

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC

FORM 10-Q (Quarterly Report)

Filed 05/15/97 for the Period Ending 03/31/97

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	SPRINGDALE, AR 72764
Telephone	479-756-7400
CIK	0000849706
Symbol	AERT
SIC Code	2430 - Millwork, Veneer, Plywood, And Structural Wood
Industry	Constr. - Supplies & Fixtures
Sector	Capital Goods
Fiscal Year	12/31

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 March 31, 1997
Commission File Number 1-10367

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

DELAWARE
(State or other jurisdiction of
incorporation or organization)

71-0675758
(I.R.S. Employer Identification No.)

206 1/2 East Emma Avenue
P.O. Box 1237
Springdale, Arkansas
(Address of Principal Executive Office)

72765
(Zip Code)

Registrant's telephone number, including area code: (501)750-1299

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 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 May 14, 1997, 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 19,201,148 and the number of shares outstanding of the Registrant's Class B Common Stock was 1,465,530.

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

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ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

BALANCE SHEETS

	ASSETS	
	March 31, 1997 (Unaudited)	December 31, 1996
	-----	-----
Current assets:		
Cash and cash equivalents	\$ 29,131	\$ 82,756
Receivables		
Insurance	754,008	1,001,657
Trade	676,201	9,280
Inventories	550,750	593,325
Prepaid expenses and other	100,459	87,381
	-----	-----
Total current assets	2,110,549	1,774,399
	-----	-----
Buildings and equipment, at cost, including construction in progress of \$838,709 at 3-31-97, and \$838,709 at 12-31-96:		
Buildings	687,509	687,509
Machinery and equipment	6,876,974	6,791,709
Transportation equipment	135,527	135,527
Office equipment	174,062	172,597
	-----	-----
	7,874,072	7,787,342
	-----	-----
Less accumulated depreciation and amortization	3,447,340	3,182,679
	-----	-----
Net buildings and equipment	4,426,732	4,604,663
	-----	-----
Other assets, at cost less accumulated amortization of \$113,990 (1996), and \$107,798 (1995), respectively	344,680	346,487
	-----	-----
	\$6,881,961	\$6,725,549
	=====	=====

The accompanying notes to the financial statements should be read in conjunction with these statements.

LIABILITIES AND STOCKHOLDERS' EQUITY

	March 31, 1997 (Unaudited)	December 31, 1996
	-----	-----
Current liabilities:		
Accounts payable - trade	\$ 1,100,862	\$ 1,224,711
Accounts Payable - related parties	1,192,171	468,715
Current maturities of long-term debt	768,853	705,344
Accrued liabilities	293,872	207,065
Notes payable	-	61,559
	-----	-----
Total current liabilities	3,355,758	2,667,394
	-----	-----
Long-term debt, less current maturities - Related parties	719,094	799,554
Other	80,172	156,222
	-----	-----
Total long-term debt	799,266	955,776
	-----	-----
Commitments and contingencies		
Stockholders' equity		
Preferred stock, \$1 par value; 5,000,000 shares authorized, none issued	-	-
Class A common stock, \$.01 par value; 50,000,000 shares authorized, 19,201,148 (1997) and 19,201,148 (1996) shares issued and outstanding	192,012	192,012
Class B convertible common stock, \$.01 par value; 7,500,000 shares authorized, 1,465,530 (1997) and 1,465,530 (1996) shares issued and outstanding	14,655	14,655
Additional paid in capital	21,777,450	21,533,450
Accumulated Deficit	(19,257,180)	(18,637,738)
	-----	-----
Total stockholders' equity	2,726,937	3,102,379
	-----	-----
	\$ 6,881,961	\$ 6,725,549
	=====	=====

The accompanying notes to the financial statements should be read in conjunction with these statements.

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

	Three months ended March 31, 1997	Three months ended March 31, 1996
Sales	\$ 1,747,802	\$ 1,601,778
Cost of Goods Sold	1,993,546	1,746,229
Gross Margin	(245,744)	(144,451)
Selling and Administrative Costs	338,138	377,269
Operating Loss	(583,882)	(521,720)
Other Income (Expense)	(583,882)	(521,720)
Other Income	-	7
Interest Expense	-	-
Net loss	(35,559)	(60,740)
	\$ (619,441)	\$ (582,453)
	=====	=====
Net loss per share of common stock	(\$.03)	(\$.03)
	=====	=====
Weighted average number of common shares outstanding	20,666,678	17,521,033
	=====	=====

The accompanying notes to the financial statements should be read in conjunction with these statements.

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

STATEMENTS OF CASH FLOWS (UNAUDITED)

	Three months ended March 31, 1997	Three months ended March 31, 1996
	-----	-----
Cash flows from operating activities:		
Net loss	\$ (619,441)	\$ (582,453)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	264,661	277,998
Amortization of other assets	6,192	6,117
Increase in other assets	(4,385)	(14,600)
Changes in operating assets & operating liabilities	46,638	89,837
	-----	-----
Net cash used in operating activities	(306,335)	(223,101)
	-----	-----
Cash flows from investing activities:		
Insurance proceeds	250,000	-
Additions to buildings and equipment	(86,730)	(9,005)
	-----	-----
Net cash provided by (used in) investing activities	163,270	(9,005)
	-----	-----
Cash flows from financing activities:		
Proceeds from issuance of notes	-	75,551
Payments on notes	(154,560)	(158,229)
Proceeds from stock subscriptions	244,000	305,000
	-----	-----
Net cash provided by financing activities	89,440	222,322
	-----	-----
Decrease in cash & cash equivalents	(53,625)	(9,784)
Cash and cash equivalents:		
Beginning of period	82,756	15,350
	-----	-----
End of period	\$ 29,131	\$ 5,566
	=====	=====

The accompanying notes to the financial statements should be read in conjunction with these statements.

NOTES TO FINANCIAL STATEMENTS

Note 1: Unaudited Information

The financial statements included herein have been prepared by Advanced Environmental Recycling Technologies, Inc. (the Company or AERT), 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, 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 generally accepted accounting principles 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. Accordingly, the Company has reclassified certain prior period amounts to conform to the current period presentation.

Note 2: Organization and Description of the Company

The Company has developed and commenced the manufacture of a composite building material from waste plastic and wood fiber waste for certain specialized applications in the construction industry. The Company has initially marketed this material as a substitute for wood and plastic filler materials for standard door frames, window sills, and decking. The Company is comprised of two separate, yet interrelated manufacturing facilities located in Junction, Texas and Rogers, Arkansas. The Company's customers primarily consist of a number of regional and national door and window manufacturers and Weyerhaeuser, the Company's primary decking customer.

The Company was initially capitalized on December 2, 1988, with a contribution of machinery and equipment, plant facilities and technology, most of which was used by certain members of management in an unsuccessful prior business. The prior business was organized in June 1985 to manufacture artificial firelogs using certain technology somewhat similar to that used in the Company's manufacturing process. By 1986, the prior business had incurred substantial losses from operations, had no further working capital resources and discontinued its business. The initial contribution consisted of approximately \$3,000,000 in buildings, machinery and equipment, supplies and other tangible assets, as well as technological rights and expertise. In connection with such initial organization, the Company assumed \$795,000 in bank indebtedness secured by certain of the contributed assets. All amounts are reflected in the accompanying financial statements at the contributor's book value.

Note 3: Future operations

The financial statements of the Company have been prepared on the basis of accounting principles applicable to a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. At March 31, 1997, the Company had a working capital deficit of \$1,245,209 and had incurred net losses of \$619,441 for the three months ended March 31, 1997. The Company, since inception,

has not achieved a successful level of operations nor is there any assurance that the Company will be able to achieve future revenue levels sufficient to support existing operations, generate positive cash flow from operations or recover its investment in its property, plant and equipment. Further, the Company has limited additional financial resources available to support its operations and in the past few years has, in large part, been supported by certain major shareholders. There is no commitment for such shareholders to continue such support beyond the current line of credit. The Company also has claims in litigation outstanding against it as described in Note 6, the outcome of which is uncertain. There can be no assurance that the Company's financial resources will be adequate to support existing operations until such time, if ever, sales and manufacturing levels are sufficient to generate positive cash flow from operations. Further, if the litigated claims discussed in Note 6 were to be assessed against the Company, the Company would likely be unable to pay such claims. These factors, among others, raise substantial doubt concerning the ability of the Company to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amount and classification of liabilities that might result should the Company be unable to continue as a going concern. The ability of the Company to continue as a going concern is dependent upon the ongoing support of its stockholders, investors, customers and creditors and its ability to successfully mass produce and market its products at economically feasible levels.

The Company has developed, and is currently implementing, a production plan which Management believes will provide for better operating efficiencies and correct the production problems encountered in the past. Such plan includes increasing production capacity, changes to production management, further automation of the production process and better utilization of regrindable scrap. The Company is also seeking to raise approximately \$2.2 million in an offering of preferred stock, and believes that such capital will be sufficient to support the Company until such time as the Company achieves positive cash flow from operations. However, it is possible additional financial resources may be necessary to fund maturities of debt and other obligations as they come due. There is no assurance the Company will be able to correct prior production problems and, improve operating efficiencies or that the Company will be successful in securing sufficient capital resources to support the Company until such time, if ever, the Company is able to generate positive cash flow.

Effective October 1, 1995, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. SFAS No. 121 requires an assessment of the recoverability of the Company's investment in long-lived assets to be held and used in operations whenever events or circumstances indicate that their carrying amounts may not be recoverable. Such assessment requires that the future cash-flows associated with the long-lived assets be estimated over their remaining useful lives and an impairment loss recognized when the future cash- flows are less than the carrying value of such assets.

The Company has assessed the recoverability of its investment in long-lived assets to be held and used in operations under the guidelines set forth in SFAS 121 and determined that no impairment loss was required as of March 31, 1996. Such assessment required the Company to make certain estimates of future production volumes and costs and future sales volumes and prices which are expected to occur over the remaining useful lives of its long-lived assets. (Such long-lived assets primarily consist of the Company's Rogers and Junction manufacturing facilities.) The Company's estimates of these factors are based upon management's belief that future production volumes will significantly increase over previous historical production levels achieved by the

Company's manufacturing facilities and that future production costs per unit will also significantly decrease below previous historical cost levels. The Company has restructured its Rogers plastics reclamation facility and believes that no significant production problems will recur at its Junction composite manufacturing facility. As such, management of the Company believes a reasonable basis exists for the use of such future estimates which are significantly better than past historical performance.

Although the Company believes it has a reasonable basis for its estimates of future production volumes and costs and future sales volumes and prices, it is reasonably possible that the Company's actual performance could materially differ from such estimates. Management expects that the Company's performance during the last nine months of 1997 will provide additional evidence to confirm or disprove such future estimates. Management also believes that if such estimates are not confirmed, revisions to such estimates could result in a material impairment loss on its long-lived assets constituting all or a material portion of the carrying value of the Company's Rogers and Junction manufacturing facilities which was \$4,426,732 at March 31, 1997.

Note 4: Statement of Cash Flows

In order to determine net cash used in operating activities, loss from continuing operations has been adjusted by, among other things, changes in current assets and current liabilities, excluding changes in cash and cash equivalents, current maturities of long-term debt, advances from affiliates included in notes payable - related parties. Those changes, shown as an (increase) decrease in current assets and an increase (decrease) in current liabilities, are as follows:

	Three months ended March 31, 1997 (unaudited)	Three months ended March 31, 1996 (unaudited)
	-----	-----
Receivables	\$(669,273)	\$(100,927)
Inventories	42,575	171,279
Prepaid expenses and other	(13,078)	60,477
Accounts payable - trade & related parties	599,607	(63,104)
Accrued liabilities	86,807	22,112
	-----	-----
	46,638	\$ 89,837
	=====	=====

	Three months ended March 31, 1997 (unaudited)	Three months ended March 31, 1996 (unaudited)
Cash paid for interest	\$35,522	\$52,763
Cash paid for taxes	-	-

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Note 5: Significant Accounting Policies

Inventories

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

	March 31, 1997 (Unaudited)	December 31, 1996
Raw materials	\$191,084	\$210,483
Work in process	319,457	351,477
Finished goods	40,209	31,365
	-----	-----
	\$550,750	\$593,325
	=====	=====

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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.

Recently Issued Accounting Standards

In June 1996, the Financial Accounting Standards Board ("FASB") issued SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities". This statement provides accounting and reporting standards for, among other things, the transfer and servicing of financial assets, such as factoring receivables with recourse and will require the Company to classify its financial assets pledged as collateral separately in the financial statements. This statement is effective for transactions occurring after December 31, 1996, and is to be applied prospectively. Earlier or retroactive application is not permitted. In

December 1996, the FASB issued SFAS No. 127, "Deferral of the Effective Date of Certain Provisions of SFAS No. 125," SFAS No. 127 moves forward some, but not all, of the provisions of SFAS No. 125 to December 31, 1997. The Company presently factors, with recourse, receivables to a related party. Effective January 1, 1997, the Company adopted SFAS No. 125.

In February 1997, the FASB issued SFAS No. 128, "Earnings Per Share." SFAS No. 128 replaces the presentation of Primary Earnings Per Share (EPS) with Basic EPS and 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 shareholders 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. Diluted EPS is computed similarly to Fully Diluted EPS pursuant to Accounting Principles Board Opinion No. 15, "Earnings Per Share." SFAS No. 128 is effective for financial statements of issued after December 15, 1997, and earlier application is not permitted. SFAS No. 128 requires restatement of all prior-period EPS data presented.

Note 6: Commitments and contingencies

On June 9, 1992, Mobil Oil Corporation ("Mobil") commenced an action against the Company in the United States District Court for the District of Delaware entitled Mobil Oil Corporation v. Advanced Environmental Recycling Technologies, Inc. In its complaint, Mobil sought entry of a declaratory judgment that: (a)

AERT is without right or authority to threaten suit against Mobil or its customers for alleged infringement of AERT patents; (b) The AERT patents are invalid and unenforceable, and (c) Mobil has not infringed the AERT patents through any products or method. Mobil seeks no monetary damages in this suit, but does seek reimbursement of its attorneys' fees.

On December 8, 1992, the Company answered Mobil's Complaint. In its Answer, the Company denied Mobil's claims and asserted counterclaims against Mobil and three Mobil executives for: (1) an illegal combination or contract in restraint of trade in violation of federal antitrust laws; (2) a pattern of intentional misconduct constituting an attempt to monopolize in violation of federal antitrust laws; (3) breach of a confidential relationship between Mobil and the Company; and (4) unfair competition. The Company sought monetary damages, punitive damages and injunctive relief. Mobil filed an answer to AERT's counterclaims, denying any liability. The Delaware Court then bifurcated the trial into patent and non-patent issues and ordered the patent issues tried first.

In February 1994, after a trial on the patent issues, a Delaware jury returned a verdict that four AERT patents on its composite product technology were invalid. The jury also determined that Mobil had not infringed two of the four patents which AERT had asserted against Mobil. The jury verdict answered a number of interrogatories on the factual issues, and rendered advisory findings for the Court on Mobil's allegation that AERT had obtained its patents by inequitable conduct. Thereafter, the Judge adopted the jury's advisory findings on inequitable conduct and held that each of the four AERT patents were unenforceable for failure to disclose certain alleged prior art to the patent office during patent prosecution.

Because of the nature of certain of the jury verdict interrogatory responses, AERT's counsel concluded that the verdict was adversely affected by improper conduct by Mobil counsel during trial, and false statements of law and fact made during closing argument, that caused the jury to misapply the law on inequitable conduct and to render clearly erroneous findings. Consequently, AERT moved for a new trial. That motion was denied. The Company's additional post-trial motions were also denied by the Delaware Court. On March 14, 1995, the Company filed a sealed motion with the Court based upon newly discovered evidence which alleges prejudicial misconduct by Mobil prior to the trial. The motion also brings to the Court's attention, evidence which the Company believes was intentionally withheld from it in direct defiance of the Delaware Court's January 4, 1994 Motion to Compel, prior to the trial. It also brings to the Court's attention, an official government safety approval document which was altered prior to submission to AERT during pre-trial discovery, which also relates to a portion of the alleged withheld discovery documentation. The motion seeks further discovery into Mobil's misconduct, and a new trial. In December 1995, the Company also moved to supplement its pending March 14, 1995 Motion with additional tampered evidence and discovery misconduct by Mobil. The March 14, 1995 motion is currently stayed before the Delaware Court. The Company filed an appeal with the U.S. Court of Appeals on July 10, 1995 on the initial trial arguments. In January 1996, oral arguments were presented before the U.S. Court of Appeals. On June, 1996, the U.S. Court of Appeals reversed a portion of the earlier ruling that two of the patents were invalid, and that Mobil did not infringe. The Company did not further appeal this issue to the Supreme Court. Should the Delaware Court deny the Company's pending Prejudicial Misconduct Motion, the Company intends to follow-up with an additional appeal on these issues. Should the Court not rule in favor of the Company on such motions, all appellate processes available will be pursued. There can be no assurance that the Company will receive a more favorable outcome upon appeal.

In August 1994, Mobil filed a motion seeking an award of attorneys' fees and costs in the amount of \$2.7 million. On November 1, 1994, the Court ruled that the motion was premature and will not be considered at the present time. In January 1995, Mobil renewed its Motion for Attorneys' Fees. In April 1995, the Court requested AERT to respond to Mobil's Motion. The Motion is currently stayed. With the recent appeals court ruling upholding the invalidity of two patents and the ruling of inequitable conduct, the Company has been advised that if and when the court decides to entertain Mobil's motion for the attorney's fees, and if and when Mobil decides to submit documentation and substantiate its claim, that the Company could face possible risk from an adverse decision from the court by awarding a portion of said fees to Mobil. The Company has been advised in a worse case scenario that it could face an aggressive challenge against it for a significant portion of the said \$2.7 million attorney's fees in an attempt to end this litigation prior to the company's prejudicial misconduct motion or pending counterclaims against Mobil being heard. The Company will vigorously defend against Mobil's claim for attorneys, fees and costs, however, there can be no assurances as to the outcome of this litigation. The Company believes that the Mobil motion for attorney's fees and the AERT prejudicial misconduct motion for a new trial could be addressed sometime during 1997 by the Delaware Court. The Company has not recorded any liability related to such litigation at March 31, 1997.

ARTHUR ANDERSEN LLP

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Board of Directors and Stockholders of Advanced Environmental Recycling Technologies, Inc.

We have reviewed the accompanying balance sheet of Advanced Environmental Recycling Technologies, Inc. (a Delaware corporation), as of March 31, 1997, and the related statements of operations and cash flows for the three-month periods ended March 31, 1997 and 1996. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the financial statements referred to above for them to be in conformity with generally accepted accounting principals.

/s/ ARTHUR ANDERSEN LLP

*San Antonio, Texas
May 6, 1997*

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

The Company has developed technologies to reclaim polyethylene plastics and manufacture engineered composite products that exhibit superior moisture resistance and dimensional stability. To date, the Company has received 13 United States Patents on its technologies and additional patent applications are currently pending. (Note: Legal Proceedings) The Company has built and currently operates a plastics reclamation facility in Rogers, Arkansas (the "Rogers Facility") and a composites manufacturing facility in Junction, Texas (the "Junction Facility"). The Company has experienced increased customer demand for its engineered composite products that are marketed under the trade-names, Moistureshield/TM/ and CHOICEDEK/TM/. The Company's efforts are now primarily directed towards increasing production capacity and increasing its production to supply its existing customer base, and promptly attaining positive cash flows and profitability.

To date, the Company has experienced a substantial backlog for its CHOICEDEK/TM/ line of residential decking products through Weyerhaeuser Distribution and has commenced an expansion program intended to increase production capacity for Weyerhaeuser and its other OEM customers. To date, the Company has been limited in its ability to supply the residential decking market and has only been able to supply its CHOICEDEK/TM/ line to a limited number of distribution centers.

The Company's sales are now primarily focused towards the following three market areas which are currently supplied by the Company's composites manufacturing facility in Junction, Texas: (1) components for the national door and window market, (2) the heavy industrial flooring market as floor blocks for industrial applications, and (3) as decking components for commercial and residential applications through Weyerhaeuser. The Company experienced a series of extensive fires that caused substantial damage during the last half of 1996 at its Rogers, Arkansas plastic reclamation facility. These fires in September and December of 1996 halted the Company's plastic reclamation program and limited composite sales growth. As of this date, the Company has received notification that the insurance company has concluded the property claim of \$1.95 million is compensable under the terms and conditions of the policy and there are some differences in the measure of loss which the Company plans to resolve in the second quarter. The Company to date has received \$1.1 million in advances from the insurance carrier. The Company is currently rebuilding said facility and intends to resume operations during the second quarter of 1997. Although the Company has established alternate supply sources and is currently meeting its customers minimum requirements, it will require the Rogers facility to come back on line to provide the quality, consistency, and volume of plastic required for the Company to continue to increase composite sales to a level required to attain profitability.

The Company, in conjunction with the fires at the Rogers facility mentioned above, has also experienced production difficulties associated with raw material problems with its plastic supplies, created when the Company had to purchase all plastic from outside vendors due to the above mentioned fires. The Company was also restrained in its efforts to further increase sales due to production limitations and inefficiencies at the Junction,

Texas composites facility. The Company currently operates three extrusion lines at the Junction facility and due to increased composite sales demands is working to expand its composite manufacturing capacity by the addition of a fourth extrusion line in the near future. The Company is also working to establish an additional composite manufacturing capability with Sutton Engineered Wood Products near Harrison, Arkansas.

Due to the significant amount of loss from the two Rogers, Arkansas fires experienced during the second half of 1996, the Company was notified that its fire insurance carrier had chosen not to renew the policy when it expired on May 1997. The Company has been able to secure coverage for another year through a different carrier with an increase in premium and the deductible but with no lapse in coverage.

The Company is currently unable to predict the future size of the markets for its composite building products, however, the Company believes that the national door and window and residential decking material markets are significant. The Company believes that it can further penetrate these markets and/or expands sales to its existing customer base if the Company's goals for increased production capacity and efficiency are achieved. By focusing its marketing strategy on a limited number of large door and window companies, and by initiating sales of its new decking products through the Weyerhaeuser marketing and distribution agreement, the Company believes it can increase market penetration and sales without significantly increasing administrative overhead. Also, the Company's marketing focus utilizes outside commissioned sales representatives for a portion of its door and window accounts.

Results of Operations

Quarter ended March 31, 1997 compared to quarter ended March 31, 1996

Net sales of \$1,747,802 for the quarter ended March 31, 1997 represented an increase in sales of 9% or \$146,024 over the first quarter of 1996. Although there was an increase over the first quarter of 1996 and the Company continued to have a backlog of orders for its products, the Company was restrained in its efforts to further increase sales primarily due to the limited supply and quality of the raw material plastic. Sales during the quarter show a further correlation with this problem, with monthly sales of \$409,038, \$640,112, and \$708,863 for January, February and March, respectively as the Company dealt with the problem of securing additional plastic vendors after the December 1996 fire at the Rogers facility.

Cost of goods sold was \$1,993,546 for the first quarter of 1997 compared to \$1,746,229 for the first quarter of 1996. Real dollars and the overall cost of goods sold to sales ratio increased from 1996 due to increased sales and less than desirable operating efficiencies at the Junction facility. The Company's material and labor costs were adversely impacted by the quality and consistency of the outside vendor raw material plastic. In addition, these costs increased due to excessive scrap rates and inefficient utilization of the regrindable scrap primarily occurring in the month of January. Significant categories are as follows:

Expense Category	1997	1996
-----	----	----
Payroll and payroll taxes	\$ 684,354	\$ 622,532
Depreciation	260,158	273,519
Direct material costs	428,699	308,125
Other	620,335	542,053
	-----	-----
Total	\$1,993,546	\$1,746,229
	=====	=====

Selling, general and administrative expenses were \$338,138 vs. \$377,269 during the first quarter of 1996. The decrease in selling, general, and administrative expenses is primarily attributed to decreased professional fees and the Company's efforts to reduce overhead and streamline operations.

The net loss for the quarter ended March 31, 1997 was \$619,441, or a net loss per weighted average common share outstanding of \$.03. The loss compares to a loss of \$582,433, or a net loss per weighted average common share outstanding of \$.03 for the three months ended March 31, 1996. The losses by month were \$408,521, \$132,913, and \$78,007 for January, February, and March, respectively. The loss can be attributed to less than anticipated sales due to limited supply and quality of raw material plastic and less than desirable operating efficiencies at the Junction facility primarily occurring in the month of January.

The Company has developed, and is currently implementing, a production plan which Management believes will provide for better operating efficiencies and correct the production problems encountered in the past. Such plan includes increasing production capacity, changes to production management, further automation of the production process and better utilization of regrindable scrap. The Company has restructured its operations management regarding the composites division bringing in a new chief operating officer in February of 1997, and believes that with the planned additional production line, as well as resuming plastic production at the Rogers facility, the Company should be able to reduce its existing backlog, thereby significantly increasing sales to its existing customer base and to improve existing operating efficiencies as a result of increased economies of scale. However, the Company's operations remain subject to numerous risks associated with the continued establishment of its business, including lack of financial sources and competition from numerous large, well-established and well-capitalized competitors who manufacture products for the same applications. In addition, the Company has in the past and may again in the future, encounter unanticipated problems, including manufacturing, distribution, and marketing difficulties, some of which may be beyond the Company's financial and technical abilities to resolve. The occurrence of, or failure to adequately address such difficulties could have a material adverse effect on the Company's prospects, including its ability to achieve anticipated sales levels.

Liquidity and Capital Resources

At March 31, 1997, the Company had a working capital deficit of \$1,245,209 compared to a working capital deficit of \$1,781,768 at December 31, 1996. The decrease is primarily attributable to the Company's 1996 recording of a receivable from the insurance company regarding the Rogers fire. Cash and cash equivalents decreased \$53,625 in the first quarter of 1997. Significant components of that decrease were: (I) cash used in

operating activities of \$306,335, which consisted of the net loss for the period of \$619,441, reduced by depreciation and amortization of \$271,101 and other uses of cash of \$46,638; (ii) cash provided by investing activities of \$163,270, and (iii) cash provided by financing activities of \$89,440. Payments on notes during the period were \$154,560 and there were no proceeds from the issuances of notes. At March 31, 1997, the Company had notes payable in the amount of \$1,568,119, of which \$768,853 were current notes payable or current portion of long-term debt. In January 1996, a major stockholder, Marjorie S. Brooks (the "Major Stockholder"), exercised 500,000 Class F Warrants. The proceeds from the exercise of these warrants, which amounted to \$305,000, reduced the working capital deficit of the Company and were used to reduce current liabilities.

The Company maintains an accounts receivable factoring agreement for up to \$700,000 through an affiliated company of a related party. The terms of this agreement call for the factor to advance 99.12% of the total of invoices presented by the Company and for the Company to indemnify the factor against loss of the amounts advanced. At March 31, 1997, approximately \$102,389 was available to factor additional receivables. The Company also maintains a line of credit from the Major Stockholder which consists of a long-term note payable, which had a balance of \$1,355,607 at March 31, 1997, and a \$433,097 revolving line of credit to be available as needed. As of March 31, 1997, the total amount of the line was available.

Since the completion of the first quarter, the Company has received additional sources of capital as described below. Historically, revenues have not been sufficient to support the Company's current operational needs. However, the Company continues to attempt to improve production rates and efficiencies in an effort to reduce or eliminate the need for additional future capital to support existing operations. Further, continued improvements in production efficiency and capacity will be required for the Company to increase sales to a level that will allow the Company to attain profitability. There can be no assurance that such improvements in production efficiency or capacity will be achieved.

As previously disclosed, Management is currently undertaking steps to increase sales to its existing customer base by expanding its production capacity. To finance existing operations and required capital expenditures, the following transactions were completed during or subsequent to the first quarter: (I) the Company received \$244,000 cash relating to an offering to qualified foreign investors under Regulation S of the Securities Act of 1933.

There can be no assurance that the Company will be able to maintain its current operating levels or achieve increased production volumes and sales levels or that the Company will be able to obtain additional capital resources to support manufacturing operations if required.

If the Company is unable to achieve and maintain a successful level of operations in the near future or unable to secure additional debt or equity financing to provide support for ongoing operations, or were it to be assessed the Mobil legal claims described in Note 6 to the financial statements, it is likely the Company would be unable to continue as a going concern.

The foregoing discussion contains certain estimates, predictions, projections and other "forward-looking statements" (within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934) that involve various risks and uncertainties. While these forward-looking statements, and

any assumptions upon which they are based, are made in good faith and reflect the Company's current judgment regarding the direction of its business, actual results will almost always vary, sometimes materially, from any estimates, predictions, projections, assumptions, or other future performance suggested herein. Some important factors (but not necessarily all factors) that could affect the Company's sales volumes, growth strategies, future profitability and operating results, or that otherwise could cause actual results to differ materially from those expressed in any forward-looking statement include the following: market, political or other forces affecting the pricing and availability of plastics and other raw material accidents or other unscheduled shutdowns affecting the Company's, its suppliers' or its customers' plants, machinery, or equipment; competition from products and services offered by other enterprises; state and federal environmental, economic, safety and other policies and regulations, any changes therein, and any legal or regulatory delays or other factors beyond the Company's control; execution of planned capital projects; weather conditions affecting the Company's operations or the areas in which the Company's products are marketed; adverse rulings, judgments, or settlements in litigation or other legal matters. The Company undertakes no obligation to publicly release the result of any revisions to any such forward- looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Item 1. Legal Proceedings

On June 9, 1992, Mobil Oil Corporation ("Mobil") commenced an action against the Company in the United States District Court for the District of Delaware entitled Mobil Oil Corporation v. Advanced Environmental Recycling Technologies, Inc. In its complaint, Mobil sought entry of a declaratory judgment that: (a)

AERT is without right or authority to threaten suit against Mobil or its customers for alleged infringement of AERT patents; (b) The AERT patents are invalid and unenforceable, and (C) Mobil has not infringed the AERT patents through any products or method. Mobil seeks no monetary damages in this suit, but does seek reimbursement of its attorneys' fees.

On December 8, 1992, the Company answered Mobil's Complaint. In its Answer, the Company denied Mobil's claims and asserted counterclaims against Mobil and three Mobil executives for: (1) an illegal combination or contract in restraint of trade in violation of federal antitrust laws; (2) a pattern of intentional misconduct constituting an attempt to monopolize in violation of federal antitrust laws; (3) breach of a confidential relationship between Mobil and the Company; and (4) unfair competition. The Company sought monetary damages, punitive damages and injunctive relief. Mobil filed an answer to AERT's counterclaims, denying any liability. The Delaware Court then bifurcated the trial into patent and non-patent issues and ordered the patent issues tried first.

In February 1994, after a trial on the patent issues, a Delaware jury returned a verdict that four AERT patents on its composite product technology were invalid. The jury also determined that Mobil had not infringed two of the four patents which AERT had asserted against Mobil. The jury verdict answered a number of interrogatories on the factual issues, and rendered advisory findings for the Court on Mobil's allegation that AERT had obtained its patents by inequitable conduct. Thereafter, the Judge adopted the jury's advisory findings on inequitable conduct and held that each of the four AERT patents were unenforceable for failure to disclose certain alleged prior art to the patent office during patent prosecution.

Because of the nature of certain of the jury verdict interrogatory responses, AERT's counsel concluded that the verdict was adversely affected by improper conduct by Mobil counsel during trial, and false statements of law and fact made during closing argument, that caused the jury to misapply the law on inequitable conduct and to render clearly erroneous findings. Consequently, AERT moved for a new trial. That motion was denied. The Company's additional post-trial motions were also denied by the Delaware Court. On March 14, 1995, the Company filed a sealed motion with the Court based upon newly discovered evidence which alleges prejudicial misconduct by Mobil prior to the trial. The motion also brings to the Court's attention, evidence which the Company believes was intentionally withheld from it in direct defiance of the Delaware Court's January 4, 1994 Motion to Compel, prior to the trial. It also brings to the Court's attention, an official government safety approval document which was altered prior to submission to AERT during pre-trial discovery, which also relates to a portion of the alleged withheld discovery documentation. The motion seeks further discovery into Mobil's misconduct, and a new trial. In December 1995, the Company also moved to supplement its pending March 14, 1995 Motion with additional tampered evidence and discovery misconduct by Mobil. The March 14, 1995 motion is currently stayed before the Delaware Court. The Company filed an appeal with the U.S. Court of

Appeals on July 10, 1995 on the initial trial arguments. In January 1996, oral arguments were presented before the U.S. Court of Appeals. On June, 1996, the U.S. Court of Appeals reversed a portion of the earlier ruling that two of the patents were invalid, and that Mobil did not infringe. The Company did not further appeal this issue to the Supreme Court. Should the Delaware Court deny the Company's pending Prejudicial Misconduct Motion, the Company intends to follow-up with an additional appeal on these issues. Should the Court not rule in favor of the Company on such motions, all appellate processes available will be pursued. There can be no assurance that the Company will receive a more favorable outcome upon appeal.

In August 1994, Mobil filed a motion seeking an award of attorneys' fees and costs in the amount of \$2.7 million. On November 1, 1994, the Court ruled that the motion was premature and will not be considered at the present time. In January 1995, Mobil renewed its Motion for Attorneys' Fees. In April 1995, the Court requested AERT to respond to Mobil's Motion. The Motion is currently stayed. With the recent appeals court ruling upholding the invalidity of two patents and the ruling of inequitable conduct, the Company has been advised that if and when the court decides to entertain Mobil's motion for the attorney's fees, and if and when Mobil decides to submit documentation and substantiate its claim, that the Company could face possible risk from an adverse decision from the court by awarding a portion of said fees to Mobil. The Company has been advised in a worse case scenario that it could face an aggressive challenge against it for a significant portion of the said \$2.7 million attorney's fees in an attempt to end this litigation prior to the companies prejudicial misconduct motion or pending counterclaims against Mobil being heard. The Company will vigorously defend against Mobil's claim for attorney's fees and costs, however, there can be no assurances as to the outcome of this litigation. The Company believes that the Mobil motion for attorney's fees and the AERT prejudicial misconduct motion for a new trial could be addressed sometime during 1997 by the Delaware Court. The Company has not recorded any liability related to such litigation as of March 31, 1997.

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 thereunto duly authorized.

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.

BY: /s/ Joe G. Brooks

JOE G. BROOKS
President

Date: May 14, 1997

BY: /s/ Jake M. Bushey

JAKE M. BUSHEY
Corporate Controller

May 14, 1997

ARTICLE 5

PERIOD TYPE	3 MOS
FISCAL YEAR END	DEC 31 1997
PERIOD START	JAN 01 1997
PERIOD END	MAR 31 1997
CASH	29,131
SECURITIES	0
RECEIVABLES	1,430,209
ALLOWANCES	0
INVENTORY	550,750
CURRENT ASSETS	2,110,549
PP&E	7,874,072
DEPRECIATION	3,447,340
TOTAL ASSETS	6,881,961
CURRENT LIABILITIES	3,355,758
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	206,667
OTHER SE	2,520,270
TOTAL LIABILITY AND EQUITY	6,881,961
SALES	1,747,802
TOTAL REVENUES	1,747,802
CGS	1,993,546
TOTAL COSTS	2,331,684
OTHER EXPENSES	0
LOSS PROVISION	0
INTEREST EXPENSE	35,559
INCOME PRETAX	(619,441)
INCOME TAX	0
INCOME CONTINUING	(619,441)
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	(619,441)
EPS PRIMARY	(.03)
EPS DILUTED	(.03)

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