,935)   |
| Long-term debt, net of current portion   | \$ 35,168,203 |

*Bonds Payable*

In December 2005, the Company entered into an additional bond agreement with a commercial bank totaling approximately \$4,300,000. The bond bears variable interest at approximately TIBOR plus 0.1% and a guarantee fee at 1.1% per annum and is due in seven (7) years. The Company incurred bond commission fees of \$239,376, which are amortized over the term of the debt using the effective interest method.

The Company's obligations are collateralized by substantially all of the Company's assets. As a common practice in Japan, the Company's collateral is not allocated to each commercial bank loan. Rather, the commercial banks hold an interest in substantially all of the Company's assets together; there are no first or second position. Upon default of the loans, the Company's assets would be liquidated and the proceeds from the liquidation would be distributed to the commercial banks based on liquidation preference.

In March 2006, the Company entered into a bond agreement with a commercial bank totaling approximately \$6,800,000. The bond bears fixed interest at 1.54% and is due in seven (7) years with no collateral. The Company incurred a bond commission fee of \$306,000, which is amortized over the term of the debt using the effective interest method.

**NOTE 6 - COMMITMENTS AND CONTINGENCIES**

*Leasehold Rights*

In December 2005, the Company entered into a leasehold right agreement for a new store in Gyoda, Saitama, Japan. In connection therewith, the initial cost of the leasehold right was approximately \$1,300,000, of which the Company has paid \$600,000 as of March 31, 2006. The balance was paid in April 2006. The lease commences April 2006 and expires 30 years from such date. The Company is required to pay approximately \$6,000 per month during the term of the lease. The initial cost of the lease will be amortized over the term of the lease.

*Investment Banking Agreements*

On January 26, 2005, management entered into two agreements for services related to seeking a reverse merger partner. The investment bankers received \$15,000, and a 1.5% stock transaction fee or 2,121,530 shares of Class A preferred stock upon the close of a reverse acquisition transaction on December 9, 2005, valued at \$2,333,683.

The Company entered into a 12-month agreement with its investment banker to raise equity capital on a best efforts basis. Pursuant to the agreement the Company is required to pay a fee of 7% on gross proceeds raised from equity financings and 1.75% on gross proceeds raised from debt financings, however convertible debt shall be deemed equity. In addition, in connection with any equity financing, the Company is obligated to issue a 5-year warrant to purchase a number of equity securities equal to 4% of the equity securities sold in the financing. The exercise price of the warrant shall be equal to the purchase price in the offering. The warrants shall be exercisable on a cashless basis and shall have demand registration rights.

*Consulting Agreements*

On January, 1, 2006, management entered into two (2) consulting agreements to receive investor relations and communications services for a period of six (6) months at an aggregate cost of \$6,000 per month.

*Directors Agreement*

On January, 1, 2006, management entered into a director agreement for a period of one year, renewable annually by mutual consent if the director is re-elected. In connection therewith, the Company will pay the

director a retainer of \$1,500 per month plus \$500 per meeting attended and reimbursement of out of pocket expenses.

#### **NOTE 7 - SHAREHOLDERS EQUITY**

##### *Common Stock*

The Company issued 534,900 shares of common stock to settle \$105,892 of account payable from December 9 to December 31, 2005.

##### *Convertible Preferred Stock Outstanding*

In connection with the reverse acquisition of HAPS, PGMI shareholders received 97,059,998 shares of Class E convertible preferred stock. Since PGMI experienced a change in reporting entity, such shares have been retroactively reflected as outstanding for the periods presented. Each share is convertible into five (5) shares of common stock or a total of 485,299,940 shares. The holders of the Class E preferred stock are not entitled to receive dividends.

In connection with the reverse acquisition, the Company issued 2,121,530 shares of Class A preferred stock for fees to its investment banker in representation of the transaction. Each share of Class A preferred stock is convertible into five (5) shares of common stock. The holders of the Class A preferred stock are not entitled to receive dividends. Management determined the fair value of the underlying common stock to be \$0.22 per share or \$2,333,683 based on the average of the closing price of the common stock 15 days before and after the announcement of the transaction.

In connection with the reverse acquisition on December 9, 2005, the shareholders of HAPS retained 3,153,923 shares of Class A preferred stock and 18,848,746 shares of common stock. The amounts previously reported were corrected. As discussed above, each share of Class A preferred is convertible into five (5) shares of common stock. These shares of Class A preferred stock and common stock are reflected as issued on December 9, 2005, as a result of the change in reporting entity.

##### *Restricted Retained Earnings*

As required under Japanese laws, the Company must accumulate 10% of dividends paid until restricted retained earnings amounts to 25% of common stock. As of March 31, 2006, the Company was in satisfaction of this requirement.

#### **NOTE 8 - GAMING OPERATIONS**



## Edgar Filing: PGMI, INC. - Form 10QSB

The Company derives revenue primarily from the operation of pachinko and pachislot games. The Company is subject to annual licensing requirements established by the Prefectural Public Safety Commission. The Company must renew this license yearly to operate. The Company pays sales taxes of 5% of net revenues.

A summary of gross wagers, less winning patron payouts, for the three months ended March 31, 2006 and 2005, are as follows:

|                 | <b>2006</b>   |    | <b>2005</b>  |
|-----------------|---------------|----|--------------|
| Gross Wagers    | \$ 47,743,167 | \$ | 47,342,860   |
| Patron Payouts  | (41,206,931)  |    | (40,794,494) |
| Gaming Revenues | \$ 6,536,236  | \$ | 6,548,366    |

A summary of gross wagers, less winning patron payouts, for the nine months ended March 31, 2006 and 2005, are as follows:

|                 | <b>2006</b>    | <b>2005</b>    |
|-----------------|----------------|----------------|
| Gross Wagers    | \$ 141,594,665 | \$ 135,936,100 |
| Patron Payouts  | (124,256,773)  | (119,976,857)  |
| Gaming Revenues | \$ 17,337,892  | \$ 15,959,243  |

#### **NOTE 9 INCOME TAXES**

The Company provides income taxes in Japan using an estimated effective rate of about 40%, which are reflected in the accompanying statement of operations. Income tax expenses in the United States of America were not material. Management increased its valuation allowance during the three and nine months ended March 31, 2006, for certain expenses paid in the United States that will not be deductible in Japan. At the present time, management cannot determine if there will be income in the United States to offset such expenses, which will be carried forward as net operating losses.

#### **NOTE 10 SUBSEQUENT EVENTS**

##### *Construction Planning for New Stores*

As discussed in Note 3, the Company entered into various contracts to build three new stores during and subsequent to the nine months ended March 31, 2006. The planned opening of the Bando store is October 2006. The estimated cost of the Bando building and land is \$5,600,000. The planned opening of the Gyoda store is December 2006. The estimated cost of the Gyoda building is \$6,500,000. The planned opening of the Toyota store is January 2007. The estimated cost of the Toyota building is \$5,100,000.

**ITEM 2.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS**

*This Form 10-QSB contains forward-looking statements based on our current expectations. In some cases, you can identify these statements by terminology such as may, should, plans, believe, will, anticipate, estimate, expect, or intend, including their opposites or similar expressions. You should be aware that these statements are projections or estimates as to future events and are subject to a number of factors that may tend to influence the accuracy of the statements. These forward-looking statements should not be regarded as a representation by the Company or any other person that the events or plans of the Company will be achieved. Actual results may differ materially from these forward looking statements.*

*To gain a better understanding of the risk factors that may tend to influence the accuracy of our forward looking statements, we recommend that you read the risk factors identified in the Company's Form 8-K filed with the Securities and Exchange Commission on December 9, 2005. Although we believe that the risks described in the Form 8-K represent all material risks currently applicable to us, additional risks and uncertainties not presently known to us or that are currently not believed to be important to us may also affect our actual future results and could harm our business, financial condition and results of operations.*

**Overview**

Through our subsidiaries, we own and operate 13 pachinko stores as of March 31, 2006, which is our primary operating business. We opened our 13th store in July 2004 and 14th store in March 2005; both of the new stores are our largest with 560 machines each. We closed one unprofitable store in July 2005 which operated 138 machines. We plan to close additional older stores in the next 24 months, as well as open new stores. We plan to open our next new store in September 2006, with approximately 800 machines. We operate a total of 4,796 Pachinko and Pachislo machines as of March 31, 2006. We plan to leverage our expertise and capitalize on new development opportunities to expand our operations in Japan.

**Reverse Acquisition**

On December 9, 2005, pursuant to an agreement dated October 27, 2005 by and among HAPS USA, Inc. ( HAPS ), PGMI, Inc. ( PGMI ) a Delaware corporation and all of the stockholders of PGMI, HAPS acquired all of the issued and outstanding shares of PGMI in exchange for an aggregate of 97,059,998 shares of HAPS Class E Preferred Stock. Each share of Class E preferred stock is convertible into five shares of HAPS common stock, commencing on the date which is three years from the date of their original issuance (or December 9, 2008). As a result of this transaction, PGMI is a wholly-owned subsidiary, and the PGMI stockholders own approximately 91.5% of HAPS' voting stock, on a fully-diluted basis. In addition, each share of Class E Preferred Stock is entitled to five (5) votes. No dividends shall accrue under the Class E preferred stock. In March 2006 we changed our name from HAPS USA, Inc. to PGMI, Inc.

**Results of Operations**

**Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2005***Revenues and Cost of Revenues**Revenues*

A summary of the gaming revenues for the three months ended March 31, 2006 and 2005 are as follows:

|                         | 2006          |            | 2005          |            |
|-------------------------|---------------|------------|---------------|------------|
|                         | Amount        | Percentage | Amount        | Percentage |
| Patron wagers (pay-ins) | \$ 47,743,167 | 100.0%     | \$ 47,342,860 | 100.0%     |
| Patron payouts          | (41,206,931)  | (86.3)     | (40,794,494)  | (86.2)     |
| Gaming revenues         | \$ 6,536,236  | 13.7%      | \$ 6,548,366  | 13.8%      |

Consistent with the gaming industry, we report our revenues as the net of wagers less payouts. During the three months, our gaming revenues decreased from \$6,548,366 in 2005 to \$6,536,236 in 2006, a decrease of 0.2%. Payouts as a percentage of wagers is usually increased when new store is opened due to high payout-rate campaign to promote the grand opening, and it is gradually decreased during the first six months after opening to reduce initial opening losses and ultimately achieve profitability. The new store that opened in March 2005 did not have a significant impact on the payout-rate in the three months ended March 2005 because it did not have significant operations during the quarter.

Our gross wagers increased by \$400,307 or 0.85% from \$47,342,860 for the three months ending March 31, 2005 to \$47,743,167 in the three months ending March 31, 2006. The new store that opened in March 2005 contributed \$9,461,804 to the increase in wagers, while ten stores decreased their wagers by an aggregate of \$4,253,080 as compared with the three months ended March 31, 2005, mainly due to high competition. The impact of the closed store in July 2005 was a decrease of \$124,676 in wagers. Total number of pachinko and pachislo machines was 4,796 during the quarterly period ended March 31, 2006, as compared to 4,492 machines during the quarterly period ended March 31, 2005.

Our payouts increased by \$412,437 or 1.0% from \$40,794,494 for the three months ending March 31, 2005 to \$41,206,931 for the three months ending March 31, 2006.

### *Cost of Revenues*

Costs of revenues as a percentage of total revenues for the three months ended March 31, 2006 and 2005 are as follows:

|                                      | 2006  | 2005  |
|--------------------------------------|-------|-------|
| Depreciation                         | 38.8% | 43.2% |
| Salaries and Wages                   | 15.1% | 16.4% |
| Facilities and other                 | 18.5% | 23.2% |
| Impairment of property and equipment | 5.8%  | 11.0% |
| Total cost of revenues               | 78.2% | 93.8% |

Cost of revenues for the three months ended March 31, 2006 were \$5,487,781, a decrease of \$961,980 or 14.9 % from \$6,449,761 for the three months ended March 31, 2005. As a percentage of revenues, our costs in the three months ended March 31, 2006 decreased to 78.2% from 93.8% for the three months ended March 31, 2005. The large contributors to this decrease are reduced overhead costs due to our improved overhead cost management. In addition, a decrease in depreciation expense, which is mainly due to high depreciation expense in fiscal 2005 caused by highly accelerated depreciation in pachinko machines invested to the new store opened in March 2005, while no stores were opened in the three months ended March 2006. Our impairment loss was also decreased in fiscal 2006 since no stores were opened and fewer pachinko machines were purchased and disposed of compared to fiscal 2005. Finally, salaries and wages were decreased due to our improved labor management and the replacement of regular employees with part-time workers according to availability.

### *Marketing and Advertising Expense*

We incurred \$210,093 and \$346,647 of marketing and advertising expenses representing 3.0% and 5.0% of revenues for the three months ended March 31, 2006 and 2005, respectively. The higher percentage against the total revenue in 2005 was mainly due to the advertising costs incurred in connection with the opening of our new store in March 2005.

### *General and Administrative Expenses*

General and administrative expenses for the three months ended March 31, 2006 decreased by \$238,258 or 20.2% to \$942,715 from \$1,180,973 for the three months ended March 31, 2005. General and administrative expenses for the three months ended March 31, 2006 constituted 13.4% of revenues in comparison to 17.2 % for the three months ended March 31, 2005. The decrease in expenses was mainly due to the high volume of advertisement in the three months

ended March 2005 for the opening of the new store.

*Other Income and Expenses*

Interest expense increased by \$36,145 to \$525,298 in the three months ended March 31, 2006, from \$489,153 for the three months ended March 31, 2005, an increase of 7.4%. The increase of interest expense is attributable to an increase in long-term loans and lease contracts used to make improvements to leased properties and acquire equipment in new stores.

In connection with the reverse acquisition, we paid a merger fee by issuing shares of our Class A preferred stock valued at \$2,333,683, which was charged to expense. The value was established based on an average of the closing ask price 15 days before and after the announcement of the transaction.

Our interest swap liabilities decreased \$495,848 due to a favorable change in the three month TIBOR (Tokyo Inter Bank Offer Rate), and the related gain is included in other income.

***Income Taxes***

Our provision for income taxes increased by \$576,355 for the three months ended March 31, 2006, from a \$339,850 benefit to a \$236,505 expense. The effective tax rate against income before income tax was 59.4% for the three months ended March 31, 2006. Tax expense incurred for the three months ended March 31, 2006 was calculated for the taxable income earned in Japan using the effective tax rate of approximately 40%. The allowance was taken to fully write off the tax benefit of net operating loss of approximately \$2,800,000 incurred in the U.S.A. as of March 31, 2006.

***Net Income (Loss)***

We generated net income for the three months ended March 31, 2006 of \$161,858 versus \$875,430 of net loss for the three months ended March 31, 2005. This increase in net income can be attributed to an aggregate decline of approximately \$960,000 in cost of revenues for the three months ended March 31, 2006, general and administrative expenses and marketing and advertising expenses.

**Nine Months Ended March 31, 2006 Compared to Nine Months Ended March 31, 2005**

***Revenues and Cost of Revenues***

***Revenues***

A summary of the gaming revenues for the nine months ended March 31, 2006 and 2005 are as follows:

|                         | 2006           |            | 2005           |            |
|-------------------------|----------------|------------|----------------|------------|
|                         | Amount         | Percentage | Amount         | Percentage |
| Patron wagers (pay-ins) | \$ 141,594,665 | 100.0%     | \$ 135,936,100 | 100.0%     |
| Patron payouts          | (124,256,773)  | (87.8)     | (119,976,857)  | (88.3)     |
| Gaming revenues         | \$ 17,337,892  | 12.2%      | \$ 15,959,243  | 11.7%      |

During the nine months, our gaming revenues increased from \$15,959,243 in 2005 to \$17,337,892 in 2006, an increase of 8.6%. Payouts as a percentage of wagers is usually increased when new store is opened due to high payout-rate campaign to promote the grand opening, and it gradually decreased during the first six months after opening to reduce initial opening losses and ultimately achieve profitability. The new store that opened in March 2005 did not have a significant impact on the payout-rate in the three months ended March 2005 because it did not have significant operations during the quarter.

Our gross wagers increased by \$5,658,565 or 4.2% from \$135,936,100 for the nine months ending March 31, 2005 to \$141,594,665 for the nine months ending March 31, 2006. The new store that opened in March 2005 contributed \$28,838,830 to the increase in wagers, while nine stores decreased their wagers by an aggregate of \$13,874,880 as compared with in the nine months ended March 31, 2005, mainly due to high competition. The impact of the closed store in July 2005 was a decrease of \$426,544 in wagers. Total number of pachinko and pachislo machines was 4,796 during the nine months ended March 31, 2006.

Our payouts increased by \$4,279,916 or 3.6% from \$119,976,857 for the nine months ending March 31, 2005 to \$124,256,773 for the nine months ending March 31, 2006. Our payouts as a percentage of wagers slightly decreased from 88.3% in 2005 to 87.8% in 2006.



***Cost of Revenues***

Costs of revenues as a percentage of total revenues for the nine months ended March 31, 2006 and 2005 are as follows:

|                                      | 2006  | 2005  |
|--------------------------------------|-------|-------|
| Depreciation                         | 34.5% | 35.8% |
| Salaries and Wages                   | 18.7% | 20.8% |
| Facilities and other                 | 20.7% | 26.4% |
| Impairment of property and equipment | 6.8%  | 9.1%  |
| Total cost of revenues               | 80.7% | 92.1% |

Cost of revenues for the nine months ended March 31, 2006 were \$15,037,430, a decrease of \$816,735 or 5.2% from \$15,854,165 for to the nine months ended March 31, 2005. As a percentage of revenues, our costs in the nine months ended March 31, 2006 decreased to 80.7% from 92.1% for the nine months ended March 31, 2005. The decrease in facilities and other expense is due to the extra cost to conform the slot machines to the new regulations for the nine months ended March 2005.

***Marketing and Advertising Expense***

We incurred \$704,988 and \$818,327 of marketing and advertising expenses representing 3.8% and 4.8% of revenues for the nine months ended March 31, 2006 and 2005, respectively. The higher percentage against total revenue in 2005 was mainly due to the advertising costs associated in opening the new stores.

***General and Administrative Expenses***

General and administrative expenses for the nine months ended March 31, 2006 decreased by \$145,330 or 5.9% to \$2,317,378 from \$2,462,708 for the nine months ended March 31, 2005. General and administrative expenses for the nine months ended March 31, 2006 constituted 12.4% of revenues in comparison to 14.3 % for the nine months ended March 31, 2005. The decrease in expenses was mainly due to the high volume of advertisement in the three months ended March 2005 for the opening of the new store.

***Other Income and Expenses***

Interest expense increased by \$121,826 to \$1,379,729 in the nine months ended March 31, 2006, from \$1,257,903 for the nine months ended March 31, 2005, an increase of 9.7%. The increase of interest expense is attributable to an increase

in long-term loans and lease contracts used to make improvements to leased properties and acquire equipment in new stores.

As discussed previously, in connection with the reverse merger, we paid a merger fee by issuing shares of our Class A preferred stock valued at \$2,333,683, which was and charged to expense.

*Income Taxes*

Our provision for income taxes increased by \$913,282 for the nine months ended March 31, 2006, from a \$1,729,316 benefit to a \$183,966 expense. The effective tax rate against loss before income tax decreased to 7.8% for the nine months ended March 31, 2006 from 32.9% for the nine months ended March 31, 2005. Tax expense incurred for the nine months ended March 31, 2006 was calculated for the taxable income earned in Japan using the effective tax rate of approximately 40%. The decrease in effective tax rate was attributable to the

allowance to fully write off the tax benefit of net operating loss of approximately \$2,800,000 incurred in USA as of March 31, 2006.

#### *Net Income (Loss)*

We generated net loss for the nine months ended March 31, 2006 of \$2,531,871 versus \$1,489,174 for the nine months ended March 31, 2005. This increase in net loss can be attributed to the approximate \$2,333,000 stock based merger fee charged to expense for the nine months ended March 31, 2006.

#### **Liquidity and Sources of Capital**

##### *Cash Flows*

During the nine months ended March 31, 2006 and 2005, we provided \$6,868,852 and \$3,204,118 respectively, of cash flows from operating activities. Our cash provided by operating activities during the nine months ended March 31, 2006 and 2005, included non-cash depreciation and impairment losses aggregating \$8,070,266 and \$8,057,931 respectively. Our increase in cash generated in the nine months ended March 31, 2006 relates primarily to a decrease in payments to vendors in the nine months ended March 31, 2005.

During the nine months ended March 31, 2006 and 2005, we used cash of \$7,183,733 and \$1,951,761, respectively, on investing activities. During the nine months ended March 31, 2006, we spent approximately \$5,611,582 for capital additions mainly purchasing pachinko machines. We also incurred \$201,668 and \$4,611,646 for property and equipment acquired under capital lease contracts during the nine months ended March 31, 2006 and 2005.

During the nine months ended March 31, 2006, we provided cash of \$4,916,002 in financing activities. During this period, we borrowed \$12,136,985 from five banks, and we repaid debt totaling \$5,685,941. We used funds for purchasing pachinko machines and increased working capital. In 2005, we provided cash from our financing activities in the amount of \$34,871. We borrowed \$9,673,669 and repaid long-term debt of \$9,231,650 during the nine months ended March 31, 2005. We repaid \$1,511,582 and \$331,256 of lease obligations during the nine months ended March 31, 2006 and 2005, respectively.

##### *Liquidity*

## Edgar Filing: PGMI, INC. - Form 10QSB

As of March 31, 2006, the Company has working capital totaling \$4,047,903. We have \$7,761,935 in current portion of long term debt to be repaid within one year. We have good relations with our banks in Japan. We believe PGMI will continue its growth and generate positive cash flows from operations to fund its daily operations and service its debt obligations. There are no assurances that we will be successful in our plans. No adjustments have been made to the carrying value of assets or liabilities as a result of the uncertainty about obtaining cash required to pay obligations as they come due. Our independent registered public accounting firm has included an explanatory paragraph in their report on our consolidated financial statements ended June 30, 2005, regarding substantial doubt about our ability to continue as a going concern because of these matters.

Our level of indebtedness presents other risks to investors, including the possibility that we may be unable to generate cash sufficient enough to pay the principal of and interest on our indebtedness when due; and that we may not be able to meet tests and covenants of such debt agreements and achieve satisfactory resolution of such non-compliance with the lenders. In such an event, the holders of our indebtedness may be able to declare all indebtedness owing to them be due and payable immediately, and proceed against any collateral securing such indebtedness. These actions could limit our ability to borrow additional funds and would likely have a material adverse effect on our business and results of operations.

## **Critical Accounting Policies**

Our significant accounting policies are included in Note 2 of our Consolidated Financial Statements included elsewhere in this Report. These policies, along with the underlying assumptions and judgments made by our management in their application, have a significant impact on our consolidated financial statements.

### ***Impairment of Long-Lived Assets and Intangibles***

We review the carrying value of our long-lived assets whenever events or changes in circumstances indicate that such carrying values may not be recoverable annually. Unforeseen events and changes in circumstances and market conditions and material differences in estimates of future cash flows could negatively affect the fair value of our assets and result in an impairment charge. Fair value is the amount at which the asset could be bought or sold in a current transaction between willing parties. Fair value can be estimated utilizing a number of techniques including quoted market prices, prices for comparable assets, or other valuation processes involving estimates of cash flows, multiples of earnings or revenues. For land impairments, we have used government prefecture estimated fair values, which they use for assessing taxes.

### ***Income Taxes***

We account for income taxes in accordance with *Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes* (SFAS No. 109) which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the bases used for financial reporting and income tax reporting of recorded assets and liabilities. SFAS No. 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized. We have provided valuation allowances because we feel that certain deferred tax assets generated in the United States will not be recovered through future operations. We must continue to monitor our deferred tax assets in light of recent losses we have incurred.

### ***Interest Rate Swap Agreements***

Interest swap agreements and the related hedged debt are considered ineffective against changes in the fair value of the debt due to changes in the benchmark interest rates over their terms, as provided by SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. We do not have an established formal risk management policy with respect to the use of derivative instruments, and the related term and notional amounts of the interest swap agreements do not coincide with the debt financed. The fair value of the swaps is carried as an asset or a liability in the consolidated balance sheet and the changes is recorded as a gain or loss to operations. The fair values of PGMI's interest rate swaps are the estimated amounts it would receive or pay to terminate the agreements as of the reporting date as determined by the bank. As of March 31, 2006, the fair value of the outstanding interest rate swap liabilities was \$198,520.

**ITEM 3.**

**CONTROLS AND PROCEDURES**

Our principal executive officer and principal financial officer have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this quarterly report on Form 10-QSB. Based on this evaluation, our principal executive officer and principal financial officer concluded that these disclosure controls and procedures need improvement to ensure that the information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the requisite time periods.

In connection with its review of the our consolidated financial statements for the year ended June 30, 2005, McKennon, Wilson & Morgan LLP, the Company's independent accountants, advised management of certain significant internal control deficiencies that they considered to be, in the aggregate, a material weakness, including, inadequate staffing and supervision leading to the untimely identification and resolution of certain accounting matters; failure to perform timely reviews, substantiation and evaluation of certain general ledger account balances; lack of procedures or expertise needed to prepare all required disclosures; and evidence that employees lack the qualifications and training to fulfill their assigned functions. McKennon, Wilson & Morgan LLP indicated that they considered these deficiencies to be a material weakness as that term is defined under standards established by the American Institute of Certified Public Accountants. A material weakness is a significant deficiency in one or more of the internal control components that alone or in the aggregate precludes our internal control from reducing to an appropriately low level the risk that material misstatements in our financial statements will not be prevented or detected on a timely basis. We considered these matters in connection with the quarter-end closing of accounts and preparation of financial statements as and for the quarter ended March 31, 2006 and determined that no prior period financial statements were materially affected by such matters.

In response to the observations made by McKennon, Wilson & Morgan LLP, we will proceed more expeditiously with our existing plan to enhance our internal controls and procedures, which we believe addresses each of the matters raised by, McKennon, Wilson & Morgan LLP.

**PART II OTHER INFORMATION**

**ITEM 1.**                    **LEGAL PROCEEDINGS.**

We are not currently a party to any legal proceedings.

**ITEM 2.**                    **CHANGES IN SECURITIES AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES.**

None.

**ITEM 3.**                    **DEFAULTS UPON SENIOR SECURITIES.**

None.

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

By written consent dated as of February 10, 2006, a majority of our shareholders approved an amendment to our

Articles of Incorporation to change our name to PGMI, Inc. In connection with their written consent we filed a Definitive Information Statement on Schedule 14c that was mailed to our shareholders on or around February 21, 2006. In accordance with applicable federal securities laws, the name change was effective on March 16, 2006.

**ITEM 5.**                    **OTHER INFORMATION.**

None.

**ITEM 6.**                    **EXHIBITS.**

- |      |   |
|------|---|
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 32   | 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 |



**SIGNATURES**

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

PGMI, INC.

Dated: May 22, 2006

By: /s/ Shinichi  
Kanemoto  
Shinichi Kanemoto  
President & Chief Executive Officer

/s/ Gakushin Kanemoto  
Gakushin Kanemoto  
Chief Financial Officer  
(signed both as an  
officer duly authorized to sign on  
behalf of the Registrant and principal  
financial officer and chief accounting  
officer)