GENERAL KINETICS INC
Form 10-K
August 30, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended May 31, 2004

Commission File No. 0-1738

GENERAL KINETICS INCORPORATED

(Exact Name of Registrant as specified in its Charter)

Virginia	**54-0594435**
(State of Incorporation)	**(IRS Employer Identification No.)**
10688-D Crestwood Drive, Manassas, VA	**20109**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number (703) 331-8033

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Title of Each Class

Common Stock, $0.25 par value 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 check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K [ ].

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2) YES ¨ NO x

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based upon the closing sale price of Common Stock on November 30, 2003, the last business day of the registrant s most recently completed second fiscal quarter, as reported on the NASD OTC Bulletin Board, was approximately $208,837. Shares of Common Stock held by the executive officers, directors and under the Registrant s ESOP have been excluded in that such persons may be deemed affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares outstanding of Registrant s Common Stock, $0.25 par value, as of August 16, 2004, was	7,118,925

Documents Incorporated by Reference

Certain portions of the Registrant s Proxy Statement to be filed with the Securities and Exchange Commission not later than 120 days after the end of the Registrant s 2004 fiscal year are incorporated into Part III hereof.

CAUTIONARY STATEMENT REGARDING FORWARD LOOKING STATEMENTS

Certain statements contained in this Annual Report on Form 10-K constitute forward-looking statements . In some cases, forward-looking statements can be identified by the use of forward-looking terminology such as may, will, estimate, intend, continue, believe, expect o anticipate or the negatives thereof, variations thereon or similar terminology. The forward-looking statements contained in this Annual Report are generally located in the material set forth under the headings Business and Management s Discussion and Analysis of Financial Condition and Results of Operations, but may be found in other locations as well. These forward-looking statements generally relate to plans and objectives for future operations and are based upon management s reasonable estimates of future results or trends. Although the Company believes that the plans and objectives reflected in or suggested by such forward-looking statements are reasonable, such plans or objectives may not be achieved. Actual results may differ from projected results due, but not limited, to unforeseen developments, including developments relating to the following:

the risk that the Company may not be able to obtain and complete sufficient new orders to maintain positive cash flow;

the risk that the Company may not maintain its present financing facility or obtain additional financing, if necessary;

the risk that it will not be able to repay or refinance in full the approximately $8.8 million principal amount of its outstanding convertible debentures due August 2004;

the risk that the Company may not be able to continue the necessary development of its operations, including maintaining or increasing sales and production levels, on a profitable basis;

the risk the Company may in the future have to comply with more stringent environmental laws or regulations or more vigorous enforcement policies of regulatory agencies, and that such compliance could require substantial expenditures by the Company; and

the risk that U.S. defense spending may be substantially reduced; and

the risk that the Company s Common Stock will not continue to be quoted on the NASD Over The Counter Bulletin Board.

You should read this Annual Report completely and with the understanding that actual future results may be materially different from what the Company expects. All subsequent written and oral forward-looking statements attributable to the Company or to persons acting on the Company s behalf are expressly qualified in their entirety by the foregoing factors. These forward-looking statements speak only as of the date of the document in which they are made. The Company disclaims any obligation or undertaking to provide any updates or revisions to any forward-looking statement to reflect any change in the Company s expectations or any change in events, conditions or circumstances in which the forward-looking statement is based.

PART I

ITEM 1 - BUSINESS

(a) General Development of Business

General Kinetics Incorporated (the Company or GKI) designs and manufactures high-quality precision enclosures for sophisticated electronic systems, principally for sale to the U.S. Department of Defense and the U.S. Navy.

The Company was founded as a Virginia corporation in 1954 and its common stock became publicly traded in November 1961.

Beginning in December 1992, and ending in August 1994, the Company s operations were financed to a significant extent by debt and equity investments made by clients of Gutzwiller & Partner, A.G.(Gutzwiller), a corporation formed under the laws of Switzerland, now known as Rabo Investment Management Ltd. (the Manager). At May 31, 2004, convertible debentures initially issued to clients of Gutzwiller were outstanding in an aggregate principal amount of approximately $8.8 million. Such debentures mature in August 2004, are convertible into common stock at a conversion price of $0.50 per share, and bear interest at 1% per annum, which is payable annually. Shares issuable upon conversion are also subject to certain rights to registration under the Securities Act of 1933, as amended.

In a Schedule 13-D/A filed with the SEC dated November 9, 2001, the Manager indicated that it may be deemed to be the beneficial owner of debentures in an aggregate principal amount of $7,885,000, including debentures in an aggregate principal amount of $585,000 which were purchased by the Manager to which the Manager is the economic beneficial owner of and holds sole voting and dispositive power, and $7,300,000 held in client accounts managed by the Manager on behalf of various clients who hold beneficial economic ownership thereof to which the Manager holds voting and dispositive power. Such Schedule 13D/A also indicated that the Manager may be deemed to be the beneficial owner of an aggregate of 1,715,000 outstanding shares of the Company s common stock, including 242,700 shares purchased by the Manager to which the Manager is the economic beneficial owner of and holds sole voting and dispositive power and 1,472,300 shares held in client accounts.

On March 12, 2003, Manassas Partners LLC, a Delaware limited liability company of which Larry Heimendinger, Chairman of the Board of Directors of the Company, is the managing member, purchased from third parties, at a significant discount, a portion of the Company s outstanding convertible debentures in an aggregate principal amount of $5,800,000.

The Company s cash flow, capital resources, and overall financial condition will not be sufficient to repay or refinance in full the approximately $8.8 million principal amount of outstanding convertible debentures which mature on August 14, 2004. The Company has reached agreement in principal with holders of approximately $1.7 million principal amount of such debentures for the purchase of these debentures at a total price (including interest) equal to 3% the principal amount. At present, the Company is in discussion with certain other debenture holders, but has decided on no specific plans with respect to the repayment or refinancing of the debentures. The Company is continuing to review the situation and consider its potential alternatives. There can be no assurances, however, that the Company will be able to come to agreement with the other debenture holders with respect to repayment or refinancing of the debentures.

(b) Financial Information About Industry Segments

The Company is currently operating in a single industry segment.

(c) Narrative Description of Business

The Business

General

The Company designs and manufactures high-quality precision enclosures for sophisticated electronic systems. The Company is a manufacturing and engineering services company which produces build-to-print as well as custom engineered products. The Company has manufactured electronics-ready enclosures and mounting systems for over 40 years. Products include both standard and made-to-order racks, cabinets and kits. These products are precision-manufactured to enclose and protect sensitive electronic communication and detection equipment from shock and vibration. The principal customer for these products is the U.S. Navy which, directly or indirectly through its prime contractors, accounted for 99%, 93%, and 94% of the Company s revenues in fiscal 2004, 2003 and 2002, respectively. The Company sells these products as a prime contractor and also as a subcontractor to major prime contractors such as Lockheed Martin, Raytheon, SAIC, Northrop Grumman, and DRS Laurel Technologies.

Strategy

The Company s long-term goals are to increase market penetration within the Department of Defense, and to expand into the non-government marketplace by targeting build-to-print or engineering design opportunities for enclosures and related products. The Company entered the commercial enclosure marketplace in fiscal 2000. The current strategy for these products is to concentrate on selling high-end precision enclosures through a small network of U.S. sales representatives. The Company does not expect the non-government marketplace to provide a significant portion of the Company s sales during fiscal 2005. Management intends to use its current sales force and build on its reputation for quality to expand sales to the U.S. Navy and other agencies within the government.

The Company plans to finance its strategy for fiscal 2005 through cash on hand as of May 31, 2004, careful management of operating expenses, factoring accounts receivable to alleviate short-term cash requirements, and cash flow generated through operations. The Company may also seek additional sources of debt or equity financing to allow it to meet cash commitments if sales and shipment levels fluctuate throughout the fiscal year.

Products

The Company s principal products are enclosures, such as racks, cabinets, consoles, and mounting platforms for sophisticated electronic systems generally made in accordance with specific client requirements. The Company has developed a series of consoles and enclosures to offer as commercial-off-the-shelf products to be sold to prime contractors for contracts in the defense community that require this type of enclosure. These consoles and enclosures provide an environment that makes it possible to use commercial electronics while meeting the need for combat ready systems.

The Company s production processes cover a wide range of operations, including high volume production using tight tolerance, military-specified engineering requirements. Military specifications for metal fabrication and machinery require geometric dimensioning to and from fabricated areas to datums within ten thousandths (.0001) of an inch of their true fabricated position, and the machining of parts to a size of plus or minus one thousandth (.001) of an inch of their specified dimension. Furthermore, the Company has in-plant facilities to test for radio frequency interference (R.F. testing) as it is required to certify certain products. The Company fabricates metal cabinets and other products from sheet aluminum and steel and other metal components, all of which are readily available from numerous domestic suppliers. The manufactured products must satisfy the close-tolerance specifications of its customers and are subjected to in-house sound testing to ensure that the levels of noise emanating from the enclosures at various frequencies are within customer specifications. The Company s products have high visibility in such programs as AEGIS and other major U.S. Government programs.

Customers

During fiscal years 2004, 2003, and 2002, the Company sold 99%, 93%, and 94%, respectively, of its products to the U.S. Government, principally to the U.S. Navy, either as a prime contractor or a subcontractor to major prime contractors. Therefore, a material decline in spending by the Department of Defense, in particular spending by the U.S. Navy, could have a material adverse effect on the operations of the Company, unless offset by greater market penetration or new sales to other government and commercial customers. In addition, the Company s U.S. Government contracts and, in general, its subcontracts with the U.S. Government s prime contractors provide that such contracts may be terminated by the U.S. Government or prime contractor for convenience at any time. The Company considers its relationships with the U.S. Navy and its major prime contractor customers to be good.

Marketing and Sales

The Company currently markets its products through a direct sales force and through outside agencies. The Company also participates in industry trade shows as a means of contacting new and existing customers and introducing new products.

Backlog

The Company sells its products pursuant to both long and short-term contracts with scheduled backlog and delivery orders. Amounts are not carried in backlog until the related contracts receive government funding (in the case of government contracts) and, in any event, delivery orders are released to the Company. Once an order is received, production and delivery can be scheduled, but in some instances dates can be delayed by changing requirements of government or commercial customers.

The Company s contract backlog as of May 31, 2004 and May 31, 2003 was approximately $2.5 million and $1.4 million, respectively. All of the $2.5 million backlog at May 31, 2004 is expected to be shipped during fiscal 2005. The Company does not believe that seasonal fluctuations play a significant role in the backlog for its business.

Competition

The Company operates in a mature, highly fragmented market with intense competition. The principal elements of competition are price, the ability to deliver products in accordance with major U.S. Government and prime contractor production schedules, technical expertise, quality, service and support. The Company believes that the Company competes with approximately 25 other manufacturers of electronic enclosures, including, in some instances, major prime contractors, which are also customers of the Company. Certain of the Company s competitors have significantly greater financial, marketing and technological resources than the Company.

Research and Development

The Company expects research and development activities to total less than $50,000 during fiscal 2005. No material research and development expenses were incurred in fiscal 2004, 2003 or 2002.

The U.S. Government Procurement Process

The majority of the Company s fiscal 2004 revenue was generated from sales directly to departments and agencies of the U.S. Government, and to prime contractors reselling to the U.S. Government market, principally to the U.S. Navy. Revenue from these sales represented approximately 99% of the Company s total revenue in fiscal 2004. The Company sells to the U.S. Government through a wide variety of contract procurement mechanisms that include formal solicitations and requests for quotes. The Company s sales to U.S. Government prime contractors are typically made through contracts secured by formal competitive bidding.

The Company s U.S. Government contracts and, in general, its subcontracts with the U.S. Government s prime contractors, provide that such contracts may be terminated by the U.S. Government or prime contractor for convenience at any time. The Company estimates that substantially all of the Company s fiscal 2004 revenue was derived from contracts that are subject to termination for convenience. In the event of such a termination, the Company is normally entitled to receive the purchase price for delivered items, reimbursement for allowable costs for work in process, and an allowance for profit thereon or adjustment for loss if completion of performance would have resulted in a loss. There were no terminations for convenience in fiscal 2004, 2003, or 2002. Upon termination of a U.S. Government contract for contractor default, the U.S. Government may seek to recover from the defaulting contractor the increased costs of procuring the specified goods and services from a different contractor. The U.S. Government to date has not terminated for default of any contract awarded to the Company.

In connection with its efforts to compete for U.S. Government business, the Company has enjoyed certain statutory advantages as a consequence of its size, location and the American-made character of its products. Such advantages may not be available to the Company in the future. Although the Company believes that it will continue to qualify under these statutory provisions for the foreseeable future, the Company does not believe that the loss of such status would be likely to have a material adverse effect upon the Company.

The Company s sales to the U.S. Government are subject to numerous other factors beyond the Company s control that generally apply to other U.S. Government contractors, including fluctuations and delays resulting from the appropriations process, the outcome of competition for contracts, and reductions in levels of military and other agencies spending.

Employees and Labor Agreements

As of May 31, 2004, the Company had 76 employees, all located in the United States. Of the 76 employees, 18 were salaried and 58 were paid by the hour. At that date, on a Company-wide basis, there were 3 employees in engineering, 1 employee in sales and marketing, 62 employees in manufacturing and assembly operations, and 10 employees in an executive capacity or in finance and administration. Forty-nine of the Company s employees are represented by the International Brotherhood of Electrical Workers Union (the Union) in Johnstown, Pennsylvania. The Company and the Union are working under a three-year collective bargaining agreement that will expire on May 31, 2007. The Company considers its employee relations to be good.

Environmental Matters

The Company uses limited amounts of hazardous materials in its production process, primarily in the treatment of metal components. All such materials are disposed of by independent certified carriers. The Company believes it operates its facilities in compliance, in all material respects, with all existing federal, state and local environmental regulations.

Pursuant to the requirements of applicable federal, state, and local statutes and regulations, the Company believes it has received all of the environmental permits and approvals necessary for the operations of its facilities.

(d) **Financial Information about Geographic Areas**

The Company has not had significant foreign operations or export sales.

ITEM 2 - PROPERTIES

The Company maintains its executive offices in a leased facility in Manassas, Virginia that is approximately 1,850 square feet.

The Company s manufacturing facilities are presently located in an industrial manufacturing plant in Johnstown, Pennsylvania that was owned by the Company. On May 19, 2004 the Company sold its single-story manufacturing facility in Johnstown, Pennsylvania to James F. Hargreaves and Carl Vulcan, Trustees of Fund A Under the Last Will and Testament of Paul J. Petrovich, Deceased (the Buyer), in a sale-leaseback transaction. The Buyer has no material relationship to the Company or any of its affiliates, any director or officer of the Company or any associate of any such director or officer.

The property consists of the building, fixtures and other improvements constructed thereon, including but not limited to approximately 56,000 square feet of manufacturing facilities and office space and approximately 10 acres of land. The total sale price of the property was $1,000,000. After payment of the mortgage on the property and other expenses incurred in connection with the sale, the net proceeds to the Company were approximately $692,000. The amount of consideration paid was determined in arms-length negotiations between the parties.

The Company s lease for the manufacturing facility commenced on June 1, 2004 and will end on May 31, 2009. The current annual base rent payable under the lease is approximately $180,000. The Company has the right, at its option, to extend the initial term of its lease for two additional five-year periods at a base rent to be negotiated, but not more than 10% over the base rent charged during the previous term. The Buyer, as landlord, is responsible for the maintenance and repair of the roof, plumbing, electrical, heating and air conditioning, exterior walls, doors, windows, corridors and other common areas of the manufacturing facility.

The Company believes that its present facilities are adequate to meet its current production requirements.

ITEM 3 - LEGAL PROCEEDINGS

As of the date hereof, there are no material pending legal proceedings, to which the Company is a party or of which any of its property is the subject.

ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SHAREHOLDERS

None

PART II

ITEM 5 - MARKET FOR THE COMPANY S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company s Common Stock, $0.25 par value per share, is quoted on the Over the Counter (OTC) Bulletin Board, under the symbol GKIN . The table below presents the high and low sales prices as reported for the fiscal quarters within the two most recent fiscal years:

Quarter Ended	High	Low
May 31, 2004	$ 0.05	$ 0.02
February 29, 2004	$ 0.06	$ 0.02
November 30, 2003	$ 0.06	$ 0.02
August 31, 2003	$ 0.03	$ 0.01
May 31, 2003	$ 0.09	$ 0.02
February 28, 2003	$ 0.06	$ 0.01
November 30, 2002	$ 0.04	$ 0.01
August 31, 2002	$ 0.05	$ 0.03

The number of holders of record of the Company s Common Stock, $0.25 par value, as of August 25, 2004, was 1,002.

The Company has not paid any dividends during the last five fiscal years and has no present plans to pay dividends in the foreseeable future.

ITEM 6 - SELECTED FINANCIAL DATA

The following sets forth certain selected financial data for each of the years in the five-year period ended May 31, 2004. The statement of operations data for the fiscal years ended May 31, 2004, 2003, 2002 and the balance sheet data at May 31, 2004 and 2003 are derived from and are qualified by reference to the financial statements of the Company audited by BDO Seidman, LLP, the Company s independent registered public accounting firm, included elsewhere, herein. The statement of operations data for the fiscal years ended May 31, 2001 and 2000 and the balance sheet data at May 31, 2002, 2001 and 2000 are derived from financial statements of the Company also audited by BDO Seidman, LLP, but not included herein. The financial data should be read in conjunction with, and are qualified by reference to, the financial statements and related notes and other financial information, the going concern opinion provided by the Company s auditors, and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere herein.

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	Years ended May 31				
	2000	2001	2002	2003	2004
	(in thousands, except per share data)				
Statement of Operations Data:					
Net Sales	$ 8,833	$ 8,259	$ 8,870	$ 6,377	$ 6,358
Cost of sales	7,828	6,736	7,691	5,107	5,521
Gross profit	1,005	1,523	1,179	1,270	837
Selling, general, and administrative expenses	1,514	1,565	1,559	1,203	1,150
Product R&D, and improvement	0	43	0	3	1
Manufacturing Start-Up Costs	0	0	265	0	0
Operating income (loss)	(509)	(85)	(645)	64	(314)
Gain on Note Settlement	279	0	0	0	0
Other Income	0	175	37	0	0
Interest expense, net	(299)	(220)	(227)	(195)	(213)
Loss before income taxes	(529)	(130)	(835)	(131)	(527)
Provision for income taxes	0	0	0	0	0
Net Loss	$ (529)	$ (130)	$ (835)	$ (131)	$ (527)
Basic and Diluted Earnings Per Share:					
Basic loss per share	(.08)	(.02)	(.12)	(.02)	(.07)
Weighted average common shares outstanding	6,719	6,719	6,719	6,899	7,119
Cash dividends per common share	0	0	0	0	0

Balance Sheet and Other Data:

	May 31,				
	2000	2001	2002	2003	2004
			(in thousands)		
Working capital (deficit)	$ 1,381	$ 1,351	$ 606	$ 556	$ (8,109)
Cash	958	388	185	114	670
Total assets	4,130	4,009	2,918	2,156	2,405
Net property, plant & equipment	925	802	800	703	162
Capital expenditures	93	34	46	50	18
Long-term liabilities	9,570	9,551	9,597	9,334	696
Total Stockholders Deficit	$ (7,166)	$ (7,296)	$ (8,132)	$ (8,065)	$ (8,592)

ITEM 7 - MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

The following table sets forth items from the Company s statements of operations for fiscal years 2002, 2003 and 2004 (each ended May 31), as a percentage of revenue.

Percent of Revenue

	2002	2003	2004
Net sales	100.0%	100.0%	100.0%
Gross profit	13.3%	19.9%	13.2%
Operating expenses	(20.6)%	(18.9)%	(18.1)%
Operating income (loss)	(7.3)%	1.0%	(4.9)%
Interest expense	(2.5)%	(3.1)%	(3.4)%
Other Income	0.4%	0.0%	0.0%
Net loss	(9.4)%	(2.1)%	(8.3)%

Fiscal Year 2004 Compared to Fiscal Year 2003

Net sales for fiscal 2004 were $6.36 million and substantially unchanged from $6.38 million for fiscal 2003.

The principal customer for the Company s products is the U.S. Government, principally the U.S. Navy, which, directly or through its prime contractors, accounted for 99% of the Company s revenues in fiscal year 2004. The Company s sales to the U.S. Government and its prime contractors represented approximately 93% and 94% of total net sales during the Company s fiscal years ended May 31, 2003 and May 31, 2002, respectively, and are expected to continue to account for a substantial portion of the Company s revenues for the foreseeable future. The Company s contracts with the U.S. Government are subject to the availability of funds through annual appropriations, may be terminated by the government for its convenience at any time and generally do not require the purchase of a fixed quantity of products. Reductions in U.S. Government defense spending could adversely affect the Company s operating results. While the Company is not aware of present or anticipated reductions in U.S. Government spending on specific programs or contracts pursuant to which the Company has sold material quantities of its products, there can be no assurance that such reductions will not occur or that decreases in U.S. Government defense spending in general will not have an adverse effect on sales of the Company s products in the future.

Gross profit for fiscal 2004 was approximately $837,100 compared with approximately $1.3 million for fiscal 2003. Gross profit as a percentage of sales decreased from 19.9% in fiscal 2003 to 13.2% in fiscal 2004. The primary reason for the decrease in gross profit margins was changes in the mix of jobs produced in the fiscal year ended May 31, 2004 as compared to the job mix in the fiscal year ended May 31, 2003. The Company operates as a job shop, making a mix of build-to-print cabinets and parts, standard cabinets, and special orders, all with variable quantities depending on the current contracts. Therefore, the mix of orders and margins associated with those orders can vary significantly between quarters. The Company continues to address production planning through plant supervision and regular updating of scheduling and planning procedures. The Company is trying to stabilize the level of shipments at a profitable level through these changes.

Operating expenses for fiscal 2004 were approximately $1.15 million compared with $1.21 million for fiscal 2003. The small decrease from fiscal 2003 was principally due to cost reduction measures during the first two quarters of fiscal 2004, including salary decreases, put into place by management in response to then reduced backlog and shipping levels.

Interest Expense

Interest expense increased to $213,500 in fiscal 2004 as compared to $195,200 in fiscal 2003. This increase occurred principally because interest expense from factoring accounts receivable was $40,000 in fiscal 2004 as compared to $12,000 in fiscal 2003.

The overall net loss was $527,300 for fiscal 2004 as compared to a net loss of $131,400 in fiscal 2003. The increase in the loss was primarily due to the decrease in gross profits discussed above.

Income Taxes

The Company had no income tax provision in fiscal 2004 or fiscal 2003 due to the net losses. Under Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (SFAS 109), deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company has provided a full valuation allowance against its net deferred tax asset due to uncertainties of its ultimate realization. If the Company achieves profitable operations, it will be subject to alternative minimum taxes, which have a lower effective tax rate than the statutory rate of 34%.

Fiscal Year 2003 Compared to Fiscal Year 2002

Net sales for fiscal 2003 were approximately $6.4 million as compared with $8.9 million for fiscal 2002, representing a decrease of 28%. The decrease in sales was due primarily to a decrease in orders under a large blanket contract with a prime contractor to the U.S. Navy, in addition to an overall slowdown of orders from customers involved in projects related to the U.S. Navy.

Gross profit for fiscal 2003 was approximately $1.3 million compared with approximately $1.2 million for fiscal 2002. Gross profit as a percentage of sales increased from 13.3% in fiscal 2002 to 19.9% in fiscal 2003. The primary reasons for the increase in the gross profit percentage were the mix of jobs for the current fiscal year as compared to the prior fiscal year, along with improved scheduling and planning procedures implemented during the prior fiscal year.

Operating expenses for fiscal 2003 were approximately $1.2 million compared with $1.8 million for fiscal 2002. The decrease from fiscal 2002 was partially due to the Company recognizing, in 2002, $265,100 in start-up costs related to a large blanket contract with a U.S. Navy prime contractor. The Company incurred significant costs in planning, implementing, and training employees for the new production process related to this contract. In accordance with generally accepted accounting principles, the Company expensed these start-up costs. No such costs were incurred in fiscal 2003. In addition, the reduction was partially due to cost control measures during the third and fourth quarters of fiscal 2003, including salary reductions implemented by management in response to reduced backlog and shipping levels.

During fiscal 2002, the Company recorded $37,400 in other income related to stock issued to the Company in December 2001 by Prudential Financial upon its conversion from a mutual life insurance company to a stock company.

Interest Expense

Interest expense decreased to $195,200 in fiscal 2003 as compared to $227,800 in fiscal 2002. This decrease occurred principally because interest expense from factoring accounts receivable was $12,000 in fiscal 2003 as compared to $29,500 in fisca