AERO SYSTEMS ENGINEERING INC
Form 10-Q
August 09, 2002

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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

For the quarterly period ended June 30, 2002

( ) 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

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

As of June 30, 2002, 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, 2002

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

AERO SYSTEMS ENGINEERING, INC.
CONDENSED BALANCE SHEETS

ASSETS	June 30, 2002 (Unaudited)	De
	(000's omitted, except share	
CURRENT ASSETS		
Cash and cash equivalents	$ 1,735	$
Accounts Receivable, net	6,013	
Costs and Estimated Earnings in Excess of Billings on Uncompleted		

Contracts	5,664	
Inventories:		
Materials and Supplies	925	
Projects in Process	336	
Prepaid Expenses	135	
Total Current Assets	14,808	
PROPERTY, PLANT AND EQUIPMENT		
Land	486	
Buildings	3,025	
Furniture, Fixtures, & Equipment	8,771	
Wind Tunnels & Instrumentation	3,190	
Building Improvements	1,495	
	16,967	
Less Accumulated Depreciation	12,867	
Property, Plant, and Equipment, net	4,100	
Total Assets	$ 18,908	$

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

LIABILITIES	June 30, 2002
	(Unaudited) (000's omitted, exc
CURRENT LIABILITIES	
Current Maturities of Capital Lease Obligations	$ 127
Notes Payable	0
Notes Payable with related parties	300
Accounts Payable:	
Trade	1,947
Related parties	57
Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts	3,155

Accrued Warranty and Losses	525
Accrued Salaries and Wages	1,070
Income Tax Payable	201
Other Accrued Liabilities	4,343
Total Current Liabilities	11,725
OTHER LIABILITIES	
Long-term debt with related parties	1,500
Capital Lease Obligations, Less Current Maturities	94
Commitments and Contingencies	
STOCKHOLDERS' EQUITY	
Common Stock - Authorized 10,000,000 Shares of $.20 Par Value; Issued 4,401,625 on June 30, 2002 and December 31, 2001.	880
Additional Paid-in Capital	900
Retained Earnings	3,809
Total Stockholders' Equity	5,589
Total Liabilities and Stockholders' Equity	$ 18,908

Note: The balance sheet at December 31, 2001 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
(Unaudited, 000's omitted)

	Three Months Ended June 30		
	2002	2001	
Earned Revenue	$ 10,973	$ 6,093	$
Cost of Earned Revenue	8,520	4,447	

Gross Profit	2,453	1,646	
Operating Expenses	1,579	1,536	
Operating Profit	874	110	
Other Income (Expense)			
Interest Expense	(86)	(189)	
Other	7	(17)	
	(79)	(206)	
Income (Loss) Before Income Taxes	795	(96)	
Income Tax Expense	270	-	
Net Income (Loss)	$ 525	$ (96)	$
NET INCOME (LOSS) PER SHARE	$ 0.12	$ (0.02)	$
Dividends per Share	None	None	

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AERO SYSTEMS ENGINEERING, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited, 000's omitted)

	Six Mo J
	2002
CASH FLOW FROM OPERATING ACTIVITIES:	
Net Income (Loss)	$ 718
Adjustment to reconcile net income (loss) to net cash provided (used) by operating activities:	
Depreciation	702
(Increase) Decrease in Assets:	
Accounts Receivable	(1,283)
Cost and Estimated Earnings in Excess of Billings on Uncompleted Contracts	(787)
Inventories	(40)
Prepaid Expenses	183
Increase (Decrease) in Liabilities:	

Accounts Payable and Accrued Expenses	2,605
Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts	1,464
Net Cash Provided (Used) by Operating Activities	3,562
CASH FLOW FROM INVESTING ACTIVITIES:	
Capital Expenditures	(189)
Net Cash Used in Investing Activities	(189)
CASH FLOW FROM FINANCING ACTIVITIES:	
Net Borrowings under Line of Credit Agreement	(1,700)
Principal Payments under Capital Lease Obligations	(35)
Net Cash Provided (Used) by Financing Activities	(1,735)
NET CHANGE IN CASH	1,638
CASH AT BEGINNING OF YEAR	97
CASH AT END OF QUARTER	$ 1,735

AERO SYSTEMS ENGINEERING , INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited, 000's omitted)
June 30, 2002

NOTE A - BASIS OF PRESENTATION

The accompanying unaudited condensed financial statements have been prepared in accordance with generally accepted accounting principles 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 generally accepted accounting principles 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, 2002 are not necessarily indicative of the results that may be expected for the year ended December 31, 2002. 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, 2001.

NOTE B - INCOME TAXES

Income taxes are provided on an interim basis based upon management's estimate of the annual effective tax rate. The income tax rate in 2001 is not comparable to the current year rate due to the termination of the intercompany tax sharing agreement in September 2001 when Minnesota

ASE acquired 51% of the Company's outstanding stock from Celsius Inc.

NOTE C - CONTRACTS IN PROCESS

Information with respect to contracts in process follows:

	June 30, 2002
Costs Incurred on Uncompleted Contracts	$ 49,313
Estimated Earnings Thereon	17,244
Total Earned Revenue on Uncompleted Contracts	66,557
Less Billings Applicable thereto	64,048
	$ 2,509
Included in Accompanying Balance Sheet Under Following Captions:	
Costs and Estimated Earnings in Excess of Billings on Uncompleted Contracts	$ 5,664
Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts	3,155
	$ 2,509

NOTE C - CONTINGENCIES AND COMMITMENTS

Guarantees of approximately $5,055,730 were outstanding on June 30, 2002 to various customers as bid bonds or in exchange for down payments or warranty performance bonds.

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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, 2001. Actual results may vary materially from those anticipated.

Results of Operations

Second quarter 2002 (All dollar amounts are in thousands.)

Worldwide revenue for second quarter 2002 totaled $10,973 which was a 80% increase from $6,093 in second quarter of last year. Net income for second quarter was $525 as compared to the second quarter loss of $96 last year.

Backlog of orders as of June 30, 2002 was $26,201 as compared with $29,483 and $27,303 as of December 31, 2001 and June 30, 2001, respectively. This 4% decrease from second quarter 2001 is mostly the result of the conversion of backlog to revenue on the large Singapore wind tunnel project. The total orders received during the second quarter were $6,300.

The strong revenue increase experienced by the Company was mostly attributable to the increase in orders in process, resumption of normal activities on the Singapore wind tunnel project since receipt of the export license in early September 2001 and success in new initiatives in new markets. The improvement in net income in the second quarter was mostly due to increased revenues. Also, interest expense was reduced as a result of lower interest rates and lower debt levels.

Cost of earned revenue for second quarter of 2002, which includes manufacturing and engineering costs, was 78% of revenue as compared to 73% during the same period of last year. This increase is mostly the result of work shifting to slightly lower margin projects in the wind tunnel portion of the business during the second quarter 2002.

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 of $1,474 were 13% of revenues during second quarter 2002 as compared to $1,399 and 23% during the same period of last year. The increase of $75 is mostly related to higher corporate legal fees.

Research and development expenses were $105 during second quarter of 2002 as compared to $137 in the same period in 2001. This decrease of $32 or 23% is mostly related to the focus of certain resources in second quarter 2002 on project work rather than on R&D activities. During the remainder of 2002, additional R & D will be incurred for continued enhancements to the ASE2000, aero-acoustic analysis and new product initiatives.

Interest expense of $86 was incurred during the second quarter 2002 as compared to $189 from the same period in the prior year. The average rate of interest on short-term borrowings was lower partially as a result of the interest rate reductions experienced during latter portion of 2001 and partially due to the new bank agreements. Also, the average amount of borrowings outstanding has decreased in the second quarter 2002 as compared to the second quarter of last year mostly due to the Company's ability to resume normal invoicing activities on the Singapore wind tunnel project after the receipt of the export license.

Income tax expense was $270 for the second quarter 2002 as compared to $0 for the second quarter of 2001. Income taxes are provided on an interim basis based upon management's estimate of the annual effective tax rate. The income tax rate in 2001 is not comparable to the current year rate due to the termination of the intercompany tax sharing agreement in September 2001. Through September 25, 2001, Aero Systems was included in the consolidated federal income tax return of Celsius Inc., which owned 80% of the Company's outstanding stock. The Company's income tax provision was calculated and presented on a separate return basis. As a result of the acquisition of 51% of Aero Systems's stock by Minnesota ASE, LLC, Celsius Inc. now owns less than 80% of Aero Systems and, accordingly, is no longer able to include Aero Systems in its consolidated federal income tax return.

Financial Condition

Accounts receivable at the end of second quarter 2002 was $6,013 as compared with the year end balance of $4,730. This increase of $1,283 was due mainly to the timing of project billing milestones resulting in several large invoices outstanding at the end of the second quarter of 2002.

Costs and estimated earnings in excess of billings on uncompleted contracts at the end of second quarter 2002 was $5,664, which is an increase of $787 or 16% as compared with the year-end 2001 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 increase 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.

Notes payable balances totaled $300 as compared to the year-end 2001 balance of $2,000, which is a decrease of $1,700 or 85%. This decrease is primarily the result of the timing of project expenditures as compared to invoicing milestones resulting in the repayment of the bank line of credit down to $0 and $1,735 of cash on hand at the end of the second quarter.

Accounts payable and accrued expenses totaling $8,143 at the end of second quarter 2002 increased $2,605 or 47% as compared to the year-end 2001 balance. This was primarily due to an increase 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 increased $1,464 to $3,155 compared to the year-end 2001 balance of $1,691. The increase 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. 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 $3,000 of letter of credit funds. Also related to the transaction, Celsius Inc. 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 Celsius Inc. 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 Celsius Inc. to secure Celsius Inc.'s interest in the above items. The average funds available and amounts outstanding on the operating line and letter of credit during the second quarter 2002 were $281 outstanding on $2,897 available and $2,480 outstanding on $3,000 available, respectively.

At the end of the second quarter 2002, the Company had notes payable balances of $300 current and $1,500 long term. The current notes payable balance of $300 consisted of $300 of interim loans provided by Minnesota ASE, LLC. The $300 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 during the second quarter 2002 were $146 as compared to $152 for the same period of 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, 2002 to approximate the year ended December 31, 2001.

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. 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.

Forward-Looking Information

Highly competitive market conditions have minimized the margins on new contracts. Productivity improvements and cost reduction programs are continually being initiated to increase margins.

Looking ahead throughout the remainder of 2002, 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.

PART II - OTHER INFORMATION

Item 4: Submission of Matters to a Vote of Security Holders

(a) The Company held its annual meeting on May 29, 2002.

(b) The Company solicited proxies for the annual meeting pursuant to Regulation 14 under the Securities Exchange Act of 1934. The only items on the agenda were to fix the number of directors and to elect the directors. There was no solicitation in opposition to management's nominees as listed in the Company's Proxy Statement prepared for the meeting, and all such nominees were elected.

The first agenda item was to fix the number of directors at seven. The votes cast for, against and withheld (if any) with respect to this agenda item, and the number of broker non-votes, were as follows:

	Number of Votes			
Agenda Item 1	For	Against	Withheld	Number of Broker Non-Vot
Fix the number of Directors at seven	4,114,951	2,127	0	0

The second agenda item was to elect the Directors. The nominees consisted of all directors serving as such at the time of the annual meeting, and all such nominees were re-elected as directors. The directors elected consisted of Richard A. Hoel, Charles H. Loux, A. L. Maxson, Dr. Leon E. Ring, James S. Kowalski, Thomas L. Auth and Mark D. Pugliese. The votes cast for, against and withheld (if any) with respect to each director, and the number of broker non-votes with respect to each such director, were as follows:

Number of Votes

Name of Director	For	Against	Withheld	Number of Broker Non-Vot
Richard A. Hoel	4,116,733	0	345	0
Charles H. Loux	4,115,641	0	1437	0
A. L. Maxson	4,116,733	0	345	0
Dr. Leon E. Ring	4,116,043	0	1035	0
James S. Kowalski	4,116,733	0	345	0
Thomas L. Auth	4,116,733	0	345	0
Mark D. Pugliese	4,116,733	0	345	0

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AERO SYSTEMS ENGINEERING, INC.

Item 6: Exhibits and Reports on Form 8-K

(a) Exhibits 99.1 (Certification of Chief Financial Officer) and 99.2 (Certification of Chief Executive Officer).

(b) One Form 8-K filing occurred on May 1, 2002 to file a press release announcing an exclusive services agreement with Honeywell.

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 8, 2002

/s/ Charles Loux

Charles H. Loux, President and CEO

/s/ Steven R. Hedberg

Steven R. Hedberg, Chief Financial Officer