

KEYSTONE AUTOMOTIVE INDUSTRIES INC

Form 10-Q

February 08, 2006

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

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**FORM 10-Q**

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(Mark One)

**Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934.**

For the quarterly period ended: December 30, 2005

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 0-28568

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**KEYSTONE AUTOMOTIVE INDUSTRIES, INC.**

(Exact name of registrant as specified in its charter)

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**California**  
(State or other jurisdiction of  
incorporation or organization)

**95-2920557**  
(I.R.S. Employer  
Identification Number)

**700 East Bonita Avenue, Pomona, CA**  
(Address of principal executive offices)

**91767**  
(Zip Code)

**(909) 624-8041**

(Registrant's telephone number including area code)

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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 to such filing requirements for the past 90 days. Yes  No .

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). 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 .

The number of shares outstanding of the registrant's Common Stock, no par value, at February 3, 2006 was 16,128,815 shares.

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Keystone Automotive Industries, Inc.****Condensed Consolidated Balance Sheets****(In thousands, except share amounts)**

	<b>December 30,</b>	<b>April 1,</b>
	<b>2005</b>	<b>2005</b>
	<b>(Unaudited)</b>	<b>(Note)</b>
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 5,599	\$ 4,054
Accounts receivable, net of allowance of \$1,333 at December 2005 and \$1,270 at April 2005	58,669	49,719
Inventories, primarily finished goods	129,123	119,679
Other current assets	12,653	12,018
	<u>206,044</u>	<u>185,470</u>
Total current assets	206,044	185,470
Plant, property and equipment, net	30,911	31,079
Goodwill	39,151	11,309
Other intangibles, net of accumulated amortization of \$4,145 at December 2005 and \$3,851 at April 2005	1,639	925
Other assets	6,235	5,801
	<u>283,980</u>	<u>234,584</u>
Total assets	\$ 283,980	\$ 234,584
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current Liabilities:		
Credit facility	\$ 21,363	\$
Accounts payable	33,135	25,950
Accrued liabilities	19,306	14,274
	<u>73,804</u>	<u>40,224</u>
Total current liabilities	73,804	40,224
Other long-term liabilities	2,113	2,583
Commitments and contingencies		
Shareholders' Equity:		
Preferred stock, no par value:		
Authorized shares 3,000,000		
None issued and outstanding		
Common stock, no par value:		
Authorized shares 50,000,000		
Issued and outstanding shares 16,022,000 at December 2005 and 15,839,000 at April 2005, at stated value	94,059	93,244
Restricted Stock	994	460
Additional paid-in capital	7,695	7,695
Retained earnings	105,796	91,101
Accumulated other comprehensive loss	(481)	(723)
	<u>(481)</u>	<u>(723)</u>

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Total shareholders' equity	208,063	191,777
Total liabilities and shareholders' equity	\$ 283,980	\$ 234,584

The accompanying notes are an integral part of these condensed consolidated financial statements.

NOTE: The balance sheet information at April 1, 2005 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

**Table of Contents****Keystone Automotive Industries, Inc.****Condensed Consolidated Statements of Income****(In thousands, except share and per share amounts)****(Unaudited)**

	Thirteen Weeks Ended December 30, 2005	Thirteen Weeks Ended December 31, 2004	Thirty-nine Weeks Ended December 30, 2005	Forty Weeks Ended December 31, 2004  (Restated)
Net sales	\$ 164,387	\$ 136,631	\$ 448,389	\$ 405,156
Cost of sales	90,143	76,819	248,448	229,128
Gross profit	74,244	59,812	199,941	176,028
Operating expenses:				
Selling and distribution	47,897	40,379	135,494	122,376
General and administrative	14,840	13,166	41,676	39,169
Operating income	11,507	6,267	22,771	14,483
Other income	607	402	1,988	2,102
Interest expense	(334)	(58)	(466)	(216)
Income before income taxes	11,780	6,611	24,293	16,369
Income taxes	4,672	2,599	9,598	6,455
Net income	\$ 7,108	\$ 4,012	\$ 14,695	\$ 9,914
Per Common Share:				
Net income per share:				
Basic	\$ .44	\$ .26	\$ .92	\$ .64
Diluted	\$ .44	\$ .25	\$ .91	\$ .63
Weighted average common shares outstanding:				
Basic	16,008,000	15,699,000	15,956,000	15,597,000
Diluted	16,183,000	15,844,000	16,094,000	15,776,000

The accompanying notes are an integral part of these condensed consolidated financial statements.



**Table of Contents****Keystone Automotive Industries, Inc.****Condensed Consolidated Statements of Cash Flows****(In thousands)****(Unaudited)**

	<b>Thirty-nine</b>	<b>Forty</b>
	<b>Weeks Ended</b>	<b>Weeks Ended</b>
	<b>December 30,</b>	<b>December 31,</b>
	<b>2005</b>	<b>2004</b>
	<u>          </u>	<u>          </u>
		<b>(Restated)</b>
<b>Operating activities:</b>		
Net income	\$ 14,695	\$ 9,914
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	6,548	5,729
Provision for losses on uncollectible accounts	1,294	300
Provision for write-down of inventories	2,340	1,830
Gain on sale of assets	(25)	(33)
<b>Changes in operating assets and liabilities, net of effect of business acquisitions:</b>		
Accounts receivable, net	(7,662)	(4,136)
Inventories	(7,150)	(7,926)
Other assets	1,280	3,446
Accounts payable and accrued liabilities	10,347	6,164
	<u>          </u>	<u>          </u>
<b>Net cash provided by operating activities</b>	<b>21,667</b>	<b>15,288</b>
<b>Investing activities:</b>		
Proceeds from sale of assets	295	462
Purchases of property, plant and equipment	(5,344)	(6,899)
Acquisitions of certain service centers, net of cash received	(37,185)	(2,401)
	<u>          </u>	<u>          </u>
<b>Net cash used in investing activities</b>	<b>(42,234)</b>	<b>(8,838)</b>
<b>Financing activities:</b>		
Borrowings (payments) on credit facility	21,363	(7,627)
Other debt, net	(66)	(11)
Net proceeds on option exercise	815	2,819
	<u>          </u>	<u>          </u>
<b>Net cash provided by (used in) financing activities</b>	<b>22,112</b>	<b>(4,819)</b>
	<u>          </u>	<u>          </u>
<b>Net increase in cash and cash equivalents</b>	<b>1,545</b>	<b>1,631</b>
Cash and cash equivalents at beginning of period	4,054	3,176
	<u>          </u>	<u>          </u>
<b>Cash and cash equivalents at end of period</b>	<b>\$ 5,599</b>	<b>\$ 4,807</b>
	<u>          </u>	<u>          </u>
<b>Supplemental disclosures</b>		
Interest paid during the period	\$ 444	\$ 224
	<u>          </u>	<u>          </u>



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Income taxes paid during the period	\$ 7,311	\$ 2,441
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The accompanying notes are an integral part of these condensed consolidated financial statements.

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**Keystone Automotive Industries, Inc.**

**Notes to Condensed Consolidated Financial Statements**

**(Unaudited)**

**December 30, 2005**

**1. Basis of Presentation**

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments, consisting only of normal recurring accruals considered necessary for fair presentation, with respect to the interim financial statements, have been included. The results of operations for the 39-week period ended December 30, 2005 are not necessarily indicative of the results that may be expected for the full year ending March 31, 2006. For further information, refer to the financial statements and footnotes thereto for the year ended April 1, 2005, included in Keystone Automotive Industries, Inc.'s (the Company) report on Form 10-K filed with the Securities and Exchange Commission on June 15, 2005.

**2. Fiscal Year**

The Company uses a 52/53 week fiscal year. The Company's current fiscal year ends on March 31, 2006. The operating results for the nine-month period ended December 30, 2005 contained thirty-nine weeks as compared to the same period in the prior fiscal year which contained forty weeks.

**3. Income Taxes**

The income tax provision for interim periods is based on an estimated effective annual income tax rate.

**4. Recently Issued Accounting Pronouncements**

In December 2004, the Financial Accounting Standards Board (FASB) issued a revised Statement 123, *Share Based Payment* (Statement 123R), to address the accounting for stock-based employee plans. The statement eliminates the ability to account for share-based compensation transactions using Accounting Principles Board (APB) Opinion No. 25 and instead requires that such transactions be accounted for using a fair value based method of accounting. The impact of adoption of Statement 123R cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had the Company adopted Statement 123R in prior periods, the impact of that standard would have approximated the impact of Statement 123 as described in the disclosure of proforma net income and earnings per share in Note 11

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to our consolidated financial statements in the Company's Form 10-K for the year ended April 1, 2005. Statement 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows in periods after adoption. Statement 123R, as recently amended, is effective the beginning of the first fiscal year which begins after June 15, 2005. Consequently, Statement 123R will not impact the Company until the beginning of fiscal 2007 and the adoption of Statement 123R is not expected to have a material adverse impact on the Company's consolidated financial position or cash flows.

In November 2004, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 151, Inventory Costs, an amendment of APB No. 43, Chapter 4 (SFAS 151). SFAS 151 amends Accounting Research Bulletin No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overhead to inventory be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect that the adoption of this standard will have a material impact on its consolidated financial position or cash flows.

In June 2005, the FASB Emerging Issues Task Force reached a consensus on Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements (EITF 05-6). The guidance requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of the business combination or purchase. The guidance is effective for periods beginning after June 29, 2005. The adoption of EITF 05-6 will not have an impact on the Company's consolidated financial statements.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections - A Replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior periods' financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

**Table of Contents****5. Acquisitions**

The results of operations for the 13 and 39-week periods ended December 30, 2005 reflect the operations from a business acquired in the third quarter of fiscal 2005 and businesses acquired in June and October 2005, as of the date of each acquisition. The unaudited pro forma results for the 13 and 39-week periods ended December 30, 2005, assuming these acquisitions had been made at the beginning of fiscal 2006, would not be materially different from the results presented.

**6. Stock Compensation Plans**

The Company adopted SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amends SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirement of SFAS No. 123 to require more prominent and more frequent disclosures in financial statements of the effects of stock-based compensation. If the Company had elected to recognize compensation cost based on the fair value of the options granted at the grant rate as prescribed by SFAS No. 148, net income and earnings per share would have been reduced to the pro forma amounts shown below:

	<u>Thirteen Weeks Ended</u>		<u>Thirty-nine</u>	<u>Forty</u>
	<u>December</u>	<u>December</u>	<u>Weeks</u>	<u>Weeks</u>
	<u>30,</u>	<u>31,</u>	<u>Ended</u>	<u>Ended</u>
	<u>2005</u>	<u>2004</u>	<u>December</u>	<u>December</u>
	<u>2005</u>	<u>2004</u>	<u>30,</u>	<u>31,</u>
	<u>(thousands, except per share amount)</u>		<u>(thousands, except per share amount)</u>	
			<u>(Restated)</u>	
Pro forma:				
Net income as reported	\$ 7,108	\$ 4,012	\$ 14,695	\$ 9,914
Add: Stock based compensation	129	64	323	157
Less: Fair value stock-based compensation	(290)	(117)	(741)	(430)
Net income pro forma	\$ 6,947	\$ 3,959	\$ 14,277	\$ 9,641
Net income per share as reported:				
Basic	\$ .44	\$ .26	\$ .92	\$ .64
Diluted	\$ .44	\$ .25	\$ .91	\$ .63
Net income per share pro forma:				
Basic	\$ .43	\$ .25	\$ .90	\$ .62
Diluted	\$ .43	\$ .25	\$ .89	\$ .61

The effects of applying SFAS No. 123 as amended by SFAS No. 148, for purposes of determining pro forma net income (loss) and net income (loss) per share are not likely to be representative of the effects on reported net income (loss) for future years. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model using the following weighted average assumptions:

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	Thirty-nine Weeks Ended December 30, 2005	Forty Weeks Ended December 31, 2004
Risk free interest rate	4.35	4.69
Expected life in years	4.10	4.50
Expected volatility	40.26%	40.49%
Expected dividend yield	0.0%	0.0%

**Table of Contents****7. Sales By Product**

	Thirteen Weeks Ended		Thirty-nine	Forty
	December 30, 2005	December 31, 2004	Weeks Ended December 30, 2005	Weeks Ended December 31, 2004
	(in millions)		(in millions)	
Automotive body parts	\$ 89.4	\$ 73.3	\$ 233.1	\$ 210.0
Bumpers	48.7	39.7	135.2	118.7
Paint and related materials	14.1	13.7	45.4	45.9
Wheels and related products	13.5	10.2	38.3	31.0
Other <sup>(1)</sup>	(1.3)	(0.3)	(3.6)	(0.5)
Net Sales	\$ 164.4	\$ 136.6	\$ 448.4	\$ 405.1

<sup>(1)</sup> Represents discounts and allowances, net of sales of glass and truck accessories.

**8. Employee Benefit Plans**

The Company has suspended its defined benefit pension plan (the Plan) to provide pension benefits to all non-union employees. Plan benefits are based on an employee's years of service and the compensation during the five years of employment which would yield the highest average compensation. Effective in April 1997, the Company suspended the accrual of future benefits.

The net periodic pension cost for the Company's benefit plan was as follows:

	Thirteen Weeks Ended		Thirty-nine	Forty
	December 30, 2005	December 31, 2004	Weeks Ended December 30, 2005	Weeks Ended December 31, 2004 <sup>(1)</sup>
Service cost	\$ 30	\$	\$ 90	\$
Interest cost	67	67	213	202
Expected return on plan assets	(80)	(73)	(267)	(219)
Recognized net actuarial (gains) or losses	45	18	155	54
Prior service cost recognized	4		311	
	\$ 66	\$ 12	\$ 502	\$ 37

<sup>(1)</sup> In addition, for the nine months ended December 31, 2004 an additional amount of \$264,000 was charged to expense to represent an anticipated settlement charge during the fiscal year. The total amount charged to expense for the nine months ended December 31, 2004 was \$301,000.

**9. Restatement**

During the fourth quarter of fiscal 2005, the Company adjusted its accounting for rent under its various operating leases in accordance with the requirements of SFAS No. 13. SFAS No. 13 requires the Company to record straight line lease expenses over the term of the lease when a lease contains a fixed rent escalation clause. The Company had been recording the actual rent expense for each year of the lease. As a result, the Company recorded an adjustment of \$1.2 million in fiscal 2005, substantially all of which was recorded as additional selling and distribution expenses. Of this amount, \$0.9 million related to fiscal years prior to 2005 and was recorded in the first quarter of fiscal 2005, which resulted in a restatement of the results of operations for that period (see the table below) and \$0.3 million was recorded in the fourth quarter of fiscal 2005. While the \$0.9 million was material to the first quarter of fiscal 2005, it was not material to prior fiscal years.

	<b>Consolidated Statements of Income</b>		
	<b>As Previously Reported</b>	<b>Adjustments</b>	<b>As Restated</b>
	(in thousands except per share amounts)		
Forty weeks ended December 31, 2004			
Selling and distribution expenses	\$ 121,479	897	122,376
Income before income taxes	17,266	(897)	16,369
Income taxes	6,810	(355)	6,455
Net income	10,456	(542)	9,914
Net income per share:			
Basic	0.67	(0.03)	0.64
Diluted	0.66	(0.03)	0.63

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### **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Except for the historical information contained herein, certain matters addressed in this Item 2 constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such forward-looking statements are subject to a variety of risks and uncertainties that could cause actual results to differ materially from those anticipated by the Company's management. The Private Securities Litigation Reform Act of 1995 (the Act) provides certain safe harbor provisions for forward-looking statements. All forward-looking statements made in this Quarterly Report on Form 10-Q are made pursuant to the Act and are subject to the cautionary statements set forth herein and in the Company's report on Form 10-K for the year ended April 1, 2005, on file with the Securities and Exchange Commission. We undertake no obligation to publicly update or revise any forward-looking statements to reflect future events or circumstances.

#### **General**

The first nine months of Fiscal 2006 contained 39 weeks as compared to 40 weeks for the first nine months of fiscal 2005. Consequently, comparisons of certain results may not be meaningful.

See Footnote 9 to the Notes to Condensed Consolidated Financial Statements above for information relating to a restatement of the Statement of Income for the forty weeks ended December 31, 2004, as a result of an adjustment to the accounting for rent under the Company's various operating leases. The Company has over 200 leases and no lease is material to the operations of the Company.

The Company offers a limited lifetime warranty with respect to many of the parts it sells guaranteeing its parts to be free of defects in material and workmanship as long as the owner of the vehicle when repairs are made remains the owner when the warranty claim is made. To date, warranty claims have been minimal.

On October 14, 2005, the Company acquired the business of Veng USA LLC (Veng). Veng distributes aftermarket collision replacement parts throughout the New England region, with seven locations in Massachusetts, New Hampshire, Connecticut and Maine. The acquisition price was \$36.4 million. Scott Edwards, the principal shareholder of Veng, became a Vice President of the Company and, to date, Veng's operations continue substantially unchanged.

#### **Critical Accounting Policies**

*General.* The Company's discussion and analysis of its financial condition and results of operations are based upon its consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an ongoing basis, the Company evaluates its estimates, including those related to product returns, bad debts, inventories, intangible assets, income taxes, insurance, pensions and contingencies and litigation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.



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The Company believes that the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its consolidated financial statements.

*Bad Debt.* The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. The Company adjusts its allowance monthly based upon a formula relating to the aging of its receivables. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

*Inventory.* The Company writes down its inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of the inventory and its estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

*Deferred Taxes.* The Company records a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. While the Company has considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event the Company were to determine that it would be able to realize its deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made. Likewise, should the Company determine that it would not be able to realize all or part of its net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made.

*Insurance.* The Company's main insurance programs (medical, workers' compensation and vehicle) are designed as large deductible programs. Through these programs, the Company self-insures losses up to a deductible limit and purchases stop-loss insurance to protect against losses that are over the deductible. The stop-loss insurance is purchased on an individual and aggregate basis. The amount of the deductible has risen significantly in the last two years resulting in a shift of risk from the insurance carrier to the Company. The Company estimates its cost for these programs and maintains reserves for incurred, but not reported, losses. If the Company were to experience an increase in claims activity over anticipated amounts, and its reserves are not sufficient, additional reserves may be required, which would have an unanticipated negative impact on future earnings.

**Table of Contents****KEYSTONE AUTOMOTIVE INDUSTRIES, INC.****Results of Operations**

The following table sets forth for the periods indicated, certain selected income statement items as a percentage of net sales.

	<b>Thirteen Weeks Ended December 30, 2005</b>	<b>Thirteen Weeks Ended December 31, 2004</b>	<b>Thirty-nine Weeks Ended December 30, 2005</b>	<b>Forty Weeks Ended December 31, 2004</b>
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	54.8	56.2	55.4	56.6
Gross profit	45.2	43.8	44.6	43.4
Selling and distribution expenses	29.1	29.6	30.2	30.2
General and administrative expenses	9.0	9.7	9.3	9.6
Other income	0.3	0.3	0.4	0.5
Interest expense, net	(0.2)		(0.1)	(0.1)
Income before income taxes	7.2	4.8	5.4	4.0
Income taxes	2.9	1.9	2.1	1.6
Net income (loss)	4.3%	2.9%	3.3%	2.4%

**Thirteen weeks ended December 30, 2005 compared to thirteen weeks ended December 31, 2004**

Net sales were \$164.4 million for the thirteen weeks ended December 30, 2005 (the 2005 Quarter) compared to \$136.6 million for the thirteen weeks ended December 31, 2004 (the 2004 Quarter), an increase of \$27.8 million or 20.3%. The increase in net sales was due primarily to increases in sales of automotive body parts and bumpers. During the 2005 Quarter, sales of automotive body parts (including fenders, hoods, headlights, radiators, grilles and other crash parts) increased by \$16.1 million (an increase of 22.0%); sales of new and recycled bumpers increased by \$9.0 million (an increase of 22.7%); sales of paint and related materials increased by \$0.4 million (an increase of 2.9%) and sales of remanufactured wheels and related products increased by \$3.3 million (an increase of 32.4%). The increases in net sales reflect price increases instituted in October 2004 and October 2005, favorable weather conditions in certain parts of the country and the fact that insurance companies are generally specifying more aftermarket parts in the repair of damaged vehicles. See Part II, Item 5 below.

Gross profit increased in the 2005 Quarter to \$74.2 million (45.2% of net sales) from \$59.8 million (43.8% of net sales) in the 2004 Quarter, an increase of \$14.4 million, or 24.1%, primarily as a result of the increase in net sales and price increases. The Company's gross profit margin has fluctuated, and may continue to fluctuate, depending on a number of factors, including changes in product mix, competition and currency exchange rates.

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Selling and distribution expenses increased to \$47.9 million (29.1% of net sales) in the 2005 Quarter from \$40.4 million (29.6% of net sales) in the 2004 Quarter, an increase of \$7.5 million, or 18.6%. The increase in selling and distribution expenses in the 2005 Quarter reflects increased sales, increased wages and incentive compensation of \$3.8 million and increased fuel costs of \$700,000.

General and administrative expenses increased to \$14.8 million (9.0% of net sales) in the 2005 Quarter compared to \$13.2 million (9.7% of net sales) in the 2004 Quarter, an increase of \$1.6 million, or 12.7%. The increase was primarily due to increased sales and increases in wages, salaries and incentive compensation, as well as minor increases in a number of other categories. Salaries, wages and incentive compensation increased by \$1.2 million over the 2004 Quarter as a result of an increase in administrative and operating personnel and higher earnings.

Other income remained the same at approximately \$300,000 and was made up of a number of components with over 70% of other income resulting from vendor discounts and finance fees from past-due customer accounts.

As a result of the above factors, the Company experienced an increase in net income for the 2005 Quarter to \$7.1 million (4.3% of net sales), compared to net income of \$4.0 million (2.9% of net sales) in the 2004 Quarter.

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### **Thirty-nine weeks ended December 30, 2005 compared to forty weeks ended December 31, 2004**

Because the periods being compared differ in length by one week, a comparison of results between the two periods may not be meaningful.

Net sales were \$448.4 million for the thirty-nine weeks ended December 30, 2005 (the 2005 Nine Months ) compared to \$405.2 million for the forty weeks ended December 31, 2004 (the 2004 Nine Months ), an increase of \$43.2 million, or 10.7%. This increase was made up of increases of \$23.1 million in sales of automotive body parts (including fenders, hood, headlights, radiators, grilles, and other crash parts); \$16.5 million in sales of new and recycled bumpers; \$7.3 million in sales of paint and related materials and a decrease of \$.5 million in sales of remanufactured wheels and related products. These changes represent increases of approximately 11.0%, 13.9%, 23.6% and 1.1%, respectively, over the prior year period, which was one week longer in duration.

Gross profit increased in the 2005 Nine Months to \$199.9 million (44.6% of net sales) from \$176.0 million (43.4% of net sales) in the 2004 Nine Months, an increase of \$23.9 million, or 8.4%, primarily as a result of the increase in net sales and price increases. The Company's gross profit margin has fluctuated, and may continue to fluctuate, depending on a number of factors, including changes in product mix, competition and currency exchange rates.

Selling and distribution expenses increased to \$135.5 million (30.2% of net sales) in the 2005 Nine Months from \$122.4 million (30.2% of sales) in the 2004 Nine Months, an increase of 10.7%. The increase in these expenses was generally the result of increased sales and these expenses were negatively impacted on a comparative basis by increased selling wages and salaries, including benefits, of \$5.1 million, increased fuel costs of \$2.1 million and freight costs of \$.9 million.

General and administrative expenses increased to \$41.7 million (9.3% of net sales) in the 2005 Nine Months from \$39.2 million (9.7% of net sales) in the 2004 Nine Months, an increase of 6.4%. The increase was primarily due to increased sales and increases in wages and salaries, including benefits. See the 2004 Quarter comparison above.

Other income decreased by approximately \$100,000 for the 2005 Nine Months and was made up of a number of components with over 70% of other income resulting from vendor discounts and finance fees from past-due customer accounts.

As a result of the above factors, the Company experienced an increase in net income for the 2005 Nine Months of \$14.7 million (3.3% of net sales), compared to net income of \$9.9 million (2.4% of net sales) in the 2004 Nine Months.

### **Variability of Quarterly Results and Seasonality**

The Company has experienced, and expects to continue to experience, variations in its sales and profitability from quarter to quarter due, in part, to the timing and integration of acquisitions and the seasonal nature of the Company's business. The number of collision repairs is directly impacted by the weather. Accordingly, the Company's sales generally are highest during the five-month period from December to April. The impact of seasonality has been reduced somewhat as the Company has become more geographically diversified. Other factors that influence

quarterly variations include the number of business days during the holiday seasons, the timing of the introduction of new products, the level of consumer acceptance of new products, general economic conditions that affect consumer spending, the timing of supplier price changes and the timing of expenditures in anticipation of increased sales and customer delivery requirements.

### **Liquidity and Capital Resources**

The Company's primary use of funds over the past two years has been for acquisitions, the development and implementation of an enterprise-wide management information system and the paydown of bank borrowings. At December 30, 2005, working capital was \$132.2 million, compared to \$145.2 million at April 1, 2005. The decrease in working capital is primarily the result of cash used in investing activities. The Company financed its working capital requirements and the acquisitions completed during the first nine months of fiscal 2006 from cash flow from operations, borrowings on credit facilities and the proceeds from the exercise of stock options.

During the thirty-nine weeks ended December 30, 2005, the Company's cash and cash equivalents increased by \$1.5 million. This increase is the result of (i) an increase in cash provided by operating activities of \$21.7 million resulting primarily from the elimination of \$10.2 million of non-cash expenses from the reported net income of \$14.7 million, partially offset by subtracting \$3.2 million as a result of changes in accounts receivable, inventory, other assets and accounts payable and accrued liabilities and (ii) an increase in cash provided by financing activities of \$22.1 million. The most significant non-cash expenses were depreciation and amortization. This increase was partially offset by a decrease in cash used in investing activities of \$42.2 million, primarily as a result of cash used to complete an acquisition and to purchase property and equipment. The increase in cash provided by financing activities resulted from the borrowings under the Company's credit facility and from cash proceeds from the exercise of stock options.

In October 2005, the Company acquired Veng for a cash purchase price of \$36.4 million, of which approximately \$31.6 million was borrowed under the Company's credit facility.

The Company has in place a \$75.0 million revolving secured credit facility with commercial lenders which matures on October 14, 2010. The Company has the option to expand the credit facility to \$100.0 million. Advances under the credit facility bear interest either at LIBOR plus 0.75% or at the lender's prime rate. At December 30, 2005, \$21.3 million had been drawn down under the line of credit, of which \$10.0 million of bore interest at 5.25%, \$5.0 million at 5.19% and \$6.3 million at 7.25%. The facility provides for

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certain restrictive covenants including that the Company maintain certain financial ratios. The Company was in compliance with all such covenants at December 30, 2005, and at the date of the filing of this Quarterly Report. The Company has outstanding lines of credit in the aggregate amount of \$10.6 million issued to its primary insurers to secure the Company's deductible reimbursement obligations. The aggregate amount of these letters of credit reduces the funds available under the Company's revolving credit facility.

The Company believes that its existing working capital, anticipated cash flow from operations and funds anticipated to be available under its line of credit will enable it to finance its operations, including possible acquisitions for at least the next 12 months. However, the Company's liquidity expectations are subject to numerous factors, many of which are beyond the Company's control. Anticipated cash flow from operations is subject to the risks of the business, the most significant of which are discussed under Item 1 Business-Cautionary Statements in the Company's Form 10-K for the year ended April 1, 2005 and under Item 1A Risk Factors below. The availability of funds under the Company's line of credit could also be restricted or eliminated in the event that the Company does not maintain the financial ratios required under the credit agreement. These ratios include items related to the amount of indebtedness, earnings before interest, taxes and depreciation and amortization, net worth and the current ratio. In the event that the Company's operations do not meet expectations, it is possible that needed liquidity will not be available under the credit facility.

## **Inflation**

The Company does not believe that the relatively moderate rates of inflation over the past three years have had a significant effect on its net sales or its profitability.

## **Long-Lived Assets**

Goodwill, which represents the excess of cost over the fair value of net assets acquired, amounted to \$39.2 million at December 30, 2005, or approximately 14.8% of total assets or 18.8% of consolidated shareholders' equity. Goodwill amounted to \$11.3 million at April 1, 2005, or approximately 4.8% of total assets or 5.9% of consolidated shareholders' equity. The increase in goodwill was the result of the completion of one acquisition.

Other intangible assets, consisting primarily of covenants not to compete obtained in acquisitions, which have finite lives, will continue to be amortized over the finite life. As of December 30, 2005, other intangible assets amounted to \$1.6 million. For each of the nine months ended December 30, 2005 and December 31, 2004, amortization of other intangible assets was approximately \$0.3 million.

The Company reviews the recoverability of its long-lived assets as required by SFAS No. 144 and makes assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates or their related assumptions change in the future, the Company may be required to record impairment charges for these assets not previously recorded.

## **New Accounting Standards**

See Note 4 to Notes to Condensed Consolidated Financial Statements.

**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

The Company's results of operations are subject to changes in interest rates primarily with respect to borrowings under its credit facility, where interest rates are tied to the prime rate or LIBOR. Under its current policies, the Company does not use interest rate derivative instruments to manage exposure to interest rate changes. Based on the Company's current levels of debt, the exposure to interest rate fluctuations is not considered to be material. The Company is also exposed to currency fluctuations, primarily with respect to its product purchases in Taiwan and its operations in Canada. While all transactions with Taiwan are conducted in U.S. Dollars, changes in the relationship between the U.S. dollar and the New Taiwan dollar might impact the price of products purchased in Taiwan. The Company might not be able to pass on any price increases to customers. The consolidated balance sheet amounts and statement of income reflecting the results of operations of our Canadian operations are translated on to the Company's financial statements in U.S. dollars at the current and average exchange rates, respectively. Under its present policies, the Company does not attempt to hedge its currency exchange rate exposure.

**Item 4. CONTROLS AND PROCEDURES**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Office and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

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The Company carried out an evaluation under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this Report. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

There have been no changes in the Company's internal controls over financial reporting that occurred during the Company's most recently completed fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

As previously disclosed, in November 2002 General Motors Corporation instituted a suit against the Company and a Taiwan-based manufacturer in the Federal District Court for the Eastern District of Michigan, Southern Division. The complaint alleges that the Company is distributing replacement grilles for General Motors' vehicles with a placeholder matched exactly to the Chevrolet Bow Tie design emblem and the GMC mark emblem, which infringes on General Motors' federal, state and common law trademarks. The suit claims this violates the Lanham Act and constitutes unfair competition under Michigan law. Recent General Motors' filings have disclosed that it is seeking compensatory damages of between \$2.0 and \$2.3 million as well as certain equitable relief, including an injunction. In September 2004, General Motors moved for Summary Judgment on the Company's defenses of waiver, ratification and unclean hands. On November 5, 2004, the Company moved for summary judgment on the issues of liability and damages and on the same date, General Motors moved for summary judgment on the issue of liability. After a hearing in May 2005, the Court granted the Company's motion for summary judgment and dismissed General Motors' complaint. On May 24, 2005, General Motors filed a Notice of Appeal and the appeal is pending before the Federal Sixth Circuit Court of Appeals.

On December 2, 2005, Ford Global Technologies, LLC ( Ford ) filed a complaint with the United States International Trade Commission ( USITC ) against the Company and five other named Respondents, including four Taiwan-based manufacturers. On December 12, 2005, Ford filed an Amended Complaint. Both the Complaint and the Amended Complaint charge the Company and the other Respondents with infringement of 14 design patents that Ford alleges cover eight parts on the 2004-2005 Ford F-150 truck (the Ford Design Patents ). Ford has asked the USITC to issue a permanent general exclusion order excluding from entry into the United States all automotive parts that infringe the Ford Design Patents and that are imported into the United States, sold for importation in the United States, or sold within the United States after importation. Ford also seeks a permanent order directing the Company and the other Respondents to cease and desist from, among other things, selling, marketing, advertising, distributing and offering for sale imported automotive parts that infringe the Ford Design Patents. On December 28, 2005, the USITC issued a Notice of Investigation based on Ford's Amended Complaint. The USITC's Notice of Investigation was published in the Federal Register on January 4, 2006. On January 23, 2006, the Company filed its Response to the Complaint and Notice of Investigation. In the Response, the Company denies, among other things, that any of the Ford Design Patents is valid and/or enforceable and, accordingly, denies each and every allegation of infringement. The Company further asserts several affirmative defenses, any of which, if successful, would preclude the USITC from granting any of Ford's requested relief. The Company intends to vigorously defend this Action. A final determination by the USITC is not expected before December of 2006. To date, the Company's sales of these parts have been minimal, but as the design for the 2004 model is incorporated into later year models of the F-150 and these trucks have been on the road longer, the sale of aftermarket replacement parts will increase substantially. If the USITC were to uphold each of the 14 design patents in question, it is not anticipated that the loss of sales of these parts over time would be materially adverse to the financial condition or results of operations of the Company. However, depending upon the nature and extent of any adverse ruling, other car manufacturers may attempt to assert similar allegations based upon design patents on a significant number of parts for several of its models, which over time could have a material adverse impact on the entire aftermarket parts industry.



**Item 1A. Risk Factors.**

The Company's Form 10-K for the year ended April 1, 2005 (the 2005 10-K) provides disclosure under Item 1. Business Cautionary Statements with respect to certain risks to which the Company is exposed. The risks identified in the 2005 10-K and under Part II- OTHER INFORMATION, Item 1. Legal Proceedings above, which are incorporated by reference herein, as well as those described below, may not be the only risks the Company faces. Additional risks that the Company is not yet aware of or that the Company currently considers to be immaterial may adversely affect the Company. There have been no material changes to the risk factors disclosed in the 2005 10-K except as follows:

*Litigation Impacting Aftermarket Collision Replacement Parts.* As disclosed in the 2005 10-K, there have been numerous lawsuits relating to the use of aftermarket parts in repairing motor vehicles. The leading case involving aftermarket crash parts - *Avery v. State Farm Insurance Company* - was brought in the Circuit Court in Marion, Illinois in July 1997 (Madison County). In that case, plaintiffs asserted claims for breach of contract, consumer fraud and equitable relief relating to State Farm's practice at that time of sometimes specifying aftermarket parts rather than automobile manufacturers (OEM) parts when adjusting claims for the damage to insured vehicles. It was alleged that this practice breached State Farm's insurance agreements with its policyholders and was a violation of the Illinois Consumer Fraud and Deceptive Business Practices Act. In October 1999, after a lengthy trial, the jury in *Avery* awarded plaintiffs compensatory damages of approximately \$586 million. In addition, the judge assessed punitive damages against State Farm of over \$600 million. In April 2001, the Appellate Court of Illinois, Fifth District, upheld the verdict, reducing damages by \$130 million, resulting in an aggregate award of \$1.06 billion. Thereafter, a Petition for Allowance of Appeal to the Illinois Supreme Court was filed by State Farm. In October 2002, the Illinois Supreme Court agreed to hear the appeal. On August 18, 2005, the Illinois Supreme Court reversed the judgments of the Circuit and Appellate Courts resulting in a termination of the case in favor of State Farm. The Illinois Supreme Court denied plaintiffs request for a rehearing. In December 2005, plaintiffs filed a writ of certiorari with the United States Supreme Court seeking a reversal of the action by the Illinois Supreme Court. The United States Supreme Court has the discretion to accept or reject plaintiff's request that the Court hear its appeal.

Shortly after the initial verdict in the *Avery* case, State Farm and many other insurance companies suspended their practice of specifying non-OEM crash parts on repair estimates. While many insurance companies are again specifying certain aftermarket parts in the repair of insured vehicles, State Farm, the nation's largest automobile insurer, has not. Prior to the recent reversal of the State Farm decision by the Illinois Supreme Court, the case has had a negative impact on the Company's sales and net income. There can be no assurance as to the reaction of the insurance industry in the event the United States Supreme Court reverses the dismissal of the *Avery* case by the Illinois Supreme Court or the future impact on the Company's results of operations if that occurred.

*Federal and State Action.* During the past five years, legislation was introduced or considered in over 25 states seeking to prohibit or limit the use of aftermarket parts in collision repair work and/or require special disclosure before using aftermarket parts. During 2005, 31 separate bills were introduced in 13 states. None were passed during 2005. Consistent with prior years, bills potentially impacting the aftermarket collision parts business will be, or have been, introduced in a number of states during 2006. The Company actively works with state legislators and regulatory officials to make them aware of the value to the consuming public of having available a viable alternative to OEM collision parts.

At the present time, legislation regulating the use of aftermarket parts has been adopted in over 40 states. The most common form of regulation, adopted in 35 states, requires disclosure to the vehicle owner that aftermarket crash parts will be used in the repair of the vehicle. An estimated 21 states require the aftermarket part to have the name or logo of the manufacturer affixed to the part. A few states (i) require some form of consent from the vehicle owner before aftermarket parts can be used in the repair, (ii) require that before an aftermarket part can be used in the repair of the vehicle, the part must generally be equal or equivalent in fit, quality and performance to the original equipment part it is replacing or (iii) require the use, under certain circumstances, of aftermarket parts which have been certified by an independent testing facility to be of like kind and quality to the original equipment part. Some states require a combination of the types of regulations described above.

To date, state laws have not had a material impact on the Company's overall business. If a number of states were to adopt legislation prohibiting or further restricting the use of aftermarket crash parts, it could have a material adverse impact on the Company.

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*Prelude Software System Installation.* The Company has completed the installation of its enterprise-wide management information system, consolidating the 13 systems under which the Company once operated. As of December 30, 2005, only the Company's locations in Canada and the operations of Veng acquired in October 2005 remain on separate systems. This was an extremely costly and time-consuming process and additional effort is ongoing to maximize the efficiency and utilization of the system. It is unclear how much it will cost to do the significant work necessary to refine and optimize the system to allow the Company to leverage the benefits of the system, but such costs may be substantial.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds. None.**

**Item 3. Defaults Upon Senior Securities. None**

**Item 4. Submission of Matters to a Vote of Security Holders. None**

**Item 5. Other Information. None (1)**

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- (1) The Company is in the process of discussing a comment from the staff of the Securities and Exchange Commission ( SEC ) as to whether a Form 8-K was required to be filed with the SEC with respect to the Veng acquisition which occurred in the period covered by this Report.

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**Item 6. Exhibits**

a. Exhibits

<b><u>Exhibit No.</u></b>	<b><u>Description</u></b>
31.1	Certification Pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed by the Chief Executive Officer, filed herewith.
31.2	Certification Pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 signed by the Chief Financial Officer, filed herewith.
32.1	Statement Required by 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Executive Officer, filed herewith.
32.2	Statement Required by 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 signed by the Chief Financial Officer, filed herewith.

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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.

**KEYSTONE AUTOMOTIVE INDUSTRIES, INC.**

By: /S/ John M. Palumbo  
John M. Palumbo

Chief Financial Officer

(Duly Authorized Officer and Principal Financial  
and Accounting Officer)

Date: February 8, 2006