ACR GROUP INC
Form 10-Q
July 15, 2003
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Quarterly Report Under Section 13 or 15(d)

of the Securities Exchange Act of 1934

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 May 31, 2003

OR

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

For the transition period from ________ to ________

Commission file number 0-12490

ACR GROUP, INC.

(Exact name of registrant as specified in its charter)

Texas **State or other jurisdiction of incorporation or organization)**	**74-2008473** **(I.R.S. Employer Identification No.)**
3200 Wilcrest Drive, Suite 440, Houston, Texas **(Address of principal executive offices)**	**77042-6039** **(Zip Code)**

(713) 780-8532

(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, and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Shares of Common Stock outstanding at June 30, 2003 10,681,294.

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ACR GROUP, INC. AND SUBSIDIARIES

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

ACR GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

ASSETS

	May 31, 2003	February 28, 2003
	(Unaudited)	
Current assets:		
Cash	$ 50	$ 104
Accounts receivable, net	18,910	15,202
Inventory	25,993	24,997
Prepaid expenses and other	951	311
Deferred income taxes	1,311	1,458
Total current assets	47,215	42,072
Property and equipment, net of accumulated depreciation	4,811	4,955
Goodwill, net of accumulated amortization	5,258	5,258
Other assets	432	443
Total assets	$ 57,716	$ 52,728

The accompanying notes are an integral part

of these condensed financial statements.

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ACR GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

LIABILITIES AND SHAREHOLDERS EQUITY

	May 31, 2003	February 28, 2003
	(Unaudited)	
Current liabilities:		
Current maturities of long-term debt and capital lease obligations	$ 373	$ 403
Accounts payable	22,865	16,967
Accrued expenses and other liabilities	2,631	2,097
Total current liabilities	25,869	19,467
Revolving line of credit	18,363	20,172
Long-term debt and capital lease obligations, less current maturities	1,810	1,903
Total long-term obligations	20,173	22,075
Shareholders equity:		
Common stock	107	107
Additional paid-in capital	41,691	41,691
Accumulated deficit	(30,124)	(30,612)
Total shareholders equity	11,674	11,186
Total liabilities and shareholders equity	$ 57,716	$ 52,728

The accompanying notes are an integral part

of these condensed financial statements.

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ACR GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three months ended May 31,	
	2003	**2002**
Sales	$ 42,317	$ 42,869
Cost of sales	33,012	33,789
Gross profit	9,305	9,080
Selling, general and administrative costs	8,233	8,133
Operating income	1,072	947
Interest expense	385	448
Other non-operating (income)	(103)	(115)
Income before income taxes and cumulative effect of accounting change	790	614
Provision for income taxes:		
Current	154	30
Deferred	148	125
Income before cumulative effect of accounting change	488	459
Cumulative effect of accounting change, net of taxes		(483)
Net income (loss)	$ 488	$ (24)
Basic and diluted earnings (loss) per share:		
Before cumulative effect of change in accounting principle	$ .05	$ .04
Cumulative effect of accounting change		(.04)
	$ .05	$
Weighted average shares outstanding, basic and diluted	10,681,294	10,681,294

The accompanying notes are an integral part

of these condensed financial statements.

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ACR GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three months ended May 31, 2003	Three months ended May 31, 2002
Operating activities:		
Net income (loss)	$ 488	$ (24)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Cumulative effect of change in accounting principle		483
Depreciation and amortization	258	304
Deferred income tax expense	147	125
Other		(5)
Changes in operating assets and liabilities:		
Accounts receivable, net	(3,708)	(3,444)
Inventory	(1,404)	(2,415)
Prepaid expenses and other assets	(412)	(160)
Accounts payable	5,923	4,891
Accrued expenses and other liabilities	534	322
Net cash provided by operating activities	1,826	77
Investing activities:		
Acquisition of property and equipment	(127)	(125)
Proceeds from disposition of assets	179	5
Net cash provided by (used in) investing activities	52	(120)
Financing activities:		
Net borrowings (payments) on revolving credit facility	(1,809)	304
Payments on long-term debt	(123)	(267)
Net cash (used in) provided by financing activities	(1,932)	37
Net (decrease) in cash	(54)	(6)
Cash at beginning of year	104	129
Cash at end of period	$ 50	$ 123
Non-cash sale of subsidiary s inventory and tangible capital assets for issuance of a note receivable	$ 224	$

The accompanying notes are an integral part

of these condensed financial statements.

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ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1 Basis of Presentation

The accompanying unaudited condensed historical financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States. Accordingly, they do not include all of the information and footnotes required for complete financial statements, and therefore should be reviewed in conjunction with the financial statements and related notes thereto contained in the Company s annual report for the year ended February 28, 2003 filed on Form 10-K with the Securities and Exchange Commission. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Actual operating results for the three months ended May 31, 2003, are not necessarily indicative of the results that may be expected for the fiscal year ended February 29, 2004.

Certain reclassifications were made to the prior year s financial statements to conform with current year presentation.

2 Summary of Significant Accounting Policies

For a description of these policies, refer to Note 1 of the Notes to Consolidated Financial Statements included in the Company s Annual Report on Form 10-K for the year ended February 28, 2003 and to Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations, below.

3 Contingent Liabilities

The Company has an arrangement with an HVACR equipment manufacturer and a bonded warehouse agent whereby HVACR equipment is held for sale in bonded warehouses located at the premises of certain of the Company s operations, with payment due only when products are sold. The supplier retains legal title and substantial management control with respect to the consigned inventory. The Company is responsible for damage to and loss of inventory that may occur at its premises. The Company has the ability to return consigned inventory, at its sole discretion, to the supplier for a specified period of time after receipt of the inventory. Such inventory is accounted for as consigned merchandise and is not recorded on the Company s balance sheet. As of May 31, 2003, the cost of such inventory held in the bonded warehouses was approximately $ 7,281,000.

The terms of the consignment agreement further provide that the Company may be required to purchase inventory not sold within a specified period of time. Historically, most consigned inventory is sold before the specified purchase date, and the supplier has never enforced its right to demand payment, instead permitting such inventory to remain on consignment.

4 Goodwill

Goodwill represents the excess cost of companies acquired over the fair value of their tangible net assets. The Company accounts for goodwill in accordance with Statement of Financial Accounting Standards (SFAS) Number 142. Goodwill attributable to each of the Company s reporting units is

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tested for impairment by comparing the fair value of each reporting unit with its carrying value. These impairment tests are performed at least annually. The Company performs the annual impairment test as of its year-end during the first quarter of each fiscal year.

Upon adopting SFAS No. 142, the Company s impairment tests performed during the Quarter ended May 31, 2002 resulted in a charge of $733,000, or $483,000 net of taxes, to reduce the carrying value of goodwill to its implied fair value. This charge was recorded as a cumulative effect of change in accounting principle in the Company s financial statements. The Company completed its annual impairment test as of February 28, 2003 in the first quarter of fiscal year 2004. This impairment test resulted in no additional impairment charges.

5 New Accounting Pronouncements

In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 145, Rescission of FASB Statement No. 4, 44, and 64, Amendments of FASB Statement No. 13 and Technical Corrections . This statement eliminates the requirement under SFAS 4 to aggregate and classify all gains and losses from extinguishment of debt as an extraordinary item, net of related income tax effect. This statement also amends SFAS 13 to require certain lease modifications with economic effects similar to sale-leaseback transactions to be accounted for in the same manner as sale-leaseback transactions. In addition, SFAS 145 requires reclassification of gains and losses in all prior periods presented in comparative financial statements related to debt extinguishment that do not meet the criteria for extraordinary item in APB 30. The statement is effective for fiscal years beginning after May 15, 2002 with early adoption encouraged. The Company adopted SFAS 145 effective March 1, 2003. The adoption of the statement had no material impact on the Company s financial position or results of operations.

In November 2002, the FASB issued Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others . The Interpretation requires certain guarantees to be recorded at fair value and also requires a guarantor to make certain disclosures regarding guarantees. The Interpretation s initial recognition and initial measurement provisions are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements became effective for the Company s first quarter of 2004. The adoption of the statement had no material impact on the Company s financial position or results of operations.

In January 2003, the Emerging Issues Task Force (EITF) reached a final consensus on EITF Issue No. 02-16, Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor . EITF 02-16 clarifies certain aspects for accounting and recording of consideration received from vendors. Certain provisions of the EITF are effective for fiscal years beginning after December 15, 2002, and other provisions of the EITF are effective for arrangements entered into after November 21, 2003. The Company s historical accounting for consideration received from vendors is consistent with the provisions of EITF 02-16. Therefore, the adoption of this standard had no material impact on the Company s financial statements.

In January 2003, the FASB issued Interpretation 46, Consolidation of Variable Interest Entities. In general, a variable interest entity is a corporation, partnership, trust, or other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is

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subject to a majority of the risk of loss from the variable interest entity s activities or entitled to receive a majority of the entity s residual returns or both. The Company does not believe the adoption of the Interpretation will have a material impact on its financial statements.

6 Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. The Company uses the liability method in accounting for income taxes. Under the liability method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

The Company increased the effective federal income tax rate to 34% for fiscal 2004 from 21% in fiscal 2003 due to the expiration and utilization of tax loss carryforwards. The tax expense will be used to decrease the deferred tax asset and increase the tax liability for estimated taxes payable, net of the operating loss carryforwards. The Company had approximately $1,343,000 in tax loss carryforwards at the beginning of fiscal 2004.

7 Debt

The Company has a revolving line of credit arrangement with a commercial bank (Bank). The maximum amount that may be borrowed under the revolving line of credit is $25 million, and $1 million for capital expenditures. At May 31, 2003, the Company had available credit of $5.1 and $0.2 million under the revolving credit line and the capital expenditure term loan facility, respectively. The agreement terminates in May 2004, but is automatically extended for one-year periods unless either party gives notice of termination to the other.

8 Stock-Based Compensation

In accordance with the provisions of SFAS 123, Accounting for Stock-based Compensation , the Company has elected to follow the Accounting Principles Board Opinion (APB) 25, Accounting for Stock Issued to Employees , and related interpretations in accounting for its employees stock-based compensation plans. Under APB 25, if the exercise price of employee stock options equals or exceeds the fair value of the underlying stock on the date of grant, no compensation expense is recognized.

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Had compensation expense been determined consistent with SFAS 123, the Company s net income (loss) and earnings (loss) per share would have been changed to the following pro forma amounts:

	Quarter Ended May 31,	
	2003	2002
Net income (loss) applicable to common shareholders as reported	$ 488	$ (24)
Total stock-based employee compensation expense under fair value method for all awards, net of tax		10
Pro forma income (loss) applicable to common shareholders	$ 488	$ (34)
Basic and diluted earnings per share:		
As reported	$ .05	$
Pro forma	.05	

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

INTRODUCTION

ACR Group, Inc. and its subsidiaries (collectively, the Company) is an independent distributor of heating, air conditioning and refrigeration (HVACR) equipment and related parts and supplies. The Company is among the ten largest such distributors in the United States. Substantially all of the Company s sales are to contractor dealers and institutional end-users. Generally accepted accounting principles allow the aggregation of an enterprise s segments if they are similar. Although the Company operates in different geographic areas, we have reviewed the aggregation criteria and determined that the Company operates as a single segment based on the high degree of similarity of the Company s operations.

This report on Form 10-Q includes certain statements that may be deemed to be forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements, which are other than statements of historical facts. Forward-looking statements involve risks and uncertainties that could cause actual results or outcomes to differ materially. Such risks and uncertainties may include the availability of debt or equity capital to fund the Company s working capital requirements, unusual weather conditions, the effects of competitive pricing, the strength of construction markets and general economic conditions. Our expectations and beliefs are expressed in good faith and we believe there is a reasonable basis for them, but there can be no assurance that our expectations, beliefs or projections will be achieved or accomplished. The forward-looking statements in this document are intended to be subject to the safe harbor protection provided under the securities laws.

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RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED MAY 31, 2003 COMPARED TO THE THREE MONTHS ENDED MAY 31, 2002

The Company recognized net income of $488,000 for the quarter ended May 31, 2003 (fiscal 2004) compared to a net loss of $24,000 for the quarter ended May 31, 2002 (fiscal 2003). The Company s results for the first quarter of fiscal 2003 included a charge of $483,000, net of taxes, related to the adoption of a new accounting standard for reporting of goodwill and other intangible assets. As discussed below, the Company s effective tax rate in fiscal 2004 is expected to be significantly greater than in fiscal 2003. Income before income taxes and cumulative effect of accounting change was $790,000 in the quarter ended May 31, 2003, compared to $614,000 in the quarter ended May 31, 2002, an increase of 29%. The increase in such income was attributable to improved gross margins, effective expense controls and lower interest costs in fiscal 2004 compared to fiscal 2003.

Consolidated sales decreased 1% during the quarter ended May 31, 2003 compared to the quarter ended May 31, 2002. Sales growth was strong only in California, where six of seven branch operations generated