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PENN ENGINEERING & MANUFACTURING CORP

Form 10-Q

November 09, 2004

FORM 10-Q
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(Mark One)

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2004

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 1-5356

PENN ENGINEERING & MANUFACTURING CORP.

(Exact name of registrant as specified in its charter)

Delaware

23-0951065

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

P.O. Box 1000, Danboro, Pennsylvania

18916

(Address of principal executive offices)

(Zip Code)

(215)-766-8853

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all documents and reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No []

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [X] No []

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date: 3,350,164 shares of Class A common stock, \$.01 par value, and 14,426,943 shares of common stock, \$.01 par value, outstanding on November 2, 2004.

PART 1. FINANCIAL INFORMATION

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Item 1. Financial Statements

PENN ENGINEERING & MANUFACTURING CORP. CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

ASSETS -----	(unaudited)	
	September 30, 2004	December 31, 2003
	-----	-----
CURRENT ASSETS		
Cash and cash equivalents	\$ 25,917	\$ 8,361
Short-term investments	225	228
Accounts receivable - net	44,204	37,629
Inventories -- net	45,426	48,512
Refundable income taxes	0	2,129
Other current assets	2,946	1,881
	-----	-----
Total current assets	118,718	98,740
	-----	-----
PROPERTY		
Property, plant and equipment	191,162	190,876
Less accumulated depreciation	106,457	99,774
	-----	-----
Property - net	84,705	91,102
	-----	-----
GOODWILL, NET	41,558	41,844
	-----	-----
OTHER ASSETS	4,312	4,438
	-----	-----
TOTAL ASSETS	\$ 249,293	\$ 236,124
	=====	=====
 LIABILITIES AND STOCKHOLDERS' EQUITY -----		
CURRENT LIABILITIES		
Accounts payable	\$ 7,708	\$ 6,865
Bank debt	1,510	9,042
Dividends payable	1,243	1,052
Accrued expenses:		
Pension and profit sharing	3,539	2,104
Payroll and commissions	7,440	3,040
Other	5,313	7,129
	-----	-----
Total current liabilities	26,753	29,232
	-----	-----
ACCRUED PENSION COST	0	1,192
	-----	-----
DEFERRED INCOME TAXES	11,716	10,927
	-----	-----
LONG-TERM BANK DEBT	2,563	3,173
	-----	-----
STOCKHOLDERS' EQUITY		

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Common Stock	152	150
Class A common stock	35	35
Additional paid-in capital	45,440	42,573
Retained earnings	160,931	148,906
Accumulated other comprehensive income	7,789	6,022
Treasury stock	(6,086)	(6,086)
	-----	-----
Total stockholders' equity	208,261	191,600
	-----	-----
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 249,293	\$ 236,124
	=====	=====

See Notes to Condensed Consolidated Financial Statements

* Condensed Consolidated Balance Sheet at December 31, 2003 has been derived from the audited financial statements at that date.

2

PENN ENGINEERING & MANUFACTURING CORP.
STATEMENTS OF CONDENSED CONSOLIDATED INCOME

(Dollars in thousands except per share amounts)

	THREE MONTHS ENDED		NINE MO
	(unaudited)		(unau
	September 30, 2004	September 30, 2003	September 30, 2004
	-----	-----	-----
Net Sales	\$ 59,962	\$ 46,321	\$ 184,978
Cost of Products Sold	40,880	32,728	122,780
	-----	-----	-----
Gross Profit	19,082	13,593	62,198
Selling Expenses	6,102	5,054	18,544
General and Administrative Expenses	6,649	6,562	20,966
	-----	-----	-----
Operating Income	6,331	1,977	22,688
	-----	-----	-----
Other Income (Expense):			
Interest income	35	13	97
Interest expense	(73)	(176)	(240)
Other, net	150	201	336
	-----	-----	-----
Total Other Income (Expense)	112	38	193
	-----	-----	-----
Income Before Income Taxes	6,443	2,015	22,881
Provision for Income Taxes	2,062	538	7,322
	-----	-----	-----
Net Income	\$ 4,381	\$ 1,477	\$ 15,559
	=====	=====	=====
PER SHARE DATA:			
Basic earnings	\$ 0.25	\$ 0.08	\$ 0.88
	=====	=====	=====

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Diluted earnings	\$ 0.24	\$ 0.08	\$ 0.87
	=====	=====	=====
Cash dividends declared	\$ 0.07	\$ 0.06	\$ 0.20
	=====	=====	=====

See Notes to Condensed Consolidated Financial Statements

3

PENN ENGINEERING & MANUFACTURING CORP.
STATEMENTS OF CONDENSED CONSOLIDATED CASH FLOWS

(Dollars in thousands)

	NINE MONTHS ENDED	
	(unaudited)	
	September 30, 2004	September 30, 2003
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 15,559	\$ 3,333
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,897	8,488
Deferred income taxes	(1)	
Foreign currency transaction gains	(101)	(2)
Loss on disposal of property	206	8
Changes in assets and liabilities:		
Increase in receivables	(6,468)	(7,799)
Decrease in inventories	3,051	8,900
Decrease in refundable income taxes	2,129	56
(Increase) decrease in other current assets	(1,067)	15
Decrease (increase) in other assets	80	(47)
Increase (decrease) in accounts payable	879	(1,988)
Increase in accrued expenses	5,800	4,511
(Decrease) increase in accrued pension cost	(1,192)	2,700
	-----	-----
Net cash provided by operating activities	26,772	18,466
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		
Property additions	(2,085)	(2,566)
Acquisitions of businesses (net of cash acquired)	0	(10,441)
Proceeds from disposal of property	89	1
	-----	-----
Net cash used in investing activities	(1,996)	(12,996)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net bank debt repayments	(8,079)	(17,343)
Dividends paid	(3,343)	(3,138)
Issuance of common stock	2,869	87
	-----	-----
Net cash used in financing activities	(8,553)	(19,594)
	-----	-----
Effect of exchange rate changes on cash	1,333	69
	-----	-----

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Net increase (decrease) in cash and cash equivalents	17,556	(13,43
Cash and cash equivalents at beginning of period	8,361	20,92
	-----	-----
Cash and cash equivalents at end of period	\$ 25,917	\$ 7,49
	=====	=====

See Notes to Condensed Consolidated Financial Statements

4

PENN ENGINEERING & MANUFACTURING CORP.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2004

Note 1. Condensed Consolidated Financial Statements (Unaudited).

The accompanying condensed consolidated financial statements and notes should be read in conjunction with the annual financial statements and notes thereto included in the Company's Annual Report for the year ended December 31, 2003. The information contained in this report is unaudited and, in the opinion of management, reflects all adjustments (which include only normal recurring adjustments) necessary for a fair presentation of the Company's condensed consolidated financial position at September 30, 2004 and 2003 and the condensed consolidated statements of income and cash flows for the nine-month periods then ended. The results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the results of operations to be expected for the year ending December 31, 2004.

Note 2. Inventories.

Substantially all of the Company's domestic fastener inventories are priced on the last-in, first-out (LIFO) method, at the lower of cost or market. The remainder of the inventories are priced on the first-in, first-out (FIFO) method, at the lower of cost or market. Inventories are as follows:

(Dollars in thousands)		
	September 30, 2004	December 31, 2003
	-----	-----
Raw material	\$2,638	\$2,807
Tooling	7,524	5,540
Work-in-process	10,002	11,541
Finished goods	25,262	28,624
	-----	-----
TOTAL	\$45,426	\$48,512
	=====	=====

If the FIFO method of inventory valuation had been used by the Company for all inventories, inventories would have been \$10,342,000 and \$10,072,000 higher than reported at September 30, 2004 and December 31, 2003, respectively, and net income would have been \$183,000 and \$106,000 higher than reported for the nine months ended September 30, 2004 and 2003, respectively. Long-term tooling inventory totaling \$1,225,000 at September 30, 2004 and \$1,285,000 at December 31, 2003 is included in Other Assets.

Note 3. Bank Debt.

As of September 30, 2004, the Company had four unsecured line-of-credit facilities available, all of which bear interest at interest rate

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options provided in the facilities and are reviewed annually by the banks for renewal. The facilities are as follows:

5

- o a working capital facility that permits maximum borrowings of \$7,000,000, due on demand, under which no amounts were outstanding at September 30, 2004;
- o a facility that allows for borrowings of up to \$15,000,000, under which no amounts were outstanding at September 30, 2004;
- o a facility that permits borrowings of up to \$30,000,000, under which no amounts were outstanding at September 30, 2004.
- o a committed line-of-credit that permits borrowings of up to \$8,000,000, under which no amounts were outstanding at September 30, 2004.

These line of credit facilities require that the Company comply with certain financial covenants. At September 30, 2004, the Company was in compliance with all financial covenants under these facilities.

In addition to the above domestic line-of-credit facilities, the Company's subsidiary, PennEngineering Motion Technologies (Europe) S.r.l., has two short-term credit facilities under which \$941,000 was outstanding at September 30, 2004. PennEngineering Motion Technologies (Europe) S.r.l. also has an outstanding mortgage on its building, of which \$569,000 is classified as short-term debt and \$2,563,000 is classified as long-term debt at September 30, 2004.

Note 4. Comprehensive Income.

Total comprehensive income amounted to \$5,782,000 and \$2,191,000 for the three months ended September 30, 2004 and 2003, respectively, and \$17,326,000 and \$6,296,000 for the nine months ended September 30, 2004 and 2003, respectively.

Note 5. Accounting for Stock Options.

The Company follows Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees" and related interpretations in accounting for stock options. Under APB 25, if the exercise price of stock options granted equals or exceeds the market price of the underlying common stock on the date of grant, no compensation expense is recognized. Statement of Financial Accounting Standards No. 123 ("SFAS No. 123") requires pro forma information regarding net income and earnings per share as if the Company had accounted for its employee stock options under the fair value method of SFAS No. 123. The fair value of each option granted was estimated on the date of grant using the Black-Scholes option-pricing model. For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. Had compensation costs for the Company's plans been determined based on the fair value at the grant date for

6

awards under these plans consistently with the method of SFAS No. 123, the

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impact on the Company's financial results would have been as follows:

	THREE MONTHS ENDED	
	September 30	
	2004	2003
(Dollars in thousands except per share amounts)		
Net income as reported	\$ 4,381	\$ 1,477
Pro forma compensation cost, net of tax	(346)	(302)
Pro forma net income	\$ 4,035	\$ 1,175
Basic earnings per share:		
As reported	\$0.25	\$0.08
Pro forma	0.23	0.07
Diluted earnings per share:		
As reported	\$0.24	\$0.08
Pro forma	0.22	0.07

Note 6. Use of Estimates.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that may 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.

Note 7. Components of Net Periodic Pension Cost.

Net pension costs included the following components:

	THREE MONTHS ENDED		NI
	September 30		
	2004	2003	2004
(Dollars in thousands)			
Service cost	\$ 658	\$ 595	\$ 2,0
Interest cost	769	770	2,2
Expected return on plan assets	(640)	(500)	(1,8
Net amortization and deferral	173	35	5
Net periodic pension cost	\$ 960	\$ 900	\$ 3,0

The Company previously disclosed in its Annual Report for the year ended December 31, 2003, that it expected to contribute \$5,100,000 to its pension plan in 2004. As of September 30, 2004, \$4,072,000 of contributions have been made. The Company presently anticipates contributing an additional

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\$2,271,000 to fund its pension plan in 2004 for a total of \$6,343,000.

7

Note 8. Segment Information.

(Dollars in thousands)

	THREE MONTHS ENDED			Fasteners
	September 30, 2004			
	Fasteners	Distribution	Motors	
Revenues from external customers	\$32,071	\$14,741	\$13,150	\$21,954
Intersegment revenues	10,039		180	7,243
Operating income	6,617	626	1,141	2,320

	NINE MONTHS ENDED			Fasteners
	September 30, 2004			
	Fasteners	Distribution	Motors	
Revenues from external customers	\$98,525	\$48,332	\$38,121	\$70,420
Intersegment revenues	28,363		1,377	19,895
Operating income	23,578	3,428	2,560	6,743

A reconciliation of combined operating income for the reportable segments to consolidated income before income taxes is as follows:

(Dollars in thousands)	THREE MONTHS ENDED		NI
	September 30		
	2004	2003	
Total income for reportable segments	\$ 8,384	\$ 3,843	\$29,5
Unallocated corporate expenses	(2,053)	(1,866)	(6,8
Other income (expense)	112	38	1
Income before income taxes	\$ 6,443	\$ 2,015	\$22,8

8

Note 9. Earnings Per Share Data.

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The following table sets forth the computation of basic and diluted earnings per share for the periods indicated.

(In thousands, except per share data)	THREE MONTHS ENDED		NINE
	September 30		Se
	2004	2003	2004
Basic:			
Net income	\$ 4,381	\$ 1,477	\$15,559
Weighted average shares outstanding	17,704	17,451	17,632
Basic earnings per share	\$ 0.25 =====	\$ 0.08 =====	\$ 0.88 =====
Diluted:			
Net income	\$ 4,381 =====	\$ 1,477 =====	\$15,559 =====
Weighted average shares outstanding	17,704	17,451	17,632
Net effect of dilutive stock options-based on treasury stock method	325 -----	253 -----	290 -----
Totals	18,029 =====	17,704 =====	17,922 =====
Diluted earnings per share	\$ 0.24 =====	\$ 0.08 =====	\$ 0.87 =====

9

Item 2. Management's Discussion and Analysis of Financial Condition

and Results of Operations.

Quarter Ended September 30, 2004 vs. Quarter Ended September 30, 2003

Consolidated net sales for the quarter ended September 30, 2004 were \$60.0 million, versus \$46.3 million for the quarter ended September 30, 2003, a 29.6% increase. Net sales to customers outside the United States for the quarter ended September 30, 2004 were \$22.8 million, versus \$19.4 million for the quarter ended September 30, 2003, a 17.5% increase. Net sales for the Fastening Technologies segment for the quarter ended September 30, 2004 were \$32.1 million, versus \$22.0 million for the quarter ended September 30, 2003, a 45.9% increase. Net sales for the Motion Technologies segment were \$13.2 million for the quarter ended September 30, 2004, versus \$10.5 million recorded for the quarter ended September 30, 2003, a 25.7% increase. Net sales for the Distribution segment for the quarter ended September 30, 2004 were \$14.7 million, versus \$13.9 million for the quarter ended September 30, 2003, a 5.8% increase.

Within the Fastening Technologies segment, sales volume increased 37.9% in both the domestic and international markets from the third quarter of 2003 to the third quarter of 2004, while the average selling price increased approximately 4.0%, due to a change in product mix as well as price increases that went into effect during the year to cover raw material cost increases.

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Within the Motion Technologies segment, the number of motors sold under the Pittman brand increased approximately 21.3% in the third quarter of 2004 compared to the third quarter of 2003, while the average selling price per motor increased approximately 8.9%, primarily due to a price increase effective January 1, 2004. Motor sales from PennEngineering Motion Technologies (Europe) S.r.l. (formerly MAE) were \$2.6 million in the third quarter of 2004 compared to \$2.3 million in the third quarter of 2003. Within the Distribution segment, sales into Europe increased approximately 15.7%, sales into North America increased 8.2%, while sales into Asia were the same in the third quarter of 2004 and the third quarter 2003.

Consolidated gross profit for the third quarter of 2004 was \$19.1 million, versus \$13.6 million for the third quarter of 2003, an increase of 40.4%. Gross profit as a percent of sales increased from 29.3% in the third quarter of 2003 to 31.8% in the third quarter of 2004. The Company continues to benefit from increased volume, especially in the manufacture of fasteners where increased plant and machinery utilization occurred without corresponding increases in fixed costs.

Consolidated selling, general, and administrative expenses ("SG&A") for the third quarter of 2004 were \$12.8 million, versus \$11.6 million for the third quarter of 2003, a 10.3% increase. This increase was caused mainly by increased commission expense (up 10.5%) and other direct selling expenses due to the higher sales volume.

10

Consolidated net income for the third quarter of 2004 was \$4.4 million, versus \$1.5 million for the third quarter of 2003. The effective tax rate increased from 26.7% in the third quarter of 2003 to 32.0% in the third quarter of 2004 due to the fact that a greater proportion of income was generated in the United States, with a higher corporate income tax rate compared to the locations in which income was generated in the third quarter of 2003.

Nine Months Ended September 30, 2004 vs. Nine Months Ended September 30, 2003

Consolidated net sales for the nine months ended September 30, 2004 were \$185.0 million, versus \$138.6 million for the nine months ended September 30, 2003, a 33.5% increase. Net sales to customers outside the United States for the nine months ended September 30, 2004 were \$75.5 million, versus \$55.3 million for the nine months ended September 30, 2003, an increase of 36.5%. Net sales for the Fastening Technologies segment for the nine months ended September 30, 2004 were \$98.5 million, versus \$70.4 million for the nine months ended September 30, 2003, a 39.9% increase. Net sales for the Motion Technologies segment were \$38.1 for the nine months ended September 30, 2004, versus \$31.7 million for the nine months ended September 30, 2003, a 20.2% increase. Net sales for the Distribution segment for the nine months ended September 30, 2004 were \$48.3 million, versus \$36.4 million for the nine months ended September 30, 2003, a 32.7% increase.

Within the Fastening Technologies segment, sales volume increased 31.7% from the first nine months of 2003 compared to the first nine months of 2004, while the average selling price increased 6.0%. This segment continues to benefit from the improved economy, especially in the gaming, security, and medical markets as well as the segment's traditional telecommunications and datacommunications markets. In addition, a 2.0% price increase went into effect on January 1, 2004 as well as an additional 2.0% surcharge in May 2004 on selected products to cover additional raw material cost increases. Within the Motion Technologies segment, the number of motors sold under the Pittman brand increased approximately 18.7% in the first nine months of 2004 compared to the

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first nine months of 2003, while the average selling price increased approximately 7.8%. Motor sales from PMT Europe were \$7.9 million for the nine months ended September 30, 2004 versus \$7.1 million for the nine months ended September 30, 2003. Within the Distribution segment, the Company experienced strong international sales growth during the first nine months of 2004 compared to the same period in 2003 as the Asian market increased 50.0% and the European market increased 33.7%. The domestic market continues to strengthen also as sales increased 19.8% in North America.

Consolidated gross profit for the first nine months of 2004 was \$62.2 million, versus \$39.2 million for the first nine months of 2003, a 58.7% increase. Increased volume led to the improvement in gross margin as increased costs for wages and benefits were offset by productivity improvements and better utilization of capacity.

11

Consolidated SG&A expenses for the first nine months of 2004 were \$39.5 million, or 21.4% of sales, versus \$34.7 million, or 25.0% of sales, for the first nine months of 2003, an increase of 13.8%. In addition to increased wages and employee benefits, legal and professional fees increased approximately 76% from 2003 to 2004 due mainly to increased audit and Sarbanes-Oxley related expenses.

Consolidated net income for the first nine months of 2004 was \$15.6 million, versus \$3.3 million for the first nine months of 2003. Interest expense decreased from \$701,000 in the first nine months of 2003 to \$240,000 in the first nine months of 2004 due to less debt outstanding. The effective tax rate increased from 24.0% in the first nine months of 2003 to 32.0% in the first nine months of 2004 due to the fact that a greater proportion of income was generated in the United States, with a higher corporate income tax rate compared to the locations where income was generated in the first nine months of 2003.

Liquidity and Capital Resources

Cash and cash equivalents at September 30, 2004 were \$25.9 million compared to \$8.4 million at December 31, 2003. Working capital totaled \$92.0 million at September 30, 2004 compared to \$69.5 million at December 31, 2003.

Net cash of \$26.8 million was provided by operating activities for the nine months ended September 30, 2004 compared to \$18.5 million provided by operating activities for the nine months ended September 30, 2003. The Company continued to generate cash from further reductions in overall inventory levels during the first nine months of 2004. However, as sales volume increased, the level of accounts receivable also increased, particularly in the European region where payment terms are generally longer than domestic payment terms.

Net cash used in investing activities totaled \$2.0 million for the nine months ended September 30, 2004. The Company continues to exercise caution with its capital expenditures as it attempts to utilize current capacity during the economic recovery.

Net cash used in financing activities totaled \$8.6 million for the nine months ended September 30, 2004 compared to \$19.6 million for the nine months ended September 30, 2003. Because of the decreased capital expenditures, the Company repaid short-term debt during both years.

The Company's principal contractual obligations are the repayment of its short-term debt (see Note 3) and the payment of operating lease commitments covering certain automobiles, office space, and office equipment that are listed

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in Note 12 to the Company's Annual Report for the year ended December 31, 2003. The Company anticipates that its existing capital resources and cash flow generated from future operations as well as existing short-term lines of credit will enable it to maintain its current level of operations and its planned growth for the foreseeable future.

12

Critical Accounting Policies

The Company has identified a number of its accounting policies that it has determined to be critical. These critical accounting policies primarily relate to financial statement assertions that are based on the estimates and assumptions of management, and the effect of changing those estimates and assumptions could have a material effect on the Company's financial statements. The following is a summary of those critical accounting policies.

Inventories

The Company's domestic fastener inventories are priced on the last-in, first-out (LIFO) method of accounting. Other inventories, representing approximately 79% of total inventories at September 30, 2004 and December 31, 2003, respectively, are priced on the first-in, first-out (FIFO) method. Reserves are recorded for obsolete, excess, and slow-moving inventories based on management's estimates about future demand and market conditions. At September 30, 2004, the Company's inventory balance of \$45,426,000 was net of a reserve for obsolete, excess, and slow-moving inventories of approximately \$4,210,000. At December 31, 2003, the Company's inventory balance of \$48,512,000 was net of a reserve for obsolete, excess, and slow-moving inventories of approximately \$3,512,000. If the estimated reserves for obsolete, excess, and slow-moving inventories are not sufficient based on actual future demand, additions to the reserve may be required.

Accounts Receivable

The Company maintains an allowance for doubtful accounts for trade receivables for which collectability is uncertain. At September 30, 2004 and December 31, 2003, this allowance was approximately \$1,029,000 and \$886,000, respectively. In estimating uncollectible accounts, the Company considers factors such as current overall economic conditions, industry-specific economic conditions, and historical and anticipated customer performance. While the Company believes that its procedures effectively address exposure for doubtful accounts, changes in the economy, industry, or specific customer conditions may require adjustments to the allowance.

Goodwill

SFAS No. 142 requires that goodwill no longer be amortized, and instead, be tested for impairment on a periodic basis. At September 30, 2004, the Company had \$41,558,000 in goodwill. The process of evaluating the potential impairment of goodwill is highly subjective and requires significant judgments at many points during the analysis. In estimating the fair value of the reporting units with recognized goodwill for the purposes of the Company's

13

2003 financial statements, the Company made estimates and judgments about the future cash flows of these reporting units. The Company's cash flow forecasts were based on assumptions that are consistent with the plans and estimates the Company is using to manage the underlying businesses. In addition, the Company made certain judgments about allocating shared assets to the balance sheet for those reporting units. Based on its estimates, the Company has concluded that there is no impairment of its goodwill as of December 31, 2003. However, changes in these estimates could cause one or more of the reporting units to be valued differently in the future. The Company will evaluate its goodwill again for impairment as of October 1, 2004.

Pensions

Accounting for the Company's defined benefit pension plan requires that amounts recognized in the financial statements be determined on an actuarial basis. The most significant elements in determining the Company's pension expense are pension liability discount rates and the expected return on plan assets. The pension discount rate reflects the current interest rate at which pension liabilities could be settled at the end of the year. At the end of each year, the Company determines the discount rate to be used to discount plan liabilities. In estimating this rate, the Company looks to rates of return on high-quality, fixed-income investments. At December 31, 2003, the Company determined this rate to be 6.25% and no adjustment to this rate has been made for the nine months ended September 30, 2004. Historically, the Company has assumed that the expected long-term rate of return on plan assets will be 8.00%, and this expected rate of return was used for many years. Because the Company's pension plan assets have earned substantially less than 8.00% in the last two years, the Company reduced the expected long-term rate of return to 7.00% in 2003 and no adjustment has been made for the nine months ended September 30, 2004. Should the downward trend in return on pension assets continue, future pension expense would likely increase. The net effect of changes in the discount rate, as well as the effect of differences between the expected return and the actual return on plan assets, have been deferred in accordance with SFAS No. 132 and will ultimately affect future pension expense.

Derivative Instruments and Hedging

The Company manages risks associated with foreign exchange rates and interest rates with derivative instruments. The Company does not use derivative instruments for trading or speculative purposes, and only uses derivatives when there is an underlying exposure. The evaluation of hedge effectiveness is subject to assumptions based on the terms and the timing of the underlying exposures. All derivative instruments are recognized in the Consolidated Balance Sheet at fair value, which is generally based on quoted market prices.

Section 404 of the Sarbanes-Oxley Act of 2002

Section 404 of the Sarbanes-Oxley Act of 2002 requires the Company's management to perform an evaluation of its internal control over financial reporting and have the Company's independent auditors attest to such

an evaluation. Along with many other companies whose fiscal year ends on

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December 31, the Company must implement these requirements for the first time in connection with the preparation of the Company's annual report for the year ending December 31, 2004. The Company has been actively preparing for the implementation of this requirement by, among other things, establishing an ongoing program to document, evaluate, and test the systems and processes necessary for compliance. While the Company anticipates that it will be able to comply with these requirements on a timely basis, unforeseen delays may occur that could prevent the Company from achieving timely compliance. If the Company is unable to complete its evaluation on a timely basis and in a satisfactory manner, or if the Company's external auditors are unable to attest on a timely basis to the adequacy of the Company's internal control, the Company may be subject to additional scrutiny surrounding its internal control over financial reporting.

Forward-Looking Statements

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 under the Private Securities Litigation Reform Act of 1995, are made throughout this Management's Discussion and Analysis. The Company's results may differ materially from those in the forward-looking statements. Forward-looking statements are based on management's current views and assumptions, and involve risks and uncertainties that significantly affect expected results. For example, operating results may be affected by external factors such as: changes in laws and regulations, changes in accounting standards, fluctuations in demand in markets served by the Company, particularly the computer and telecommunications markets, fluctuations in the cost and availability of the supply chain resources, and foreign economic conditions, including currency rate fluctuations.

Item 3. Quantitative and Qualitative Disclosure About Market Risk.

Reference is made to Part 2, Item 7A of the Company's Form 10-K Annual Report for the year ended December 31, 2003. There has been no material change in the information reported in that report.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

As required by Rule 13a-15 under the Securities Exchange Act of 1934, as of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on this evaluation, the Company's management, including the Chief Executive Officer and the Chief Financial Officer, concluded that the Company's disclosure controls and procedures are effective for recording, processing, summarizing, and reporting the information the Company is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the Securities and Exchange Commission's rules and forms.

Changes in Internal Control Over Financial Reporting

There have been no significant changes in the Company's internal controls over financial reporting (as such term is defined in Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934) during the three months and nine months ended September 30, 2004 that have materially affected,

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or are reasonably likely to affect materially, the Company's internal control over financial reporting.

15

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

Reference is made to Part 1, Item 3 of the Company's Form 10-K Annual Report for the year ended December 31, 2003.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Not applicable.

Item 3. Defaults upon Senior Securities.

Not applicable.

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

Not applicable.

Item 5. Other Information.

In order that the Company and its independent auditors have sufficient time to complete their compliance with the requirements of Section 404 of the Sarbanes-Oxley Act, the Company anticipates that the Company's future earnings announcements will be approximately a week before the scheduled filing dates of its quarterly and annual reports with the Securities and Exchange Commission.

Item 6. Exhibits.

Exhibit No.	Description
3.1	Restated Certificate of Incorporation (Incorporated by reference to Exhibit 3.1 of the Company's Form 10-Q Quarterly Report for the period ended March 31, 2001.)
3.2	By-laws, as amended (Incorporated by reference to Exhibit 3.2 of the Company's Form 10-K Annual Report for the year ended December 31, 2001.)
31.1	Rule 13a-14(a)/15d-14(a) Certification.
31.2	Rule 13a-14(a)/15d-14(a) Certification.
32.1	Section 1350 Certification.

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32.2

Section 1350 Certification.

16

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: November 9, 2004

PENN ENGINEERING & MANUFACTURING CORP.

By: /s/ Kenneth A. Swanstrom

Kenneth A. Swanstrom
Chairman of the Board and
Chief Executive Officer

Dated: November 9, 2004

By: /s/ Mark W. Simon

Mark W. Simon
Senior Vice President and
Chief Financial Officer

17

PENN ENGINEERING & MANUFACTURING CORP.

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18