AERO SYSTEMS ENGINEERING INC
Form 10-Q
August 08, 2003

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

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended June 30, 2003

[ ] 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 0-7390

Aero Systems Engineering, Inc.
(Exact name of registrant as specified in its charter)

Minnesota	41-0913117
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
358 East Fillmore Avenue, St. Paul, Minnesota	55107
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code 651-227-7515

Securities registered pursuant to Section 12(g) of the Act. Common Stock, Par value, $.20 per share.

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 X No

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 126-2 of the Act).

Yes No X

As of June 30, 2003, 4,401,625 shares of common stock, par value $.20 per share, were outstanding.

AERO SYSTEMS ENGINEERING, INC.

Form 10-Q

Quarter Ended June 30, 2003
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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

AERO SYSTEMS ENGINEERING, INC.
CONDENSED BALANCE SHEETS

ASSETS	June 30, 2003	December 31, 2002
	(Unaudited)	(Note)
	(000's omitted, except share data)	
CURRENT ASSETS		
Cash and Cash Equivalents	$ 1,322	$ 3,234
Accounts Receivable, net	6,044	6,672
Costs and Estimated Earnings in Excess of Billings on Uncompleted Contracts	5,798	6,361

Inventories:		
Materials and Supplies	645	843
Projects in Process	325	360
Prepaid Expenses	145	342
Deferred Income Taxes	998	998
Total Current Assets	15,277	18,810
PROPERTY, PLANT AND EQUIPMENT		
Land	486	486
Buildings	3,025	3,025
Furniture, Fixtures, & Equipment	9,431	9,038
Wind Tunnels & Instrumentation	3,291	3,227
Building Improvements	1,570	1,570
	17,803	17,346
Less Accumulated Depreciation	13,836	13,225
Property, Plant, and Equipment, net	3,967	4,121
Total Assets	$19,244	$22,931

AERO SYSTEMS ENGINEERING, INC.
CONDENSED BALANCE SHEETS
(continued)

LIABILITIES	June 30, 2003	December 31, 2002
	(Unaudited)	(Note)
	(000's omitted, except share data)	
CURRENT LIABILITIES		
Current Maturities of Capital Lease Obligations	$ 28	$ 122
Notes Payable with Related Parties	500	500
Accounts Payable:		
Trade	2,125	2,162
Related parties	53	30
Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts	1,554	3,431
Accrued Warranty and Losses	453	493
Accrued Salaries and Wages	1,244	1,135
Income Tax Payable	137	358
Other Accrued Liabilities	3,864	5,509
Total Current Liabilities	9,958	13,740

OTHER LIABILITIES

Long-term Debt with Related Parties	1,000	1,500
Capital Lease Obligations,		
Less Current Maturities	69	82
Deferred Income Taxes	378	378
STOCKHOLDERS' EQUITY		
Common Stock, $.20 par value		
Authorized shares - 10,000,000		
Issued and outstanding shares - 4,401,625	880	880
Additional Paid-in Capital	900	900
Retained Earnings	6,059	5,451
Total Stockholders' Equity	7,839	7,231
Total Liabilities and Stockholders' Equity	$ 19,244	$ 22,931

Note: The balance sheet at December 31, 2002 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

AERO SYSTEMS ENGINEERING, INC.
CONDENSED STATEMENTS OF EARNINGS

	Three Months Ended June 30,		Six Months June 3
	2003	2002	2003
	(Unaudited)	(Unaudited) (000's omitted, except share data)	(Unaudited)
Earned Revenue	$ 9,757	$ 10,973	$ 19,184
Cost of Earned Revenue	7,580	8,520	14,844
Gross Profit	2,177	2,453	4,340
Operating Expenses	1,710	1,579	3,312
Operating Profit	467	874	1,028
Other (Income) Expense			
Interest Expense	65	86	131
Other	(19)	(7)	(42)

	46	79	89
Income Before Income Taxes	421	795	939
Income Tax Expense	137	270	332
Net Income	$ 284	$ 525	$ 607
NET INCOME PER SHARE	$ 0.06	$ 0.12	$ 0.14
Number of Shares Outstanding	4,401,625	4,401,625	4,401,625
Dividends per Share	None	None	None

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AERO SYSTEMS ENGINEERING, INC.
CONDENSED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
	2003	2002
	(Unaudited)	(Unaudite
	(000's omitted)	
OPERATING ACTIVITIES		
Net income	$ 607	$ 71
Adjustment to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	611	70
Changes in operating assets and liabilities:		
Accounts receivable	628	(1,28
Costs and estimated earnings in excess of billings on uncompleted contracts	563	(78
Inventories	233	(4
Prepaid expenses and other, net	197	18
Accounts payable and accrued expenses	(1,589)	2,45
Income tax payable	(221)	15
Billings in excess of costs and estimated earnings on uncompleted contracts	(1,877)	1,46
Net cash provided by (used in) operating activities	(848)	3,56
INVESTING ACTIVITIES		
Capital expenditures	(457)	(18
Net cash used in investing activities	(457)	(18
FINANCING ACTIVITIES		
Net (repayments) borrowings under line of credit agreements	(500)	(1,70
Principal payments on borrowings from related parties		

Principal payments under capital lease obligations	(107)	(3
Net cash provided by (used in) financing activities	(607)	(1,73
Net increase (decrease) in cash and cash equivalents	(1,912)	(1,92
Cash and cash equivalents at beginning of year	3,234	9
Cash and cash equivalents at end of quarter	$ 1,322	$ 1,73
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the quarter for:		
Interest	43	4

AERO SYSTEMS ENGINEERING , INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
June 30, 2003

NOTE A - BASIS OF PRESENTATION

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by the accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting solely of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six-month period ending June 30, 2003 are not necessarily indicative of the results that may be expected for the year ended December 31, 2003. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2002.

NOTE B - INCOME TAXES

Income taxes are provided on an interim basis based upon management's estimate of the annual effective tax rate.

NOTE C - CONTRACTS IN PROCESS

Information with respect to contracts in process follows:

	June 30, 2003	June 30, 2002
	(000's omitted)	
Costs Incurred on Uncompleted Contracts	$46,467	$49,313
Estimated Earnings Thereon	11,404	17,244
Total Earned Revenue on Uncompleted Contracts	57,871	66,557
Less Billings Applicable thereto	53,627	64,048

	$ 4,244	$ 2,509
	=======	=======
Included in Accompanying Balance Sheet Under Following Captions:		
Costs and Estimated Earnings in Excess of Billings on Uncompleted Contracts	$ 5,798	$ 5,664
Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts	1,554	3,155
	-------	-------
	$ 4,244	$ 2,509
	=======	=======

AERO SYSTEMS ENGINEERING , INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
June 30, 2003

NOTE D - CONTINGENCIES AND COMMITMENTS

Guarantees of approximately $3,975,000 were outstanding at June 30, 2003 to various customers as bid bonds or in exchange for down payments or warranty performance bonds.

NOTE E - PRODUCT WARRANTIES

Aero Systems Engineering, Inc. (ASE) provides a limited standard warranty for all of it's product and services for a period of one year after final acceptance of the work completed and delivered under contract. In certain circumstances, ASE may offer extended warranty terms. ASE's sole liability in respect to any claims under it's warranty is to repair or replace any or all products and services provided which prove to be defective during the warranty period. The warranty reserve is periodically reviewed by manangement and adjusted as need based on current contractual obligations and historical cost information.

Warranty provisions and claims for the periods ended June 30, 2003 and June 30, 2002 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30	
	2003	2002	2003	2002
	(000's omitted)			
Accrued Warranty				
Beginning Balance	400	400	400	400
Warranty provisions	24	48	90	240
Warranty Claims	(24)	(48)	(90)	(240)
Ending Balance	400	400	400	400
	======	======	======	======

AERO SYSTEMS ENGINEERING, INC.

Item 2. Management's Discussion and Analysis of Financial Condition And Results of Operations

In addition to historical information, this Quarterly Report contains forward-looking statements. The forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those reflected in such forward-looking statements. Factors that might cause a difference include, but are not limited to, general economic conditions, the condition of the aerospace industry, signing of future contracts, competitive factors and other risks detailed from time to time in the Company's reports to the SEC, including the report on Form 10-K for the year end December 31, 2002. Actual results may vary materially from those anticipated.

Results of Operations

Three months (second quarter) and six months ended June 30, 2003 (All dollar amounts are in thousands.)

Worldwide revenue for the three months and six months ended June 30, 2003 totaled $9,757 and $19,184 respectively. This represents an 11% and 4% decrease respectively from the $10,973 and $19,900 of revenue for the same periods last year. Net income for the three months and six months ended June 30, 2003 was $284 and $607 respectively as compared to $525 and $718 for the same periods last year. The decrease in revenue and net income was mostly attributable to the lower level of work on the Singapore wind tunnel project during the first six months of 2003 as compared to the same period in 2002 since the project is nearing completion, resulting in lower recognized revenue and profit. This decrease was somewhat offset by an increased level of projects in process during the first three months of 2003 as compared to the same period in 2002 and lower interest expense for the first six months of 2003 as compared to the same period in 2002.

Backlog of orders as of June 30, 2003 was $21,199 as compared with $21,308 and $26,201 as of December 31, 2002 and June 30, 2002, respectively. The change from December 31, 2002 represents a 1% decrease. The total orders received through the six months ended June 30, 2003 were $19,075.

Gross profit for the three months and six months ended June 30, 2003 was $2,177 and $4,340 respectively. This represents 22% and 23% of revenue as compared to $2,453 and $4,264 gross profit respectively or 22% and 21% of revenue for the same periods last year. The $276 decrease in the three months ended June 20, 2003 is a mostly the result of the lower level of work on the Singapore wind tunnel project as it nears completion, resulting in lower recognized gross profit.

The Company recognizes revenue and profit as work on long-term contracts progresses using the percentage-of-completion method of accounting, which relies on estimates of total expected contract revenues and costs. The Company follows this method since reasonably dependable estimates of the revenue and costs applicable to various stages of a contract can be made. Because the financial reporting of these contracts depends on estimates, which are assessed continually during the term of the contract, recognized revenues and profit are subject to revisions as the contract progresses to completion. Revisions in profit estimates are reflected in the period in which the facts that give rise to the revision become known. Accordingly, favorable changes in estimates result in additional profit recognition, and unfavorable changes in estimates result in the reversal of previously recognized revenue and profits. When estimates indicate a loss under a contract, cost of revenue is charged with a provision for such loss. As work progresses under a loss contract, revenue continues to be recognized, and a portion of the contract costs incurred in each period is charged to the contract loss reserve.

Selling, general and administrative expenses for the three months and six months ended June 30, 2003 were $1,510 and $3,031 respectively. This represents 15% and 16% of revenue as compared to $1,474 and $2,820 of SG&A expenses respectively or 13% and 14% of revenue for the same periods last year. The increases for both 2003 periods is mostly related to direct marketing activities and additional third party fees related to pursuing strategic alternatives.

Research and development expenses for the three months and six months ended June 30, 2003 was $200 and $281 respectively as compared to $105 and $183 respectively for the same periods in 2002. This increase of $95 for the three months ended June 30, 2003 is mostly related to the focus of certain resources in second quarter 2003 on a couple of larger R&D projects. During 2003, additional R & D will be incurred for continued enhancements to the ASE2000, aero-acoustic analysis and new product initiatives.

Interest expense for the three months and six months ended June 30, 2003 was $65 and $131 respectively as compared to $86 and $177 respectively for the same periods in 2002. The lower interest expense is the result of a lower average amount of borrowings outstanding in the first six months of 2003 as compared to the first six months of last year, the repayment of $500 in March 2003 of the three year $1,500 note to Celsius Inc., now renamed to Saab Holdings U.S., Inc., and a reduction in capital lease interest expense.

Income tax expense for the three months and six months ended June 30, 2003 was $137 and $332 respectively as compared to $270 and $370 for the same periods in 2002. Income taxes are provided on an interim basis based upon management's estimate of the annual effective tax rate.

Financial Condition

Accounts receivable at the end of second quarter 2003 was $6,044 as compared with the year end balance of $6,672. This decrease of $628 was due mainly to the timing of billing milestones on several large contracts.

Costs and estimated earnings in excess of billings on uncompleted contracts at the end of second quarter 2003 was $5,798, which is a decrease of $563 or 9% as compared with the year-end 2002 balance. The Company recognizes profit on long-term projects on the percentage of completion basis, which permits earned revenue to be recognized prior to the time that progress payments are billed. When this occurs, amounts are added to this asset account for the recognition of earned revenue prior to the billing of progress payments. The decrease since year-end is due to the timing of billing milestones related to the contracts. Billings are a function of contract terms and do not necessarily relate to the percentage of completion of a project.

Current notes payable balances totaled $500 as compared to the year-end 2002 balance of $500. This represents a note to Minnesota ASE, LLC that does not have a stated due date.

Accounts payable and accrued expenses at the end of second quarter 2003 decreased $1,589 or 17% as compared to the year-end 2002 balance. This was primarily due to a decrease in accrued job costs relating to ongoing projects.

Billings in excess of costs and estimated earnings on uncompleted contracts at the end of second quarter 2002 decreased $1,877 to $1,554 compared to the year-end 2002 balance of $3,431. The decrease since year-end is due to the timing of billing milestones related to contracts. Billings are a function of contract terms and do not necessarily relate to the percentage of completion of a project.

Liquidity and Capital Resources

The Company has consistently relied upon bank credit lines during recent years as a source of its working capital resources and liquidity. During the third quarter 2001, Celsius Inc. which effective July 1, 2003 has been renamed to Saab Holdings U.S., Inc. ("Saab Holdings") sold 51% of the total outstanding shares of common stock of ASE to Minnesota ASE, LLC. Related to this transaction, the Company has secured new bank financing agreements for operating funds and future letter of credit needs. These new agreements are asset based collateral agreements, with the funds available under these agreements determined by the available securable assets at any point in time, up to a maximum of $6,000 of operating funds, and $4,000 of letter of credit funds. Also related to the transaction, Saab Holdings has agreed to continue to hold certain existing bank guarantees until maturity that were previously provided to a few of the Company's customers, and Saab Holdings has provided a three year $1,500 loan to the Company at 8% per year, which is subordinated debt under the new bank agreement. The Company has provided an indemnification agreement to Saab Holdings to secure Saab Holdings's interest in the above items. In March of 2003, in connection with Saab AB providing an extension to a down payment letter of credit to one of the Company's customers, the Company repaid to Saab Holdings, $500,000 of the $1,500,000 three-year note. The average funds available and amounts outstanding on the operating line and letter of credit during the second quarter 2003 were $0 outstanding on $3,040 available and $2,229 outstanding on $4,000 available, respectively.

At the end of the second quarter 2003, the Company had notes payable balances of $500 current and $1,000 long term. The current notes payable balance of $500 consisted of interim loans provided by Minnesota ASE, LLC. The $500 note to Minnesota ASE, LLC is at 8% per year and does not have a stated maturity date. The Company believes that these bank lines of credit, along with cash flows from continuing operations, are adequate to support the Company's cash needs for the immediate future.

Capital expenditures for the three months and six months ended June 30, 2003 were $327 and $457 respectively as compared to $146 and $189 for the same periods last year. Additional capital expenditures will be used to acquire additional equipment for research and development projects, facility improvements and desktop upgrades. We expect the total capital expenditures for the year ending December 31, 2003 to approximate the year ended December 31, 2002.

Market Risk

The Company operates on a global basis and, during an average year, generates approximately 50% of its revenues from international customers. This trend has continued for the last five years as foreign airlines and government agencies purchase products that ASE designs and produces. Most of the Company's contracts are denominated in U.S. dollars. However, a few of them are denominated in the customer's local currency. Therefore, the Company has entered into foreign exchange forward contracts having maturities within the next eighteen months. The face amounts represent U.S. dollar equivalents of a non-U.S. dollar denominated forward contract. The amounts at risk are not material, and the Company has the financial ability to generate cash flows to offset the expected gains or losses when the contracts mature.

Forward-Looking Information

Highly competitive market conditions have increased pressure to reduce margins on new contracts. The Company has partially offset this pressure with productivity improvements and cost reduction programs.

Looking ahead throughout the remainder of 2003, the amount of business in backlog and the number of proposals outstanding should continue to provide a solid base for the remainder of the year.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The Company's long-term contracts are substantially all denominated in U.S. dollars. In certain circumstances, the Company has hedged its exposure to foreign currency fluctuations. A 10% adverse change in foreign currency rates would not have a material effect on the Company's results of operations or financial position.

The Company is also subject to interest rate risk. The Company has not hedged its exposure to interest rate fluctuations; however, a 10% increase or decrease in interest rates would not have a material effect on the Company's results of operations, fair values, or cash flows.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The term "disclosure controls and procedures" is defined in Rules 13a-14(c) and 15d-14(c) of the Securities Exchange Act of 1934 (Exchange Act). These rules refer to the controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods. Our management, including the Chief Executive Officer and Chief Financial Officer has evaluated the effectiveness of the design and operation of our disclosure controls and procedures at the end of the period covered by this quarterly report. Based on their evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures were effective as of June 30, 2003. There were no changes in our internal controls over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to affect, the Company's internal controls over financial reporting.

Changes in Internal Controls

We maintain a system of internal accounting controls that are designed to provide reasonable assurances that our books and records accurately reflect our transactions and that our established policies and procedures are followed. For the quarter ended June 30, 2003, there were no significant changes to our internal controls or in other factors that could significantly affect our internal controls subsequent to the date of evaluation referenced in the paragraph above.

PART II - OTHER INFORMATION

Item 6: Exhibits and Reports on Form 8-K

(a) Exhibit Number and Description

31.1 Rule 13a-14(a) Certification of Charles H. Loux, Chief Executive Officer

31.2 Rule 13a-14(a) Certification of Steven R. Hedberg, Chief Financial Officer

32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to section 906 of the Sarbanes-Oxley Act of 2002 by Chief Executive Officer

32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to section 906 of the Sarbanes-Oxley Act of 2002 by Chief Financial Officer

(b) On April 29, 2003, the registrant filed a Form 10K/A Amendment No. 1 to disclose information required by Part III of it's previously filed Form 10K.

(c) Reports on Form 8-K

On August 7, 2003, the Company filed a Current Report on Form 8-K with the Securities and Exchange Commission, reporting the earnings for the second quarter ended June 30, 2003 and comments on strategic alternatives.

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 thereto duly authorized.

Date: August 7, 2003

/s/ Charles H. Loux

Charles H. Loux, President and CEO

/s/ Steven R. Hedberg

Steven R. Hedberg, Chief Financial Officer