ENGLOBAL CORP
Form 10-Q
November 19, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 29, 2012

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

Commission File No. 001-14217

ENGlobal Corporation
(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
incorporation or organization)

88-0322261
(I.R.S Employer Identification No.)

654 N. Sam Houston Parkway E., Suite 400, Houston, TX	77060-5914
(Address of principal executive offices)	(Zip code)

(281) 878-1000
(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 shortened 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 o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and smaller reporting company in Rule 12b-2 of the Exchange Act. (check one):

Large Accelerated Filer	o	Accelerated Filer	o
Non-Accelerated Filer (Do not check if a smaller reporting company)	o	Smaller Reporting Company	x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the close of business on November 14, 2012.

$0.001 Par Value Common Stock	26,964,339 shares

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QUARTERLY REPORT ON FORM 10-Q
FOR THE PERIOD ENDED SEPTEMBER 29, 2012

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PART I. - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ENGlobal Corporation
Condensed Consolidated Statements of Operations and Comprehensive Loss
(Unaudited)

	For the Three Months Ended		For the Nine Months Ended	
	September 29, 2012	September 30, 2011	September 29, 2012	September 30, 2011
	(amounts in thousands, except loss per share data)			
Operating revenues	$57,482	$60,482	$$ 175,805	$162,961
Operating costs	54,212	53,706	162,455	145,767
Gross profit	3,270	6,776	13,350	17,194
Selling, general and administrative expenses	6,162	6,682	19,301	18,716
Goodwill impairment	14,568	—	14,568	—
Operating income (loss)	(17,460)	94	(20,519)	(1,522)
Other income (expense):				
Other income (expense), net	(98)	(8)	(100)	(68)
Interest expense, net	(643)	(303)	(1,320)	(711)
Loss from continuing operations before income taxes	(18,201)	(217)	(21,939)	(2,301)
Provision (benefit) for federal and state income taxes	412	138	5,606	(460)
Loss from continuing operations	(18,613)	(355)	(27,545)	(1,841)
Loss from discontinued operations, net of taxes	(3,717)	(918)	(4,779)	(1,263)
Net loss	(22,330)	(1,273)	$(32,324)	(3,104)
Other comprehensive income (expense)				
Foreign currency translation adjustment	—	—	(1)	—
Comprehensive loss	$(22,330)	$(1,273)	$(32,325)	$(3,104)
Loss per common share – basic and diluted:				
Net loss from continuing operations	$(0.69)	$(0.01)	$(1.02)	$(0.07)
Net loss from discontinued operations	$(0.14)	$(0.04)	$(0.18)	$(0.05)
Net loss	$(0.83)	$(0.05)	$(1.20)	$(0.12)
Weighted average shares used in computing loss per common share – basic and diluted	26,964	26,620	26,882	26,585

See accompanying notes to unaudited interim condensed consolidated financial statements.

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ENGlobal Corporation
Condensed Consolidated Balance Sheets
(Unaudited)

ASSETS	September 29, 2012	December 31, 2011
	(amounts in thousands, except share amounts)	
Current Assets:		
Cash and cash equivalents	$634	$26
Restricted cash	6,134	2,275
Trade receivables, net of allowances of $2,299 and $1,792	46,949	44,159
Prepaid expenses and other current assets	504	846
Notes receivable	514	514
Costs and estimated earnings in excess of billings on uncompleted contracts	7,632	6,790
Assets held for sale	13,813	19,054
Federal and state income taxes receivable	389	79
Deferred tax asset	—	3,989
Total Current Assets	76,569	77,732
Property and equipment, net	3,241	3,260
Goodwill	2,805	17,373
Other intangible assets, net	2,097	2,835
Long-term trade and notes receivable, net of current portion and allowances	899	899
Deferred tax asset, non-current	—	1,206
Other assets	882	874
Total Assets	$86,493	$104,179

LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$9,247	$8,316
Accrued compensation and benefits	13,328	10,400
Current portion of debt	29,406	16,602
Deferred rent	606	635
Billings in excess of costs and estimated earnings on uncompleted contracts	3,986	4,421
Liabilities held for sale	2,862	4,058
Other current liabilities	706	1,247
Total Current Liabilities	60,141	45,679
Commitments and Contingencies (Note 11)		
Stockholders' Equity:		
Common stock - $0.001 par value; 75,000,000 shares authorized; 26,964,339 and 26,882,518 shares outstanding and 27,945,438 and 27,803,617 shares issued at September 29, 2012 and December 31, 2011, respectively	28	28
Additional paid-in capital	38,258	38,081
Retained earnings (deficit)	(9,502)	22,822
Treasury stock - 981,099 shares at September 29, 2012 and December 31, 2011	(2,362)	(2,362)
Accumulated other comprehensive loss	(70)	(69)
Total Stockholders' Equity	26,352	58,500

Total Liabilities and Stockholders' Equity	$86,493	$104,179

See accompanying notes to unaudited interim condensed consolidated financial statements.

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ENGlobal Corporation
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	For the Nine Months Ended September 29, 2012	September 30, 2011
	(amounts in thousands)	
Cash Flows from Operating Activities:		
Net loss	$(32,324)	$(3,104)
Adjustments to reconcile net loss to cash provided by (used in) operating activities:		
Depreciation and amortization	1,452	2,730
Share-based compensation expense	177	307
Deferred income tax expense (benefit)	6,166	(1,047)
Impairment of goodwill	16,965	—
(Gain) loss on disposal of property, plant and equipment	47	(18)
Changes in current assets and liabilities, net of acquisitions:		
Trade accounts and other receivables	(1,467)	(3,300)
Costs and estimated earnings in excess of billings on uncompleted contracts	(704)	(1,693)
Prepaid expenses and other assets	16	482
Accounts payable	770	(210)
Accrued compensation and benefits	3,986	4,289
Billings in excess of costs and estimated earnings on uncompleted contracts	(520)	1,163
Other liabilities	(2,578)	1,876
Income taxes receivable	(264)	(425)
Net cash provided by (used in) operating activities	$(8,278)	$1,050
Cash Flows from Investing Activities:		
Property and equipment acquired	(228)	(452)
Restricted cash	(3,859)	—
Proceeds from sale of other assets	170	65
Net cash used in investing activities	$(3,917)	$(387)
Cash Flows from Financing Activities:		
Borrowings on line of credit	149,872	118,947
Payments on line of credit	(136,818)	(116,358)
Repayments under capital lease	—	(51)
Other long-term debt repayments	(250)	(941)
Net cash provided by financing activities	$12,804	$1,597
Effect of Exchange Rate Changes on Cash	(1)	—
Net change in cash	608	2,260
Cash and cash equivalents, at beginning of period	26	49
Cash and cash equivalents, at end of period	$634	$2,309

See accompanying notes to unaudited interim condensed consolidated financial statements.

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Notes to Unaudited Interim Condensed Consolidated Financial Statements

NOTE 1 – BASIS OF PRESENTATION AND CRITICAL ACCOUNTING POLICIES

The condensed consolidated financial statements of ENGlobal Corporation (which may be referred to as "ENGlobal", "the Company," "we," "us," or "our") are prepared in accordance with accounting principles generally accepted in the United States of America. The Company consolidates all of its subsidiaries' financial results, and significant inter-company accounts and transactions have been eliminated in the consolidation.

The condensed consolidated financial statements of the Company included herein are unaudited for the three and nine-month periods ended September 29, 2012 and September 30, 2011, have been prepared from the books and records of the Company pursuant to the rules and regulations of the Securities and Exchange Commission, and in the case of the condensed balance sheet as of December 31, 2011, have been derived from the audited financial statements of the Company. These financial statements reflect all adjustments (consisting of normal recurring adjustments), which are, in the opinion of management, necessary to fairly present the results for the periods presented. Certain information and note disclosures, normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission. These condensed consolidated financial statements should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2011, included in the Company's Annual Report on Form 10-K, as amended, filed with the Securities and Exchange Commission. The Company has assessed subsequent events through the date of filing of these condensed consolidated financial statements with the Securities and Exchange Commission and believes that the disclosures made herein are adequate to make the information presented herein not misleading. Certain reclassifications have been made to the 2011 condensed consolidated financial statements to conform the presentation to report discontinued operations. Refer to Note 3.

On January 1, 2012, we changed from a traditional month-end calendar close cycle to a 4-4-5 calendar close methodology. Under this new methodology, each quarter (formerly comprised of 3 calendar months) is comprised of 13 weeks, which includes two 4-week months and one 5-week month. This change in accounting periods has not had a material effect on the comparability to prior periods.

NOTE 2 – LIQUIDITY

The Company has been operating under difficult circumstances in 2012. For the nine-month period ended September 29, 2012, the Company reported a net loss of approximately $32.3 million that included a non-cash charge of approximately $16.9 million relating to a goodwill impairment (see Note 4) and a non-cash charge of approximately $6.2 million relating to a valuation allowance established in connection with the Company's deferred tax assets (see Note 9). During 2012, our net borrowings under our revolving credit facilities have increased approximately $13.0 million to fund our operations. Due to challenging market conditions, our revenues and profitability have declined during 2012. As a result, we have failed to comply with several financial covenants under our credit facilities resulting in defaults (see Note 7). Although we have sold assets and reduced personnel in an attempt to improve our liquidity position, we cannot assure you that we will be successful in obtaining the cure or waiver of the defaults under the respective credit facilities. If we fail to obtain the cure or waiver of the defaults under the facilities after any forbearance period, the lenders may exercise any and all rights and remedies available to them under their respective agreements, including demanding immediate repayment of all amounts then outstanding or initiating foreclosure or insolvency proceedings. In such event and if we are unable to obtain alternative financing, our business will be materially and adversely affected, and we may be forced to sharply curtail or cease our operations. In addition, based on current conditions, it is probable that our independent registered public accounting firm will include an explanatory paragraph with respect to our ability to continue as a going concern in its report on our financial statements for the year ending December 31, 2012.

NOTE 3 - DISCONTINUED OPERATIONS

During the third quarter of 2011, as part of its strategic evaluation of operations, the Company determined that the expected future profitability of the Electrical Services group was not sufficient to support maintaining it as a viable business and that it did not fit within the future strategic plan due to its operational differences. As a result, effective July 1, 2011, the Company initiated a plan to sell the operations of its Electrical Services group. These assets and their related operations have been classified as discontinued operations and accordingly, are presented as discontinued operations in the Company's re-casted consolidated financial statements. The net assets and liabilities related to the discontinued operations are shown on the Condensed Consolidated Balance Sheet as "Assets held for sale" and "Liabilities held for sale," respectively. The results of the discontinued operations are shown on the Condensed Consolidated Statements of Operations as "Loss from discontinued operations, net of taxes".

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Notes to Unaudited Interim Condensed Consolidated Financial Statements

The Company has been unable to sell the Electrical Services group as planned and has decided to dispose of substantially all of the group's remaining assets. During the third quarter of 2012, the Company completed the disposal of the group's remaining assets concurrent with the completion of the last remaining lump sum project. During the third quarter, the Company incurred approximately $0.5 million of costs to complete the remaining lump sum project. Going forward, the Company will have no continuing involvement with these operations after the completion of the remaining lump sum project.

On September 10, 2012, the Company entered into a definitive agreement to sell its Field Solutions segment. The Field Solutions segment includes the Land and Right-of-Way and Inspection divisions, primarily serving pipeline and electric power companies. On November 2, 2012, the Company completed the divestiture of its Land and Right-of-Way division of its Field Solutions segment effective October 26, 2012, and retained the Inspection division pursuant to the terms of the amended definitive agreement. The transaction was valued at approximately $7.5 million, consisting of approximately $4.5 million in working capital at closing to the Company and a $3 million promissory note payable to the Company over four years. The Company is continuing to pursue the sale of the Inspection division and, as such, the Inspection division will continue to be classified as held-for-sale.

The assets and liabilities of the Electrical Services and Field Solutions divisions and their related operations have been classified as discontinued operations and accordingly, are presented as discontinued operations in the Company's re-cast condensed consolidated financial statements. The net assets and liabilities related to the discontinued operations are shown on the Condensed Consolidated Balance Sheet as "Assets held for sale" and "Liabilities held for sale," respectively. The results of the discontinued operations are shown on the Condensed Consolidated Statements of Operations as "Loss from discontinued operations, net of taxes". During the third quarter, the Company incurred or accrued approximately $3.6 million of additional costs (which includes a loss on the sale of the Land and Right-of-Way division of approximately $1.1 million) related to the sale of these divisions. Summarized financial information for the discontinued operations is shown below:

Statement of Operations Data:	For the Three Months Ended September 29, 2012 (amounts in thousands)	For the Three Months Ended September 30, 2011	For the Nine Months Ended September 29, 2012	For the Nine Months Ended September 30, 2011
Revenues	$ 14,559	$ 21,598	$ 52,442	$ 75,981
Operating costs	14,227	21,382	49,586	72,995
Operating income (loss)	332	216	2,856	2,986
SG&A	1,650	1,712	3,676	4,888
Goodwill impairment	2,397	—	2,397	—
Other income (expense)	(2)	1	(5)	2
Total income (loss) before taxes	(3,717)	(1,495)	(3,222)	(1,900)
Tax expense (benefit)	—	(577)	1,557	(637)
Net loss	$ (3,717)	$ (918)	$ (4,779)	$ (1,263)

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Notes to Unaudited Interim Condensed Consolidated Financial Statements

Balance Sheet Data:	September 29, 2012	December 31, 2011
	(amounts in thousands)	
Assets:		
Trade receivables	$ 10,929	$ 12,252
Cost and estimated earnings in excess of billings on uncompleted contracts	—	138
Deferred tax asset	—	995
Property and equipment, net	111	372
Goodwill and other assets	2,773	5,297
Total assets held for sale	$ 13,813	$ 19,054
Liabilities:		
Accounts payable	$ 316	477
Accrued compensation and benefits	1,818	760
Deferred rent	45	53
Billings in excess of costs and estimated earnings on uncompleted contracts	73	158
Other current liabilities	610	2,610
Total liabilities held for sale	$ 2,862	$ 4,058

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Notes to Unaudited Interim Condensed Consolidated Financial Statements

NOTE 4 – GOODWILL

Goodwill has an indefinite useful life. Goodwill is not amortized but, instead, tested at least annually for impairment. Because of deteriorating market conditions, our declining financial performance and the decision to sell several of our assets, we made a decision to perform an interim assessment of the carrying value of our goodwill as of September 29, 2012. We reviewed a number of factors on a segment by segment basis, including market conditions, projected cash flows, cost of capital, growth rates and other factors which could significantly impact the reported value of our goodwill. As a result of this review, we recorded a goodwill impairment of approximately $16.9 million as of September 29, 2012. Of this amount, approximately $14.6 million related to continuing operations and approximately $2.4 million relating to discontinued operations. Summarized financial information for goodwill is shown below:

Description of Segment	Balance at December 31, 2011 (amounts in thousands)	Impairments	Balance at September 29, 2012
Engineering and Construction	$ 15,288	$ (14,568)	$ 720
Automation	2,085	—	2,085
Field Solutions*	5,241	(2,397)	2,844
Total	$ 22,614	$ (16,965)	$ 5,649

* Amounts are included in Assets held for sale and Loss from discontinued operations, net of taxes

NOTE 5 – STOCK COMPENSATION PLANS

In April 2012, the Compensation Committee of the Board of Directors approved an increase of 500,000 shares under our 2009 Equity Incentive Plan (the “Equity Plan”), which was subsequently approved by our shareholders. As of November 14, 2012, 502,335 shares of restricted stock have been granted under the Equity Plan, of which 133,115 remain subject to outstanding awards. Unvested restricted stock awards and restricted stock units are included in diluted earnings per share until the shares have been vested. The vested shares are then included in basic earnings per share.

Total share-based compensation expense of approximately $18,000 and $109,000 was recognized during the three-months ended September 29, 2012 and September 30, 2011, respectively. Total share-based compensation expense in the amount of $177,000 and $307,000 was recognized during the nine months ended September 29, 2012 and September 30, 2011, respectively. Share-based compensation expense is reported in selling, general and administrative expense.

Restricted Stock Awards

Restricted stock awards granted to directors are intended to compensate and retain the directors over the one-year service period commencing July 1 of the year of service. These awards vest in quarterly installments beginning September 30 of the year of service, so long as the grantee continues to serve as a director of the Company. Restricted stock awards granted to employees vest in four equal annual installments beginning December 31 in the year granted, so long as the grantee remains employed full-time with the Company as of each vesting date. During 2012, the Company granted restricted stock awards per the following table:

Date Issued	Issued to	Number of Individuals	Number of Shares	Market Price	Fair Value	Grants Forfeited
June 14, 2012	Employee	1	50,336	$ 1.49	$ 75,000	—
June 14, 2012	Director	3	100,671	$ 1.49	$ 150,000	—

The amount of compensation expense related to all restricted stock awards that had not been recognized at September 29, 2012, totaled $173,000. This compensation expense is expected to be recognized over a weighted-average period of approximately 17 months.

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Notes to Unaudited Interim Condensed Consolidated Financial Statements

NOTE 6 – CONTRACTS

Costs, estimated earnings and billings on uncompleted contracts consisted of the following at September 29, 2012 and December 31, 2011:

Description		September 29, 2012		December 31, 2011
		(amounts in thousands)		
Costs incurred on uncompleted contracts	$	59,177	$	43,455
Estimated earnings on uncompleted contracts		8,982		5,591
Earned revenues		68,159		49,046
Less: billings to date		64,513		46,677
Net costs and estimated earnings in excess of billings on uncompleted contracts	$	3,646	$	2,369
Costs and estimated earnings in excess of billings on uncompleted contracts	$	7,632	$	6,790
Billings in excess of costs and estimated earnings on uncompleted contracts		(3,986)		(4,421)
Net costs and estimated earnings in excess of billings on uncompleted contracts	$	3,646	$	2,369

Revenue on fixed-price contracts is recorded primarily using the percentage-of-completion (cost-to-cost) method. Under this method, revenue is recognized in the ratio that contract costs incurred bear to total estimated contract costs. Revenue and gross margin on fixed-price contracts are subject to revision throughout the lives of the contracts and any required adjustments are made in the period in which the revisions become known. To manage unknown risks, management may use contingency amounts to increase the estimated costs, therefore, lowering the earned revenues until the risks are better identified and quantified or have been mitigated. Losses on contracts are recorded in full as they are identified.

The Company recognizes service revenue as soon as the services are performed. For clients that we consider higher risk, due to past payment history or history of not providing written work authorizations, we defer revenue recognition until we receive either a written authorization or a payment. The current amount of revenue deferred for these reasons is approximately $0.1 million as of September 29, 2012, compared to $0.3 million as of December 31, 2011. We expect a majority of the deferred revenue amount to be realized by year end 2012.

NOTE 7 – LINE OF CREDIT AND DEBT

The carrying value of debt is composed of the following:

Description:		September 29, 2012		December 31, 2011
Secured debt:		(amounts in thousands)		
Wells Fargo Credit Facility	$	—	$	16,352
PNC Credit Facility		29,406		—
Subordinated and unsecured debt:				
Control Dynamics International, L.P.		—		250
Total debt	$	29,406	$	16,602

The rates applicable to the PNC Credit Facility line of credit and the Wells Fargo Credit Facility line of credit outstanding at September 29, 2012 and December 31, 2011 were 7.0% and 4.125%, respectively. Effective June 20, 2012, upon defaulting on the PNC Credit Facility, the interest rate increased from 5.0% to 7.0% (the default interest rate is 2.0% higher than the applicable facility rate). For the three-month periods ended September 29, 2012 and 2011, the Company re