PENN ENGINEERING & MANUFACTURING CORP
Form 10-Q
May 10, 2005

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

(Mark One)

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

For the quarterly period ended March 31, 2005

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 14,507,438 shares of common stock, $.01 par value, outstanding on April 29, 2005.

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

PENN ENGINEERING & MANUFACTURING CORP.
CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

ASSETS

	(unaudited) March 31, 2005	December 31, 2004
CURRENT ASSETS		
Cash and cash equivalents	$ 32,179	$ 32,893
Short-term investments	222	225
Accounts receivable - net	44,755	37,138
Inventories - net	48,002	46,731
Refundable income taxes	--	1,410
Other current assets	2,916	3,120
Total current assets	128,074	121,517
PROPERTY		
Property, plant and equipment	194,374	194,631
Less accumulated depreciation	111,618	109,872
Property - net	82,756	84,759
GOODWILL	43,957	45,090
PREPAID PENSION COST	296	1,315
OTHER ASSETS	764	800
TOTAL ASSETS	$ 255,847	$ 253,481

LIABILITIES AND STOCKHOLDERS' EQUITY

	March 31, 2005	December 31, 2004
CURRENT LIABILITIES		
Accounts payable	$ 8,194	$ 8,135
Bank debt	1,531	1,664
Dividends payable	--	1,249
Accrued expenses:		
Profit sharing	1,192	1,490
Payroll and commissions	4,337	3,887
Other	7,113	5,310
Total current liabilities	22,367	21,735
DEFERRED INCOME TAXES	11,953	12,169
LONG-TERM BANK DEBT	2,379	2,819

STOCKHOLDERS' EQUITY		
Common stock	153	153
Class A common stock	35	35
Additional paid-in capital	47,447	47,354
Retained earnings	167,419	162,590
Accumulated other comprehensive income	10,180	12,712
Treasury stock	(6,086)	(6,086)
Total stockholders' equity	219,148	216,758
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 255,847	$ 253,481

See Notes to Condensed Consolidated Financial Statements

PENN ENGINEERING & MANUFACTURING CORP.
STATEMENTS OF CONDENSED CONSOLIDATED INCOME

(Dollars in thousands except per share amounts)

	THREE MONTHS ENDED (unaudited)	
	March 31, 2005	March 31, 2004
Net Sales	$ 63,832	$ 63,307
Cost of Products Sold	40,684	40,785
Gross Profit	23,148	22,522
Selling Expenses	6,226	6,409
General and Administrative Expenses	8,754	7,371
Operating Income	8,168	8,742
Other Income (Expense):		
Interest income	89	49
Interest expense	(49)	(96)
Other, net	(588)	(128)
Total Other (Expense) Income	(548)	(175)
Income Before Income Taxes	7,620	8,567
Provision for Income Taxes	2,790	2,700
Net Income	$ 4,830	$ 5,867
PER SHARE DATA:		
Basic earnings	$ 0.27	$ 0.33
Diluted earnings	$ 0.27	$ 0.33
Cash dividends declared	$ --	$ 0.06

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See Notes to Condensed Conso6lidated Financial Statements

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

(Dollars in thousands)

	THREE MONTHS ENDED (unaudited)	
	March 31, 2005	March 31, 2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 4,830	$ 5,867
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,524	2,650
Deferred income taxes	(1)	1
Foreign currency transaction losses (gains)	81	(4)
(Gain) loss on disposal of property	(2)	56
Changes in assets and liabilities:		
Increase in receivables	(7,938)	(6,754)
(Increase) decrease in inventories	(1,622)	1,577
Decrease in refundable income taxes	1,410	1,911
Decrease (increase) in other current assets	164	(317)
Decrease in prepaid pension cost	1,019	--
Decrease (increase) in other assets	36	(58)
Increase in accounts payable	231	338
Increase in accrued expenses	2,137	2,443
Net cash provided by operating activities	2,869	7,710
CASH FLOWS FROM INVESTING ACTIVITIES:		
Property additions	(1,700)	(473)
Proceeds from disposal of property	10	9
Net cash used in investing activities	(1,690)	(464)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net bank debt repayments	(352)	(770)
Dividends paid	(1,249)	(1,052)
Issuance of common stock	93	606
Net cash used in financing activities	(1,508)	(1,216)
Effect of exchange rate changes on cash	(385)	673
Net (decrease) increase in cash and cash equivalents	(714)	6,703
Cash and cash equivalents at beginning of period	32,893	8,361

Cash and cash equivalents at end of period	$ 32,179	$ 15,064

See Notes to Condensed Consolidated Financial Statements

PENN ENGINEERING & MANUFACTURING CORP.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2005

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, 2004. 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 March 31, 2005 and 2004 and its condensed consolidated statements of income and cash flows for the three-month periods then ended. The results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results of operations to be expected for the year ending December 31, 2005.

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)	March 31, 2005	December 31, 2004
Raw material	$ 3,253	$ 2,802
Tooling	6,354	6,392
Work-in-process	11,724	11,626
Finished goods	26,671	25,911
TOTAL	$48,002	$46,731

If the FIFO method of inventory valuation had been used by the Company for all inventories, inventories would have been $10,239,000 and $10,175,000 higher than reported at March 31, 2005 and December 31, 2004, respectively, and net income would have been $44,000 and $71,000 higher than reported for the three months ended March 31, 2005 and 2004, respectively. The inventory is also net of a reserve for obsolete, excess, and slow-moving inventory of approximately $4,266,000 and $5,136,000 at March 31, 2005 and December 31, 2004, respectively. Long-term tooling inventory totaling $764,000 at March 31, 2005 and $800,000 at December 31, 2004 is included in Other Assets.

Note 3. Bank Debt.

As of March 31, 2005, the Company had four unsecured line-of-credit facilities available, all of which bear interest at interest rate options provided in the facilities and are reviewed annually by the banks for renewal. The facilities are as follows:

- a working capital facility that allows for borrowings of up to $7,000,000, under which no amounts were outstanding at March 31, 2005;
- a facility that allows for borrowings of up to $15,000,000, under which no amounts were outstanding at March 31, 2005;
- a facility that permits borrowings of up to $30,000,000, under which no amounts were outstanding at March 31, 2005; and
- a committed line-of-credit that permits borrowings of up to $8,000,000, under which no amounts were outstanding at March 31, 2005.

These line of credit facilities require that the Company comply with certain financial covenants. At March 31, 2005, the Company was in compliance with all financial covenants under these facilities.

In conjunction with the pending merger of the Company (see Note 11), the Company's Board of Directors authorized management to terminate the above working capital facilities and line of credit on May 3, 2005.

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 $936,000 was outstanding at March 31, 2005. PennEngineering Motion Technologies (Europe) S.r.l. also has an outstanding mortgage on its building, of which $595,000 is classified as short-term debt and $2,379,000 is classified as long-term debt at March 31, 2005.

Note 4. Comprehensive Income.

Total comprehensive income amounted to $2,298,000 and $6,042,000 for the three months ended March 31, 2005 and 2004, 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 awards under these plans consistently with the method of SFAS No. 123, the impact on the Company's results of operations would have been as follows:

(Dollars in thousands except per share amounts)	THREE MONTHS ENDED March 31 2005	THREE MONTHS ENDED March 31 2004
Net income as reported	$ 4,830	$ 5,867
Pro forma compensation cost, net of tax	(257)	(353)
Pro forma net income	$ 4,573	$ 5,514
Basic earnings per share:		
As reported	$0.27	$0.33
Pro forma	0.26	0.31
Diluted earnings per share:		
As reported	$0.27	$0.33
Pro forma	0.25	0.31

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:

(Dollars in thousands)	THREE MONTHS ENDED March 31 2005	THREE MONTHS ENDED March 31 2004
Service cost	$ 715	$ 720
Interest cost	845	750
Expected return on plan assets	(750)	(600)
Net amortization and deferral	210	180
Net periodic pension cost	$ 1,020	$ 1,050

Note 8. Segment Information.

(Dollars in thousands)

	THREE MONTHS ENDED March 31, 2005			T
	Fasteners	Distribution	Motors	Fasteners
Revenues from external customers	$34,986	$15,057	$13,789	$33,608
Intersegment revenues	9,112		377	8,622
Operating income	8,931	1,093	1,291	8,681

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 March 31 2005	2004
Total operating income for reportable segments	$11,315	$11,132
Unallocated corporate expenses	(3,147)	(2,390)
Other income (expense)	(548)	(175)
Income before income taxes	$ 7,620	$ 8,567

Note 9. Earnings Per Share Data.

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 March 31 2005	2004
Basic:		
Net income	$ 4,830	$ 5,867
Weighted average shares outstanding	17,854	17,557
Basic earnings per share	$ 0.27	$ 0.33
Diluted:		
Net income	$ 4,830	$ 5,867
Weighted average shares outstanding	17,854	17,557
Net effect of dilutive stock options-based on treasury stock method	257	263

Total	18,111	17,820
Diluted earnings per share	$ 0.27	$ 0.33

Note 10. Impact of Recently Issued Accounting Standards.

On December 21, 2004, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 109-2 (FSP No. 109-2), "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provisions within the American Jobs Creation Act of 2004" (the Jobs Act). FSP No. 109-2 provides guidance with respect to reporting the potential impact of the repatriation provisions of the Jobs Act on an enterprise's income tax expense and deferred tax liability. The Jobs Act was enacted on October 22, 2004, and provides for a temporary 85% dividends received deduction on certain foreign earnings repatriated during a one-year period. The deduction would result in an approximate 5.25% federal tax rate on the repatriated earnings. To qualify for the deduction, the earnings must be reinvested in the United States pursuant to a domestic reinvestment plan established by a company's chief executive officer and approved by a company's board of directors. Certain other criteria in the Jobs Act must be satisfied as well. FSP No. 109-2 states that an enterprise is allowed time beyond the financial reporting period to evaluate the effect of the Jobs Act on its plan for reinvestment or repatriation of foreign earnings. The Company has not yet completed its evaluation of the impact of the repatriation provisions of the Jobs Act. Accordingly, as provided for in FSP No. 109-2, the Company has not adjusted its tax expense or deferred tax liability to reflect the repatriation provisions of the Jobs Act.

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In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123(R)), which replaces SFAS No. 123 and supersedes APB Opinion No. 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first interim period after June 15, 2005, with early adoption encouraged. The pro forma disclosures previously permitted under SFAS No. 123 will no longer be an alternative to financial statement recognition. Under SFAS No. 123(R), the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The permitted transition methods include either retrospective or prospective adoption. Under the retrospective option, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options at the beginning of the first quarter of adoption of SFAS No. 123(R), while the retrospective methods would record compensation expense for all unvested stock options beginning with the first period presented. The Company is currently evaluating the requirements of SFAS No. 123(R) and expects that adoption of SFAS No. 123(R) will have a material impact on the Company's consolidated financial position and consolidated results of operations. The Company has not yet determined the method of adoption or the effect of adopting SFAS No. 123(R), and it has not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS No. 123. See Accounting for Stock Options in Note 5 above.

During the first quarter of 2005, the Securities and Exchange Commission (the "SEC") approved a new rule for public companies which delays the adoption of SFAS No. 123(R). The SEC's new rule allows companies to implement

SFAS No. 123(R) at the beginning of their next fiscal year, instead of the next reporting period, that begins after June 15, 2005. The rule does not change the accounting required by SFAS No. 123(R); it only changes the dates for compliance for that standard. The Company expects to adopt SFAS No. 123(R) effective January 1, 2006.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs an Amendment of ARB No. 43, Chapter 4" (SFAS No. 151). SFAS No. 151 amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, handling costs and wasted material (spoilage). Among other provisions, the new rule requires that such items be recognized as current-period charges, regardless of whether they meet the criterion of "so abnormal" as stated in ARB No. 43. SFAS No. 151 is effective for fiscal years beginning after June 15, 2005. The Company does not expect that adoption of SFAS No. 151 will have a material effect on its consolidated financial position, consolidated results of operations, or liquidity.

Note 11. Merger Agreement.

On January 17, 2005, the Company entered into a definitive merger agreement whereby the Company would be acquired by PEM Holding Co., an affiliate of Tinicum Capital Partners II, L.P. in a cash transaction. Under the terms of the agreement, stockholders of the Company will receive $18.25 in cash for each share of the Company's Common Stock and Class A Common Stock. A special meeting of stockholders has been scheduled for May 24, 2005 to consider and vote on the proposed merger. The obligations of the parties to the Merger Agreement to complete the merger are subject to various conditions including PEM Holding Co. or its wholly owned subsidiary having received the proceeds of a financing under a signed financing commitment letter. Upon termination of the Merger Agreement under specified circumstances, the Company has agreed to pay PEM Holding Co. a termination fee and reimburse certain costs and expenses of PEM Holding Co.

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

Quarter Ended March 31, 2005 vs. Quarter Ended March 31, 2004

Consolidated net sales for the quarter ended March 31, 2005 were $63.8 million, versus $63.3 million for the quarter ended March 3, 2004. Net sales to customers outside the United States were $26.5 million for the quarter ended March 31, 2005 compared to $26.6 million for the quarter ended March 31, 2004. Net sales for the Fastening Technologies segment for the quarter ended March 31, 2005 were $35.0 million, versus $33.6 million for the quarter ended March 31, 2004, a 4.1% increase. Net sales for the Motion Technologies segment were $13.8 million for the quarter ended March 31, 2005, versus $12.6 million for the quarter ended March 31, 2004, a 9.5% increase. Net sales for the Distribution segment for the quarter ended March 31, 2005 were $15.1 million, versus $17.1 million for the quarter ended March 31, 2004, a 11.7% decrease.

Within the Fastening Technologies segment, sales volume decreased 2.7% in both the domestic and international markets from the first quarter of 2004 to the first quarter of 2005, while the average selling price increased approximately 6.5%. Contributing to the higher average selling price were price increases in the second quarter of 2004 in the United States and in the first quarter of 2005 in Europe, more favorable currency translation rates in Europe in 2005, and smaller distributor order quantities at corresponding higher prices. Within the Motion Technologies segment, the number of motors sold decreased approximately 6.9% in the first quarter of 2005 compared to the first quarter of 2004, while the average selling price per motor increased approximately 15.6% as a result of selective price increases. Within the Distribution segment, sales into Europe decreased approximately 20.4%, sales into North America decreased 8.4%, and sales into Asia decreased 12.1% from the first quarter of 2004 to the first quarter of 2005. Softening in the major markets served by the Company, as well as competitive pricing pressures, contributed to the decline in all areas.

Consolidated gross profit for the first quarter of 2005 was $23.1 million, versus $22.5 million for the first quarter of 2004, an increase of 2.7%. In spite of decreasing volume, the Company was able to increase its gross margin percentage from 35.6% of sales in the first quarter of 2004 to 36.3% of sales in the first quarter of 2005 due to price increases and more favorable product mix.

Consolidated selling, general, and administrative expenses ("SG&A") for the first quarter of 2005 were $15.0 million, versus $13.8 million for the first quarter of 2004, an 8.7% increase. Approximately $975,000 of this increase represents transaction expenses associated with the forthcoming merger of the Company (see Note 11) that is expected to be completed in the second quarter of 2005.

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Within the Fastening Technologies segment, operating income was $8.9 million in the first quarter of 2005 compared to $8.7 million in the first quarter of 2004, an increase of 2.3%. Within the Motion Technologies segment, operating income was $1.3 million in the first quarter of 2005 compared to $723,000 in the first quarter of 2004, an increase of 78.6%. Gross margins in this segment increased $744,000, or 22.5%, from the first quarter of 2004 to the first quarter of 2005 due to price increases, while commission expense decreased $192,000, or 21.0%, during the same period due to a change in the commission rates paid to outside sales representatives. Within the Distribution segment, operating income was $1.1 million in the first quarter of 2005 compared to $1.7 million in the first quarter of 2004, a decrease of 36.7%. This reduction was caused by the decrease in sales and the inability to lower fixed costs in the selling, general and administrative area.

Consolidated net income for the first quarter of 2005 was $4.8 million, versus $5.9 million for the first quarter of 2005. The effective tax rate increased from 31.5% in the first quarter of 2004 to 36.6% in the first quarter of 2005 due to the nondeductibility for federal income tax purposes of the $975,000 of merger transaction expenses mentioned above.

Liquidity and Capital Resources

Cash and cash equivalents at March 31, 2005 were $32.2 million compared to $32.9 million at December 31, 2004. Working capital totaled $105.7 million at March 31, 2005 compared to $99.8 million at December 31, 2004.

Net cash of $2.9 million was provided by operating activities for the three months ended March 31, 2005 compared to $7.7 million provided by operating activities for the three months ended March 31, 2004. 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 and financing activities totaled $3.2 million for the three months ended March 31, 2005 compared to $1.7 million for the three months ended March 31, 2004. Included in the $3.2 million use of cash for the three months ended March 31, 2005 was approximately $640,000 spent for land acquisition in Ireland for the future expansion of that operation.

The Company's principal contractual obligations are the repayment of its bank debt, the planned funding of its defined benefit pension plan, and the payment of operating lease commitments covering certain automobiles, office space, and office equipment that are listed in Note 12 to the Company's Annual Report for the year ended December 31, 2004. The Company anticipates that its existing capital resources and cash flow generated from future operations will enable it to maintain its current level of operations and its planned growth for the foreseeable future.

Critical Accounting Policies

The Company has identified a number of its accounting polices 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 73% and 76% of total inventories at March 31, 2005 and December 31, 2004, 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 March 31, 2005, the Company's inventory balance of $48,002,000 was net of a reserve for obsolete, excess, and slow-moving inventories of approximately $4,266,000. At December 31, 2004, the Company's inventory balance of $46,731,000 was net of a reserve for obsolete, excess, and slow-moving inventories of approximately $5,136,000. 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 March 31, 2005 and December 31, 2004, this allowance was approximately $885,000 and $829,000, 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 March 31, 2005, the Company had $43,957,000 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 2004 financial statements, the Company made estimates and judgments about the future

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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, 2004. 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, 2005.

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, 2004, the Company determined this rate to be 6.00% and no adjustment to this rate has been made for the three months ended March 31, 2005. In 2004, the Company used an expected long-term rate of return on pension plan assets of 7.00% and no adjustment has been made for the three months ended March 31, 2005. Should a downward trend in return on pension assets happen, 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

From time to time, 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.

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, 2004. 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 SEC's rules and forms.

Changes in Internal Control Over Financial Reporting

There have been no significant changes in the Company's internal control 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 ended March 31, 2005 that have materially affected, or are reasonably likely to affect materially, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

The Company is aware that four complaints have been filed in the Delaware Court of Chancery against the Company and each of its directors, one of which has been dismissed with prejudice. One of the complaints also names Tinicum Capital Partners II, L.P. ("Tinicum") and its affiliate, PEM Holding Co., as co-defendants. The complaints purport to be class actions filed on behalf of holders of the Company's common stock and Class A common stock arising from certain alleged actions by the Company and its directors in connection with the Company's proposed merger with an affiliate of Tinicum. The complaints include various allegations that: each of the defendants breached and/or aided and abetted the other defendants' breaches of fiduciary duties of loyalty, due care, candor, good faith and fair dealing; that the director defendants spent substantial effort tailoring the structural terms of the merger to meet the specific needs of Tinicum to ensure the Company's sale to it on preferential terms instead of attempting to obtain the highest price reasonably available for the Company and its stockholders, which was subversive to the interests of the Company's public stockholders; the directors structured and approved the transaction in contravention of the Company's restated certificate of incorporation, agreeing to provisions in agreements that effectively preclude a competing bid and approving an acquisition that favors insiders to the detriment of the Company's public stockholders, including the price per share offered to the holders of its common stock and Class A common stock; and the defendants failed to provide material information concerning the transaction to the Company's public stockholders. The complaints seek equitable relief in the form of an injunction enjoining the consummation of the merger or, if the merger is consummated to the detriment of the Company's public stockholders, then rescission of the transaction or unspecified damages, in addition to costs and disbursements, including reasonable attorneys' and experts' fees.

The parties have reached a settlement regarding all claims under these complaints, subject to the approval of the Delaware Court of Chancery. As part of the settlement, the Company has agreed to provide additional disclosures, including a description of an amendment to the Merger Agreement, in supplemental proxy materials to be filed with the SEC and distributed to the Company's stockholders.

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.

Not applicable.

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)/15(d)-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a)/15(d)-14(a) Certification of Chief Financial Officer.
32.1	Section 1350 Certification of Chief Executive Officer.
32.2	Section 1350 Certification of Chief Financial Officer.

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: May 10, 2005 PENN ENGINEERING & MANUFACTURING CORP.

By: /s/ Kenneth A. Swanstrom

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

Dated: May 10, 2005 By: /s/ Mark W. Simon

Mark W. Simon
Senior Vice President and Chief Financial Officer

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