

ARRHYTHMIA RESEARCH TECHNOLOGY INC /DE/
Form 10-Q
November 13, 2002

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2002 or

Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

1-9731

(Commission file No.)

ARRHYTHMIA RESEARCH TECHNOLOGY, INC.

(Exact name of registrant as specified in its charter)

DELAWARE 72-0925679
(State or other jurisdiction of (I.R.S. employer identification no.)
incorporation or organization)

25 Sawyer Passway

Fitchburg, Massachusetts 01420

(Address of principal executive office and zip code)

(978) 345-5000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (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 No

As of October 31, 2002 there were 2,748,413 shares of common stock outstanding.

This report consists of 26 pages.

ARRHYTHMIA RESEARCH TECHNOLOGY, INC.

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Part I - Financial Information

Item 1. Financial Statements

ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARY

Consolidated Balance Sheets
(Unaudited)

ASSETS	September 30, 2002

Current assets:	
Cash and cash equivalents	\$ 1,615,037
Trade and other accounts receivable, net of allowance for doubtful accounts of \$51,000	923,208
Inventories, net	1,286,612
Deposits, prepaid expenses and other current assets	61,478

Total current assets	3,886,335
Property and equipment, net of accumulated depreciation of \$4,271,826 and \$4,358,954	3,053,161
Goodwill, net of accumulated amortization of \$1,079,073 and \$1,147,326	1,244,000
Deferred income taxes, net	411,923

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Total assets	\$ 8,595,419	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current maturities of 11% bonds payable	-	
Accounts payable	242,231	
Accrued expenses	378,536	

Total current liabilities	620,767	
Shareholders' equity:		
Preferred stock, \$1 par value; 2,000,000 shares authorized, none issued	-	
Common stock, \$.01 par value; 10,000,000 shares authorized, 3,888,131 and 3,758,181 issued	38,881	
Additional paid-in-capital	9,161,707	
Common stock held in treasury, 1,059,718 and 869,305 shares at cost	(2,884,116)	
Retained earnings	1,658,180	

Total shareholders' equity	7,974,652	

Total liabilities and shareholders' equity	\$ 8,595,419	=====

The accompanying notes are an integral part of the consolidated financial statements.

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ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARY

Consolidated Statements of Income
(Unaudited)

	Three Months Ended	
	September 30,	
	2002	2001
	----	----
Revenue	\$1,630,427	\$1,637,050
Cost of sales	1,081,964	1,180,898
	-----	-----
Gross profit	548,463	456,152
	-----	-----
Selling and marketing	13,062	10,748
General and administrative	320,858	295,635
Research and development	15,322	50,078
Amortization of goodwill	-	32,472
	-----	-----
Income from operations	199,221	67,219
	-----	-----

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Other income (expense)		
Interest expense	(2,656)	(18,165)
Other income, net	5,179	8,712
	-----	-----
Income before income taxes and cumulative effect of change in accounting principle	201,744	57,766
Income tax provision (benefit)	23,000	(23,000)
	-----	-----
Income before cumulative effect of change in accounting principle	178,744	80,766
Cumulative effect of change in accounting principle, net of tax	-	-
	-----	-----
Net income	\$ 178,744	\$ 80,766
	=====	=====
Net income per share - basic	\$ 0.06	\$ 0.03
	=====	=====
Weighted average common shares outstanding - basic	2,905,804	2,976,724
	=====	=====
Net income per share - dilutive	\$ 0.06	\$ 0.03
	=====	=====
Weighted average common shares outstanding -dilutive	2,927,540	3,150,890
	=====	=====

The accompanying notes are an integral part of the consolidated financial statements.

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ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARY

Consolidated Statements of Changes in Shareholders' Equity
(Unaudited)

	Common Shares		Additional Paid-in Capital	Treasury Stock	Retain Earnings
	Number	Amount			
	-----	-----	-----	-----	-----
December 31, 1999	3,711,883	\$37,119	\$8,946,293	\$(1,151,892)	\$ 39
Issuance of common stock	17,798	178	26,322	-	
Value of warrants with bond renewal	-	-	194,000	-	
Treasury stock purchase of 265,040 shares	-	-	-	(502,772)	
Net income	-	-	-	-	62
	-----	-----	-----	-----	-----
December 31, 2000	3,729,681	\$37,297	\$9,166,615	\$(1,654,664)	\$1,01
Issuance of common stock	28,500	285	29,996	-	
Warrants repurchased	-	-	(197,030)	-	
Treasury stock purchase of 305,859 shares	-	-	-	(702,615)	
Net income	-	-	-	-	22
	-----	-----	-----	-----	-----

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December 31, 2001	3,758,181	\$37,582	\$8,999,581	\$(2,357,279)	\$1,23
Exercise of stock options and warrants	129,950	1,299	162,126	-	
Treasury stock purchase of 190,413 shares	-	-	-	(526,837)	
Net income	-	-	-	-	42
September 30, 2002	<u>3,888,131</u>	<u>\$38,881</u>	<u>\$9,161,707</u>	<u>\$(2,884,116)</u>	<u>\$1,65</u>

The accompanying notes are an integral part of the consolidated financial statements.

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ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARY

Consolidated Statements of Cash Flows
(Unaudited)

	Nine mont Septemb 2002 ----
Cash flows from operating activities:	
Net income	\$ 425,205
Adjustments to reconcile net income to net cash provided by operating activities:	
Cumulative effect of change in accounting principle, net of tax	57,000
Depreciation	466,575
Amortization	11,972
Deferred income tax provision	33,000
Changes in assets and liabilities:	
Trade and other accounts receivable	(68,782)
Inventories	(389,525)
Deposits, prepaid expenses and other assets	(33,591)
Accounts payable and accrued expenses	(12,083)
Net cash provided by operating activities	<u>\$ 489,771</u>
Cash flows from investing activities:	
Capital expenditures, net of disposals	(247,144)
Net cash used in investing activities	<u>\$ (247,144)</u>
Cash flows from financing activities:	
Issuance of common stock	163,425
Payment of bonds	(125,000)
Principle payment of long term debt	-
Purchase of treasury stock	(526,837)

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Net cash used in financing activities	\$ (488,412)

Net increase (decrease) in cash and cash equivalents	\$ (245,785)
Cash and cash equivalents at beginning of period	1,860,822

Cash and cash equivalents at end of period	\$1,615,037
	=====

The accompanying notes are an integral part of the consolidated financial statements.

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Supplemental Notes to Consolidated Financial Statements

The unaudited interim consolidated financial statements and related notes have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in complete financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations. The accompanying unaudited interim consolidated financial statements and related notes should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's most recent Form 10-K covering the year ended December 31, 2001.

The information furnished reflects, in the opinion of the management of Arrhythmia Research Technology, Inc. (the "Company") and its subsidiary Micron Products Inc., all adjustments necessary for a fair presentation of the financial results for the interim period presented.

Interim results are subject to year-end adjustments and audit of year end results by independent certified public accountants.

Inventories:

Inventories consist of the following as of:

	September 30, 2002	December 2001
	-----	-----
Raw materials	\$ 289,046	\$166,000
Work-in-process	315,829	318,000
Finished goods	681,737	412,000
	-----	-----
Total	\$1,286,612	\$897,000
	=====	=====

Goodwill:

Effective January 1, 2002 the Company adopted FASB Statement No.141, Business Combinations ("SFAS 141") and No. 142, Goodwill and Other Intangible Assets ("SFAS 142"). SFAS 141 requires the use of the purchase method of accounting and prohibits the use of the pooling-of-interest method of accounting for business combinations initiated after June 30, 2001. SFAS 141 also requires that the Company recognize acquired intangible assets apart from goodwill if the acquired intangible assets meet certain criteria. SFAS 141 applies to all

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business combinations initiated after June 30, 2001 and for purchase business combinations completed on or after July 1, 2001. It also requires, upon adoption of SFAS 142, that the Company reclassify the carrying amounts of intangible assets and goodwill based on the criteria in SFAS 141.

SFAS 142 requires, among other things, that companies no longer amortize goodwill, but test goodwill for impairment at least annually. In addition, SFAS 142, requires that the Company identify reporting units for the purpose of assessing potential future impairments of goodwill, reassess the useful lives of other existing recognized intangible assets, and cease amortization of intangible assets with an indefinite useful life. An intangible asset with an indefinite useful life should be tested for impairment in accordance with the guidelines in SFAS 142. SFAS 142 is required to be applied to all goodwill and other intangible assets regardless of when those assets were initially recognized.

As of January 1, 2002, the Company's goodwill of \$1,326,000 was composed of \$82,000 associated with attaching machine assets purchased from Newmark, Inc. in 1997 and \$1,244,000 associated with the acquisition of Micron Products Inc. in 1992. As a result of the transitional impairment tests, the goodwill associated with the Newmark agreement was determined to be impaired as determined by using the present value of future cash flows solely related to attaching machines. The balance of \$82,000 (\$57,000 net of tax) is being reported as the cumulative effect of change in accounting principle for the nine months ended September 30, 2002. The diminishing number of leases and sales of attaching machines used for the assembly of disposable medical electrodes in this mature industry lead to the impairment of Newmark goodwill. No adjustment to the \$1,244,000 balance of goodwill associated with the Micron Products acquisition was deemed necessary as of September 30, 2002.

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Goodwill - (continued)

The continued effect on reported net income due to the cumulative effect of change in accounting principle, and the discontinuance of goodwill amortization is as follows:

	Three Months Ended September 30,		Nine Months
	2002	2001	2002
Reported net income	\$ 178,744	\$ 80,766	\$ 425,205
Cumulative effect of change in accounting principle	-	-	57,000
Goodwill amortization	-	32,472	-
Adjusted net income before cumulative effect of change in accounting principle and discontinuance of goodwill amortization	\$ 178,744	\$ 113,238	\$ 482,205
Basic net income per share as reported	\$.06	\$.03	\$.15
Cumulative effect of change in accounting principle	-	-	.02
Goodwill amortization	-	.01	-
Basic net income per share before cumulative effect of change in accounting principle and discontinuance	\$.06	\$.04	\$.17

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of goodwill amortization

Diluted net income per share as reported	\$.06	\$.03	\$.14
Cumulative effect of change in accounting principle		-		-		.02
Goodwill amortization		-		.01		-

Diluted net income per share before cumulative effect of change in accounting principle and discontinuance of goodwill amortization	\$.06	\$.04	\$.16

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

Any forward looking statements made herein are based on current expectations of the Company that involves a number of risks and uncertainties and should not be considered as guarantees of future performance. These statements are made under the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. Forward looking statements may be identified by the use of words such as "expect," "anticipate," "believe," "intend," "plans," "predict," or "will." The factors that could cause actual results to differ materially include: interruptions or cancellation of existing contracts, impact of competitive products and pricing, product demand and market acceptance risks, the presence of competitors with greater financial resources than the Company, product development and commercialization risks and an inability to arrange additional debt or equity financing.

Liquidity and Capital Resources

Working capital was \$3,265,568 at September 30, 2002 compared to \$2,869,344 at December 31, 2001. The \$396,224 increase in working capital for the first nine months of 2002 is attributed to the generation of \$489,771 of operating cash flows in the nine months ending September 30, 2002. Cash of \$113,028 (\$125,000 face value) was consumed in the redemption of 11% bonds payable, which matured May 2002.

Increased inventories were created to offset possible production delays as a result of the discontinued attempt to purchase certain business assets of a competitor of Micron Products Inc. These inventories are expected to be lower at year-end through sales to existing customers. The material for the new radio translucent ECG sensor contributed to the increase in raw material inventory and this product is expected to begin shipment in early 2003.

The Company has a \$1,000,000 revolving line of credit with a bank that has been extended until May 30, 2003. The credit line provides for borrowings to be collateralized by accounts receivable and inventory. However, the Company has not used the credit line due to sufficient liquidity provided by operations.

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The Company has continued to execute the stock buy back program. During the quarter ended September 30, 2002, 100,000 shares were repurchased with an average share price of \$2.65. In the first nine months of 2002, 190,413 shares were acquired at a total market cost of \$526,837. The Board of Directors has authorized a continuation of the stock buy back program for another 50,000 shares in the 4th quarter.

Results of Operations

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Revenue for the third quarter ended September 30, 2002 was \$1,630,427 as compared to \$1,637,050 in the three months ended September 30, 2001. For the nine months ended September 30, 2002, the sales of Micron's standard ECG sensor products are 5% higher than in the same period of 2001. Micron has received notification that it has been chosen as the new supplier of the radio translucent ECG sensor from an existing customer, which will result in additional sales revenue beginning first quarter 2003.

Sales of metal snap fasteners distributed by Micron to ECG electrode manufacturers continued to decline as major accounts switch to direct purchase. There were no significant sales of the Company's SAECG product in the first nine months of 2002. These latter two product lines have combined for less than 10% of revenue for the nine-month period ended September 30, 2002.

Domestic and foreign sales, which includes sales to Canadian operations of \$664,970 for the three months ended September 30, 2002 and \$2,284,073 for the nine months ended September 30, 2002 are as follows:

	Three Months Ended September 30,				Nine Months Ended Sep			
	2002	%	2001	%	2002	%	2001	%
	----	-	----	-	----	-	----	-
Foreign Sales	\$1,403,807	86	\$1,326,656	81	\$4,579,888	85	\$4,579,888	85
Domestic Sales	226,620	14	310,394	19	797,873	15	2,284,073	15
	-----	---	-----	---	-----	---	-----	---
Total	\$1,630,427	100	\$1,637,050	100	\$5,377,761	100	\$5,377,761	100
	=====	===	=====	===	=====	===	=====	===

Currency risk does not affect the Company's financial results because the Company's foreign sales contracts are denominated in U.S. Dollars.

Cost of sales was 67% of revenue for the nine months ended September 30, 2002 compared to 70% of revenue for the same period in 2001. The improvement in 2002 was due to manufacturing efficiencies related to the increase in sales volume of Micron's ECG sensors. There have been no significant changes in material cost, wages, or production expenses over the last nine months and none are expected for the remainder of 2002.

Selling and marketing expense was \$15,402 lower in the first nine months of 2002 compared to the same period in 2001. In 2001, Micron initiated a program to expand sales of its ECG sensors in the Pacific Rim regions. This new venture has not resulted in a significant increase in the Company's revenue for the nine month period ended September 30, 2002 due to the limited availability of the Company's foreign agent.

General and administrative expense includes approximately \$111,000 of legal expenses and \$25,600 in other professional and corporate expenses in the nine month period ended September 30, 2002, which was related to an attempt to acquire certain business assets of a competitor of Micron Products Inc. The negotiations to acquire the assets were discontinued in July 2002. The increase in legal, professional and corporate expenses was offset by a reduction of general and administrative expenses associated with the consolidation of the Company's Texas office to Micron's existing location in Massachusetts. The net effect is an increase of \$19,114 in general and administrative expenses in the nine months ended September 30, 2002 compared to the same period in 2001.

Research and development expense was \$34,756 lower for the third quarter of 2002 and \$91,813 lower for the first nine months of 2002 compared to

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similar periods in 2001 due to the elimination of the Company's in-house R&D staff and overhead as part of closing the Austin, Texas office in 2001. The redesign of the Predictor(R) 7 software has been completed and minor maintenance is contracted through outside parties, if and when needed.

Interest expense is lower in both periods reported for 2002 when compared to 2001, principally as a result of the early redemption of \$425,000 of 11% bonds payable in late 2001, and maturity of \$125,000 in 2002.

Other income includes interest earned on the Company's cash equivalents of \$21,862 for the first nine months of 2002 compared to \$76,806 for the nine months ended September 30, 2001. The reduction of interest income is due to the lower returns on fixed rate investments. Offsetting part of the loss of interest income was the elimination of amortization expense on debt discount when the 11% bonds were redeemed.

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Income taxes as a percent of income for the quarters ended September 30, 2002 and 2001 were 11% and (40%) respectively. For the nine month period ended September 30, 2002 and September 30, 2001, income taxes as a percent of income before income taxes and cumulative effect of change in accounting principle (net of tax) were 23% and 14% respectively. No Federal income taxes were owed for 2001, and the Company expects to substantially reduce the Federal income taxes for 2002 by utilizing net operating loss carry forwards.

Item 3. Quantitative and Qualitative Disclosures and Market Risk

No material changes have occurred related to the Company's policies, procedures, controls or risk profile.

Item 4. Evaluation of Disclosure Controls and Procedures

Within ninety days prior to the filing date of this report, the management of the Company including James E. Rouse as President, Chief Operating Officer and Acting Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures. Under rules promulgated by the SEC, disclosure controls and procedures are defined as those "controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms." Based on the evaluation of the Company's disclosure controls and procedures, it was determined that such controls and procedures were effective as of the date of the conclusion of the evaluation.

Further, there were no significant changes in the internal controls or in other factors that could significantly affect these controls after the date of the conclusion of their most recent evaluation.

Part II - Other Information

Item 1. Legal Proceedings

From time to time the Company may be involved in disputes and litigation in the normal course of business. The Company is not presently involved in any disputes or litigation that reasonably could be expected to have a material impact on the Company's business, operating results, financial condition and cash flows.

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

On November 1, 2002, the Company held the 2002 Annual Meeting of Stockholders. At the meeting, stockholders voted the following:

(1)	The election of two Class I Directors, with terms expiring in 2005	For ---	Withheld -----
	Russell C. Chambers MD	2,502,659	2,455
	James E. Rouse	2,502,459	2,655
(2)	The Appointment of BDO Seidman to audit the consolidated financial statements of the Company for the year ended December 31, 2002.	For ---	Against -----
		2,321,413	14,394
		Against -----	Abstain -----
		169,307	14,394

Item 6. Exhibits and Reports on Form 8-K

- Exhibit 3.1 - Arrhythmia Research Technology, Inc. By-laws
- Exhibit 10.1 - Employment Agreement President James E. Rouse
- Exhibit 99.1 - Certification pursuant to 18 U.S.C.ss.1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002

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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 the undersigned thereunto duly authorized.

Arrhythmia Research Technology, Inc.

/s/ James E. Rouse

President, Chief Operating Officer and
Acting Principal Financial Officer

November 12, 2002

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CERTIFICATION

I, James E. Rouse, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Arrhythmia Research Technology, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact

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necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant issuer as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rule 13a-14 and 15d-14) for the registrant and we have:
 - a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - a. All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions in regard to significant deficiencies and material weaknesses.

DATE: November 12, 2002

/s/ James E. Rouse

James E. Rouse
President and Chief Operating Officer

I, James E. Rouse, certify that:

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1. I have reviewed this quarterly report on Form 10-Q of Arrhythmia Research Technology, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant issuer as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rule 13a-14 and 15d-14) for the registrant and we have:
 - a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):
 - a. All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions in regard to significant deficiencies and material weaknesses.

DATE: November 12, 2002

/s/ James E. Rouse

James E. Rouse

