ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC
Form 10-Q
November 10, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended September 30, 2008

OR

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

Commission File Number 1-10367

Advanced Environmental Recycling Technologies, Inc.
(Exact name of registrant as specified in its charter)

Delaware	**71-0675758**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
914 N Jefferson Street Post Office Box 1237 Springdale, Arkansas	**72765**
(Address of principal executive offices)	*(Zip Code)*

(479) 756-7400
(Registrant s telephone number, including area code)

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: þ NO: o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of *large accelerated filer,* *accelerated filer* and *smaller reporting company* in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o (Do not check if a smaller reporting company) Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date. As of November 7, 2008, the number of shares outstanding of the Registrant s Class A common stock, which is the class registered under the Securities Exchange Act of 1934, was 47,423,680 and the number of shares outstanding of the Registrant s Class B Common Stock was 1,465,530.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.
BALANCE SHEETS

	September 30, 2008 (unaudited)	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 1,389,902	$ 1,716,481
Restricted cash	10,580,408	11,461,950
Restricted certificate of deposit		871,468
Trade accounts receivable	3,500,442	1,803,168
Other accounts receivable	173,511	63,453
Inventories	13,339,663	23,622,586
Prepaid expenses	1,299,575	892,462
Total current assets	30,283,501	40,431,568
Land, buildings and equipment:		
Land	1,988,638	1,988,638
Buildings and leasehold improvements	10,008,257	10,008,257
Machinery and equipment	52,233,729	51,690,169
Transportation equipment	1,235,126	1,148,046
Office equipment	2,021,475	1,169,213
Construction in progress	5,659,960	4,218,303
Total land, buildings and equipment	73,147,185	70,222,626
Less accumulated depreciation	34,810,978	31,380,005
Net land, buildings and equipment	38,336,207	38,842,621
Other assets:		
Deferred tax asset	12,301,374	8,851,412
Debt issuance costs, net of accumulated amortization of $1,286,154 at September 30, 2008 and $1,052,949 at December 31, 2007	3,397,320	3,042,645
Debt service reserve fund	2,412,500	3,391,500
Other assets, net of accumulated amortization of $442,740 at September 30, 2008 and $421,310 at December 31, 2007	338,912	361,557
Total other assets	18,450,106	15,647,114
Total assets	$ 87,069,814	$ 94,921,303

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

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ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.
BALANCE SHEETS

	September 30, 2008 (unaudited)	December 31, 2007
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable trade	$ 9,704,959	$ 9,274,134
Accounts payable related parties	535,865	350,882
Current maturities of long-term debt	5,878,335	9,582,145
Current maturities of capital lease obligations	207,559	224,840
Accruals related to expected settlement of class action lawsuit	5,594,784	
Other accrued liabilities	6,423,642	6,084,345
Working capital line of credit	11,175,254	12,303,378
Notes payable	783,200	385,229
Total current liabilities	40,303,598	38,204,953
Long-term debt, less current maturities	25,933,557	25,707,959
Capital lease obligations, less current maturities	640,198	796,305
	26,573,755	26,504,264
Accrued dividends on convertible preferred stock	336,958	136,957
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $.01 par value; 5,000,000 shares authorized, 788,182 and 757,576 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	7,882	7,576
Class A common stock, $.01 par value; 100,000,000 shares authorized; 46,364,664 and 46,314,250 issued and outstanding at September 30, 2008 and December 31, 2007, respectively	463,647	463,143
Class B convertible common stock, $.01 par value; 7,500,000 shares authorized; 1,465,530 shares issued and outstanding at September 30, 2008 and December 31, 2007	14,655	14,655
Warrants outstanding; 3,787,880 at September 30, 2008 and December 31, 2007	1,533,578	1,533,578
Additional paid-in capital	51,727,966	50,872,462
Accumulated deficit	(33,892,225)	(22,816,285)
Total stockholders equity	19,855,503	30,075,129
Total liabilities and stockholders equity	$ 87,069,814	$ 94,921,303

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

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ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.
STATEMENTS OF OPERATIONS (UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net sales	$ 18,633,941	$ 25,237,430	$ 73,074,928	$ 73,413,020
Cost of goods sold	16,302,497	23,172,267	61,465,632	64,519,603
Estimated liability for claims resolution from class action settlement	453,284		2,869,784	
Gross margin	1,878,160	2,065,163	8,739,512	8,893,417
Selling and administrative costs	4,361,123	4,180,787	16,183,937	12,101,541
Loss from fixed asset impairment and disposition	127,622		595,860	
Operating loss	(2,610,585)	(2,115,624)	(8,040,285)	(3,208,124)
Other income (expense):				
Estimated liability from expected class action settlement			(2,500,000)	
Late registration fees	(12,904)		(682,259)	
Interest income	(88,548)	48,505	42,354	143,972
Interest expense	(302,564)	(1,081,297)	(2,745,712)	(2,970,119)
Net other expense	(404,016)	(1,032,792)	(5,885,617)	(2,826,147)
Loss before dividends, income tax and extraordinary item	(3,014,601)	(3,148,416)	(13,925,902)	(6,034,271)
Accrued dividends on preferred stock	(200,000)		(600,000)	
Loss before income tax and extraordinary item	(3,214,601)	(3,148,416)	(14,525,902)	(6,034,271)
Income tax benefit	(1,302,723)	(1,186,569)	(3,449,962)	(2,516,846)
Loss before extraordinary item	(1,911,878)	(1,961,847)	(11,075,940)	(3,517,425)
Extraordinary gain on involuntary conversion of non-monetary assets due to fire (net of income tax)		432,403		432,403
Net loss applicable to common stock	$ (1,911,878)	$ (1,529,444)	$ (11,075,940)	$ (3,085,022)
Loss per share of common stock before extraordinary item (Basic)	$ (0.04)	$ (0.04)	$ (0.23)	$ (0.08)
Loss per share of common stock before extraordinary item (Diluted)	$ (0.04)	$ (0.04)	$ (0.23)	$ (0.08)

Extraordinary gain per share of common stock (Basic and Diluted)			$	0.01			$	0.01
Loss per share of common stock after extraordinary item (Basic)	$	(0.04)	$	(0.03)	$	(0.23)	$	(0.07)
Loss per share of common stock after extraordinary item (Diluted)	$	(0.04)	$	(0.03)	$	(0.23)	$	(0.07)
Weighted average number of common shares outstanding (Basic)		47,790,672		47,736,096		47,783,437		46,780,578
Weighted average number of common shares outstanding (Diluted)		47,790,672		47,736,096		47,783,437		46,780,578

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

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ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.
STATEMENTS OF CASH FLOWS (UNAUDITED)

	Nine Months Ended September 30,	
	2008	2007
Cash flows from operating activities:		
Net loss applicable to common stock	$ (11,075,940)	$ (3,085,022)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,531,959	3,763,516
Dividends accrued on preferred stock	600,000	
Deferred tax benefit	(3,449,962)	(2,516,846)
Loss from fixed asset impairment and disposition	595,860	
Extraordinary gain on involuntary conversion of non-monetarty assets due to fire		(432,403)
(Increase) decrease in other assets	872,682	(13,374)
(Increase) decrease in cash restricted for letter of credit and interest costs	252,654	(279,616)
Changes in current assets and current liabilities	16,009,661	(913,632)
Net cash provided by (used in) operating activities	8,336,914	(3,477,377)
Cash flows from investing activities:		
Purchases of land, buildings and equipment	(4,032,259)	(3,453,281)
Insurance proceeds from involuntary conversion of non-monetary assets due to fire		700,000
Proceeds from disposition of equipment	121,802	
Net cash used in investing activities	(3,910,457)	(2,753,281)
Cash flows from financing activities:		
Net borrowings (payments) on line of credit	(1,128,124)	1,292,341
Proceeds from issuance of notes		5,750,000
Payments on notes	(4,644,921)	(3,394,647)
(Increase) decrease in cash restricted for payment of long-term debt	1,607,888	(692,010)
Debt acquisition costs	(587,879)	
Proceeds from exercise of stock options and warrants, net		1,509,475
Net cash provided by (used in) financing activities	(4,753,036)	4,465,159
Decrease in cash and cash equivalents	(326,579)	(1,765,499)
Cash and cash equivalents, beginning of period	1,716,481	2,164,532
Cash and cash equivalents, end of period	$ 1,389,902	$ 399,033

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

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NOTES TO FINANCIAL STATEMENTS

Note 1: Unaudited Information

Advanced Environmental Recycling Technologies, Inc. (the Company or AERT) has prepared the financial statements included herein without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). However, all adjustments have been made to the accompanying financial statements which are, in the opinion of the Company s management, of a normal recurring nature and necessary for a fair presentation of the Company s operating results. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented herein not misleading. It is recommended that these financial statements be read in conjunction with the financial statements and the notes thereto included in the Company s latest annual report on Form 10-K/A.

Note 2: Description of the Company

AERT recycles polyethylene plastic and develops, manufactures, and markets composite building materials that are used in place of traditional wood or plastic products for exterior applications in building and remodeling homes and for certain other industrial or commercial building purposes. The Company s products are made primarily from approximately equal amounts of waste wood fiber and reclaimed polyethylene plastics, which have been extensively tested, and are sold by leading national companies such as the Weyerhaeuser Company (Weyerhaeuser), Lowe s Companies, Inc. (Lowe s) and Therma-Tru Corporation. The Company s customers include Weyerhaeuser, its primary decking customer, and various building product distributors and manufacturers. The Company s composite building materials are marketed as an upgrade from wood and plastic filler materials for standard door components, fascia board, and exterior decking and decking components under the trade names LifeCycle®, Weyerhaeuser ChoiceDek®, Weyerhaeuser ChoiceDek® Premium, and MoistureShield® outdoor decking. AERT operates manufacturing and recycling facilities in Springdale and Lowell, Arkansas and plans to use its currently idled facility in Junction, Texas to process raw materials in the future. It also operates a warehouse and reload complex in Lowell, Arkansas. The Company s Springdale South manufacturing facility has been idled until demand for its products requires the resumption of operations at that facility.

Note 3: Statements of Cash Flows

In order to determine net cash provided by (used in) operating activities, net loss has been adjusted by, among other things, changes in current assets and current liabilities, excluding changes in cash, current maturities of long-term debt and current notes payable. Those changes, shown as an (increase) decrease in current assets and an increase (decrease) in current liabilities, are as follows for the nine months ended September 30:

	2008 (unaudited)	**2007 (unaudited)**
Receivables	$ (1,807,332)	$ 108,420
Inventories	10,282,923	(3,048,373)
Prepaid expenses and other	984,181	1,185,593
Accounts payable trade and related parties	615,808	(131,077)
Accrued liabilities	5,934,081	971,805
	$ 16,009,661	$ (913,632)
Cash paid for interest	$ 2,681,476	$ 2,040,474

Supplemental Disclosures of Non-Cash Investing and Financing Activities:

	2008 (unaudited)	**2007 (unaudited)**

Notes payable for financing of insurance policies	$1,391,293	$1,477,027
Notes payable for equipment		1,100
Dividends on preferred stock paid in preferred stock	400,000	

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Note 4: Significant Accounting Policies

Revenue Recognition Policy

The Company recognizes revenue in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements* (SAB 104). Under SAB 104, revenue is recognized when the title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, delivery has occurred or services have been rendered, the sales price is determinable and collectability is reasonably assured. The Company typically recognizes revenue at the time product is shipped or when segregated and billed under a bill and hold arrangement. Sales are recorded net of discounts and rebates, which were $194,541 and $368,343 for the quarters ended September 30, 2008 and 2007, respectively, and $812,331 and $1,150,754 for the nine months ended September 30, 2008 and 2007, respectively.

Estimates of expected sales discounts are calculated by applying the appropriate sales discount rate to all unpaid invoices that are eligible for the discount. The Company s sales prices are determinable given that the Company s sales discount rates are fixed and given the predictability with which customers take sales discounts.

Shipping and Handling

In accordance with Emerging Issues Task Force (EITF) Issue 00-10, *Accounting for Shipping and Handling Fees and Costs*, the Company records shipping fees billed to customers in net sales and records the related expenses in cost of goods sold.

Inventories

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

	September 30, 2008 (unaudited)	December 31, 2007
Parts and supplies	$ 2,031,977	$ 2,423,766
Raw materials	4,500,347	7,182,551
Work in process	1,766,730	3,906,810
Finished goods	5,040,609	10,109,459
	$ 13,339,663	$ 23,622,586

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Concentration Risk

The Company s revenues are derived principally from a number of regional and national door and window manufacturers, regional building materials dealers and Weyerhaeuser, the Company s primary decking customer, which maintains a national vendor managed inventory program for Lowe s. The inventory is strategically located in reloads throughout the United States, from which the ChoiceDek brand of decking products are sold. The Company extends unsecured credit to its customers. The Company s concentration in the building materials industry has the potential to impact its exposure to credit risk because changes in economic or other conditions in the construction industry may similarly affect the customers. Weyerhaeuser is the only customer from which the Company derived more than 10% of its revenue. Gross sales to Weyerhaeuser comprised approximately 78% and 74% of total gross sales for the quarters ended September 30, 2008 and 2007, respectively; and approximately 77% and 73% of total gross sales for the nine months ended September 30, 2008 and 2007, respectively.

Research and Development

Expenditures relating to the development of new products and processes, including significant improvements to existing products, are expensed as incurred.

Stock-Based Compensation

In 2005, the Company modified its employee/director equity compensation policies to generally provide restricted stock unit awards rather than stock options. The Company measures the cost of employee and director services received in exchange for an award of equity instruments based on the grant-date fair value of the award. Restricted stock unit awards are expensed as earned as a portion of compensation costs. In 2008, the Company s board of directors waived its stock-based compensation indefinitely.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. The issuance of this standard is meant to increase consistency and comparability in fair value measurements. In February 2008, the FASB issued FASB Staff Position 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13* (FSP 157-1) and FASB Staff Position 157-2, *Effective Date of FASB Statement No. 157* (FSP 157-2). FSP 157-1 amends SFAS 157 to remove certain leasing transactions from its scope. FSP 157-2 delays until January 1, 2009 the effective date of SFAS 157 for all non-financial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The Company adopted SFAS 157 as of January 1, 2008. The adoption of SFAS 157 did not have a material impact on its financial statements.

In February 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value, and establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The Company adopted SFAS 159 as of January 1, 2008. The adoption of SFAS 159 did not have a material effect on its financial statements and related disclosures.

In March 2008, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* (SFAS 161). SFAS 161 requires enhanced disclosures about an entity s derivative and hedging activities, including qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008.

Note 5: Income Taxes

The Company had no current income tax provisions for the quarter or nine months ended September 30, 2008 due to its net losses for those periods. The effective income tax rates for the quarter and nine months ended September 30, 2008 were 41% and 24%, respectively. The effective income tax rates for the quarter and nine months ended September 30, 2007 were 38% and 42%, respectively. The effective tax rates for 2008 differ from the U.S. federal statutory rate of 34% due primarily to temporary and permanent differences between book and tax records, state income taxes and a change in the valuation allowance. The Company increased its valuation allowance by $1.6 million during the quarter ended September 30, 2008 to reduce its deferred tax asset to the amount that is more likely than not to be realized.

Based upon a review of its income tax filing positions, the Company believes that its positions would be sustained upon an audit and does not anticipate any adjustments that would result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded. The Company recognizes interest related to income taxes as interest expense and penalties as operating expenses.

Note 6: Earnings Per Share

The Company calculates and discloses earnings per share (EPS) in accordance with Statement of Financial Accounting Standards No. 128, *Earnings Per Share* (SFAS 128). SFAS 128 requires dual presentation of basic and diluted EPS on the face of the statements of operations and requires a reconciliation of the numerator and denominator of the basic EPS computation to the numerator and denominator of the diluted EPS computation. Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company.

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In computing diluted EPS, only potential common shares that are dilutive those that reduce earnings per share or increase loss per share are included. Exercise of options and warrants or conversion of convertible securities is not assumed if the result would be antidilutive, such as when a loss from continuing operations is reported. The control number for determining whether including potential common shares in the diluted EPS computation would be antidilutive is income from continuing operations. As a result, if there were a loss from continuing operations, diluted EPS would be computed in the same manner as basic EPS is computed, even if an entity has net income after adjusting for discontinued operations, an extraordinary item or the cumulative effect of an accounting change. The Company incurred losses from continuing operations for the three and nine months ended September 30, 2008 and 2007. Therefore, basic EPS and diluted EPS are computed in the same manner for those periods.

	Three Months Ended September 30:		
	2008	2007	
		Before Extraordinary Item	After Extraordinary Item
Net loss applicable to common stock (A)	$ (1,911,878)	$ (1,961,847)	$ (1,529,444)
Assumed exercise of stock options and warrants			
Application of assumed proceeds toward repurchase of stock at average market price			
Net additional shares issuable			
Adjustment of shares outstanding:			
Weighted average common shares outstanding	47,790,672	47,736,096	47,736,096
Net additional shares issuable			
Adjusted shares outstanding (B)	47,790,672	47,736,096	47,736,096
Net loss per common share Diluted (A) divided by (B)	$ (0.04)	$ (0.04)	$ (0.03)
Antidilutive and/or non-exercisable options	1,274,000	1,521,500	1,521,500
Antidilutive and/or non-exercisable warrants	3,787,880	2,834,340	2,834,340

	Nine Months Ended September 30:	
	2008	2007
		Before