SUNAIR ELECTRONICS INC
Form 10QSB
May 16, 2005

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

FORM 10-QSB

þ **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

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

Commission file number I-4334

SUNAIR ELECTRONICS, INC.

(EXACT NAME OF SMALL BUSINESS ISSUER AS SPECIFIED IN ITS CHARTER)

FLORIDA	59-0780772
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)
3005 SW THIRD AVE., FT. LAUDERDALE, FL.	33315
(ADDRESS OR PRINCIPAL EXECUTIVE OFFICE)	(ZIP CODE)
ISSUER S TELEPHONE NUMBER (INCLUDING AREA CODE)	(954) 525-1505

NONE

(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR, IF CHANGED SINCE LAST REPORT)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ Noo

Registrant s common stock - par value 10 cents, outstanding as of May 13, 2005 - 9,014,870 shares.

Transitional Small Business Disclosure format. Yes o No þ

SUNAIR ELECTRONICS, INC. AND SUBSIDIARY

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PART I. FINANCIAL INFORMATION

SUNAIR ELECTRONICS, INC. AND SUBSIDIARIES

CONSOLIDATED CONDENSED BALANCE SHEETS (UNAUDITED)

ASSETS

	03/31/05	9/30/04
CURRENT ASSETS:		
Cash and cash equivalents	$ 27,745,052	$ 3,872,224
Accounts receivable, net	3,040,087	3,080,875
Interest receivable	10,875	108,013
Inventories	7,106,299	7,258,955
Investments		2,913,601
Deferred tax asset	61,200	180,725
Prepaid and other current assets	773,835	315,469
Total Current Assets	38,737,348	17,729,862
NOTE RECEIVABLE	405,590	405,590
PROPERTY, PLANT, AND EQUIPMENT, NET	660,205	703,381
OTHER ASSETS		
Software costs, net	4,037,384	3,955,513
Goodwill	852,683	852,683
Total Other Assets	4,890,067	4,808,196
TOTAL ASSETS	$ 44,693,210	$ 23,647,029

The accompanying notes are an integral part of these financial statements

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PART I. FINANCIAL INFORMATION

SUNAIR ELECTRONICS, INC. AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS (UNAUDITED)

LIABILITIES AND STOCKHOLDERS EQUITY

	03/31/05	9/30/04
CURRENT LIABILITIES:		
Accounts payable	$ 1,131,972	$ 1,501,864
Accrued expenses	845,189	1,186,250
Bank lines of credit	47,000	2,047,000
Unearned revenues	100,689	115,857
Loan from shareholder	22,800	22,800
Notes payable	23,028	33,585
Income taxes payable	448,232	212,688
Payable in connection with acquisition of Telecom FM	0	1,500,000
Total Current Liabilities	2,618,910	6,620,044
DEFERRED TAX LIABILITY	199,200	199,000
STOCKHOLDERS EQUITY:		
Preferred stock, no par value, 8,000,000 shares authorized, none issued and outstanding		
Common stock, $.10 par value, 100,000,000 shares authorized, 9,014,870, and 4,006,620 shares issued and outstanding at March 31, 2005 and September 30, 2004 respectively	901,487	400,662
Additional paid-in-capital	27,612,264	3,852,106
Retained earnings	13,310,724	12,575,217
Translation adjustment	50,625	
Total Stockholders Equity	41,875,100	16,827,985
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 44,693,210	$ 23,647,029

The accompanying notes are an integral part of these financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(UNAUDITED)

	SIX MONTHS ENDED 03/31/05	SIX MONTHS ENDED 03/31/04
SALES	$ 9,940,320	$ 4,530,456
COST OF SALES	5,537,526	2,519,019
GROSS PROFIT	4,402,794	2,011,437
SELLING GENERAL AND ADMINISTRATIVE EXPENSES	3,419,467	1,030,174
INCOME FROM OPERATIONS	983,327	981,263
OTHER INCOME:		
Interest income	150,426	124,483
Interest expense	(32,140)	
Other expense	(18,306)	(4,045)
Total Other Income	99,980	120,438
INCOME BEFORE (PROVISION) FOR INCOME TAXES	1,083,307	1,101,701
(PROVISION) FOR INCOME TAXES	(347,800)	(308,600)
NET INCOME	$ 735,507	$ 793,101
NET INCOME PER COMMON SHARE:		
BASIC	$ 0.14	$ 0.21
DILUTED	$ 0.11	$ 0.20
WEIGHTED AVERAGE SHARES OUTSTANDING:		
BASIC	5,412,524	3,787,249
DILUTED	6,667,402	3,876,088

The accompanying notes are an integral part of these financial statements

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CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(UNAUDITED)

	THREE MONTHS ENDED 03/31/05	03/31/04
SALES	$ 4,846,332	$ 3,215,882
COST OF SALES	2,736,727	1,820,770
GROSS PROFIT	2,109,605	1,395,112
SELLING GENERAL AND ADMINISTRATIVE EXPENSES	1,628,952	543,623
INCOME FROM OPERATIONS	480,653	851,489
OTHER INCOME:		
Interest income	114,650	62,051
Interest expense	(12,258)	
Other expense	(11,460)	(2,878)
Total Other Income	90,932	59,173
INCOME BEFORE (PROVISION) FOR INCOME TAXES	571,585	910,662
(PROVISION) FOR INCOME TAXES	(208,483)	(290,100)
NET INCOME	$ 363,102	$ 620,562
NET INCOME PER COMMON SHARE:		
BASIC	$ 0.05	$ 0.16
DILUTED	$ 0.04	$ 0.16
WEIGHTED AVERAGE SHARES OUTSTANDING:		
BASIC	6,848,203	3,809,777
DILUTED	9,993,921	3,903,353

The accompanying notes are an integral part of these financial statements

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CONSOLIDATED CONDENSED STATEMENT OF CASH FLOWS
(UNAUDITED)

	SIX MONTHS ENDED 03/31/05	SIX MONTHS ENDED 03/31/04
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 735,507	$ 793,101
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	96,249	78,921
Amortization	159,437	14,337
Deferred taxes	119,725	
Translation adjustment	50,625	
Inventories reserve	52,571	
(Increase) decrease in Assets:		
Accounts receivable	40,788	(422,043)
Interest receivable	97,138	1,810
Inventories	100,085	375,121
Prepaid and other current assets	(458,366)	(28,811)
Increase (decrease) in Liabilities:		
Accounts payable and accrued expenses	(710,953)	(269,051)
Unearned revenue	(15,168)	
Income taxes payable	235,544	600
Net Cash Provided By Operating Activities	503,182	543,985
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property, plant, and equipment	(67,410)	(14,050)
Proceeds from sale of held-to-maturity investment	2,913,601	
Software development costs	(226,971)	
Cash paid for acquisition of Telecom FM	(1,500,000)	
Purchases of investments		(498,546)
Net Cash Provided By (Used In) Investing Activities	1,119,220	(512,596)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	18,563	176,512
Repayment of line of credit	(2,000,000)	
Repayment of notes payable	(10,557)	
Proceeds from sale of common stock, net	24,242,420	
Net Cash Provided By Financing Activities	22,250,426	176,512

NET INCREASE IN CASH AND CASH EQUIVALENTS	23,872,828	207,901
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	3,872,224	1,022,175
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 27,745,052	$ 1,230,076
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the year for income taxes	$ 125,000	$ 308,000
Cash paid during the year for interest	$ 32,140	$

The accompanying notes are an integral part of these financial statements

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

1. Basis of Consolidated Financial Statement Presentation:

The accompanying unaudited consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission and in accordance with the instructions to Form 10-QSB and do not include all the information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America. The information furnished in the interim financial statements includes normal recurring adjustments and reflects all adjustments, which, in the opinion of management, are necessary for a fair presentation of such financial statements. For further information refer to the consolidated financial statements and footnotes thereto included in the Company s most recent audited consolidated financial statements and notes thereto included in its September 30, 2004 annual report on Form 10-KSB. Operating results for the six months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending September 30, 2005.

2. Significant Accounting Policies:

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Accounts Receivable

Accounts receivable consist of balances due from sales. The Company monitors accounts receivable and provides allowances when considered necessary. As of March 31, 2005 and September 30, 2004, the Company established an allowance of $48,485.

Investments

Certain investments that management has the intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts that are recognized in interest income using the interest method over the period to maturity.

Marketable and debt securities which management has classified as trading are carried at fair value with net unrealized gains and losses reported in operations. Realized gains and losses on marketable equity and debt securities are recognized upon sale using the specific identification method.

Inventories

Inventories, which consist of raw materials, work-in-process, and finished goods, are stated at the lower of cost or market value, cost being determined using the first in, first out method. Fixed and variable manufacturing costs and overhead are included in the carrying values of finished goods and work-in-process. The Company records reserves for inventory shrinkage and obsolescence, when considered necessary. For the six months ended March 31, 2005, inventory shrinkage and obsolescence reserves increased $52,571.

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Property, Plant, and Equipment

Property, plant and equipment are carried at cost. Depreciation is provided over the estimated useful lives of the assets using both the straight-line and accelerated methods. The estimated useful lives used to compute depreciation are as follows:

Buildings and improvements	10 to 30 years
Machinery and equipment	4 to 10 years

The cost of maintenance and repairs is charged to expense as incurred; renewals and betterments are capitalized. When properties are retired or otherwise disposed of, the cost of such properties and the related accumulated depreciation are removed from the accounts. Any profit or loss is credited, or charged to income.

Software Costs

The Company capitalizes certain costs associated with software development in accordance with statement of Financial Accounting Standard #86 (FASB #86) Accounting for the costs of computer software to be sold, leased, or otherwise marketed. The Company amortizes costs over 10 years, the estimated useful life of the asset.

Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed of

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the assets exceeds the fair value. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. There were no assets impaired during the first six months ended March 31, 2005.

Income (Loss) Per Share

Basic earnings per share amounts are computed by dividing the net income by the weighted average number of common shares outstanding. Diluted earnings per share amounts are computed by dividing net income by the weighted average number of shares of common stock, common stock equivalents, and stock options outstanding during the period.

Revenue Recognition

Sales revenues are recorded when products are shipped and title has passed to unaffiliated customers. Installation revenues are considered earned at the time the project is completed. Maintenance contracts are recorded as unearned revenues at the time of collection and are recognized as income monthly over the term of the contract. Interest and dividends earned on investments are recorded when earned.

Advertising Costs

The Company expenses advertising costs as incurred.

Research and Development

Expenditures for research and development are charged to operations as incurred.

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Foreign Currency Translation

Telecom s functional currency is the British Pound Sterling, its local currency. Accordingly, balance sheet accounts are translated at exchange rates in effect at the end of the year and income statement accounts are translated at average exchange rates for the year. Translation gains and losses are included as a separate component of stockholders equity as cumulative translation adjustments. Foreign currency transaction gains and losses are included in other income and expenses.

Comprehensive Income

Comprehensive income is comprised of net income and other comprehensive income. Other comprehensive income includes certain changes in equity that are excluded from net income. At March 31, 2005 and September 30, 2004, accumulated other comprehensive income was comprised of cumulative foreign currency translation adjustments.

3. Acquisitions:

Acquisition of Percipia, Inc. and Subsidiary

For purposes of expanding into the telecommunication market, the Company completed its acquisition of all the issued and outstanding common stock of Percipia, Inc. (Percipia), and its wholly owned subsidiary, Percipia Networks, Inc on August 6, 2004. The consideration paid by the Company consisted of cash of $841,510 (including $53,550 paid to retire all outstanding stock options of Percipia and $127,960 paid for acquisition costs) and 190,000 shares of its common stock valued at $997,500 based on an average price of $5.25 over the thirty days prior to the acquisition for a total purchase price of $1,839,010. As a result, Percipia became a wholly owned subsidiary of the Company. For accounting purposes, the effective date of the acquisition was June 30, 2004.

The following table sets forth the preliminary allocation of the purchase price to Percipia s tangible and intangible assets acquired and liabilities assumed as of July 1, 2004:

Cash	$ 17,690
A/R	425,417
Inventory	380,750
Deferred tax assets	653,000
Fixed assets	95,453
Software	2,700,000
Note receivable and other assets	80,362
Goodwill	852,683
Accounts payable	(239,098)
Accrued liabilities	(555,877)
Deferred tax liability	(860,000)
Unearned revenues	(145,106)
Line of credit	(99,300)
Notes payable	(1,428,089)
Capital leases	(38,875)
Total	$ 1,839,010

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The goodwill resulting from this acquisition is expected to be amortized over fifteen years for tax purposes.

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Acquisition of CPM FM Limited (formerly known as Telecom FM Limited)

On October 5, 2004, the Company, through a wholly owned subsidiary, Sunair Communications, Limited, a private limited company incorporated in England (SCL), entered into a definitive asset purchase agreement by and among SCL, CPM FM Limited (formerly known as Telecom FM Limited) (Telecom), a private limited company incorporated in England, and TFM Group Limited, a private limited company incorporated in England and the sole shareholder of Telecom, pursuant to which the Company acquired substantially all of the assets and assumed certain liabilities of Telecom for $1,500,000 cash. The purpose of this acquisition was to expand into the telecommunication market.

In addition, the Company incurred $340,913 of transaction costs consisting principally of legal and accounting fees.

The transaction was closed on October 11, 2004 and, as stated in the asset purchase agreement, became effective on September 1, 2004.

The following table sets forth the allocation of the purchase price to Telecom s tangible assets acquired and liabilities assumed as of September 1, 2004:

Inventories	$ 910,282
Accounts receivable	1,303,570
Prepaid expenses and other current assets	171,103
Fixed assets	22,763
Software costs	1,164,699
Accounts payable	(991,475)
Bank overdraft	(411,773)
Accrued expenses	(238,136)
Loan payable	(90,120)
Total	$ 1,840,913

The $1,500,000 due to the principles of Telecom were accrued as payable as of September 30, 2004. Of this amount, $1,250,000 was paid in October of 2004. Costs accrued in connection with the acquisition of $249,312 are included in accrued expenses as of September 30, 2004.

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Pro-forma results of operations

The following sets forth the Company s results of operations for the six months and three months ended March 31, 2005 as if the acquisitions had taken place on October 1, 2003.

	SIX MONTHS ENDED MARCH 31,	
	2005	2004
Revenues	$ 9,940,320	$ 8,489,420
Net income	$ 735,507	$ 625,399
Earnings per share		
Basic	$ 0.14	$ 0.17
Diluted	$ 0.11	$ 0.16

	THREE MONTHS ENDED MARCH 31,	
	2005	2004
Revenues	$ 4,846,332	$ 5,733,787
Net income	$ 363,102	$ 731,217
Earnings per share		
Basic	$ 0.05	$ 0.19
Diluted	$ 0.04	$ 0.19

4. Inventories

Inventories consist of the following:

	03/31/05	09/30/04
Materials	$ 1,799,699	$ 1,565,463
Work in progress	4,112,914	4,117,503
Finished goods	1,193,686	1,575,989
	$ 7,106,299	$ 7,258,955

5. Earnings Per Common Share:

Basic earnings per share amounts are computed by dividing the net income by the weighted average number of common shares outstanding. Diluted earnings per share amounts are computed by dividing net income by the weighted average number of shares of common stock, common stock equivalents, and stock options outstanding during the period.

6. Preferred Stock:

At March 31, 2005, the Company had 8,000,000 authorized shares of preferred stock, no par value, that may be issued at such terms and provisions as determined by the board of directors. None are outstanding.

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7. Stock Options and Warrants:

At the fiscal year ended September 30, 2004, options to purchase 270,000 shares of the Company s common stock at $2.25 per share had been issued to key employees of the Company. 45,600 stock options were exercised in fiscal 2003 and 78,450 stock options were exercised in fiscal 2004. Due to a majority change in ownership in November 2003, all of the Company s outstanding stock options became fully vested and exercisable. At the beginning of the current fiscal year, there were options outstanding to purchase 145,950 shares of common stock at $2.25 per share of which 8,250 stock options were exercised in the first fiscal quarter. These options are fully vested and are exercisable until November 21, 2005.

On February 4, 2005, the shareholders of the Company approved the issuance of options outside of the existing option plan to three directors. The options are for the purchase of 60,000 shares of common stock at $4.79 per share and are fully vested and exercisable at March 31, 2005.

Pursuant to employment agreements entered into in February, 2005 between the Company and Mr. Laurent, Mr. Durham and Mr. Budde, officers of the Company, an aggregate of 60,000 options were granted for the purchase of the Company s common stock at $13.78 per share. The options will vest equally over a period of 24 months at a rate of 1,666 per month so long as the option holder is currently employed by the Company.

On February 8, 2005, the Company completed its sale of 5,000,000 units to Coconut Palm Capital Investors 11, Ltd., a Florida limited partnership (Coconut Palm) pursuant to a Purchase Agreement dated as of November 17, 2004, by and between the Company and Coconut Palm (the Purchase Agreement). The aggregate purchase price paid by Coconut Palm for the units was $25 million. The units consist of 5 million shares of the Company s common stock, warrants to purchase an additional five million shares of the Company s common stock at an exercise price of $6.00 per share, which are immediately exercisable and will expire after three years; and warrants to purchase an additional five million shares of the Company s common stock at an exercise price of $7.00 per share, which are immediately exercisable and will expire after five years.

In addition, on February 8, 2005 a grant for 166,667 stock options to purchase 166,667 shares of common stock at $5.00 per share became effective for options granted to the President/CEO of the Company. The options will vest equally over a period of four years beginning in November, 2005.

There are 333,333 options outstanding which were granted to two individuals contingent upon their employment with the Company. At March 31, 2005, these individuals were not employed by Sunair.

8. Equipment and Service Information:

	SIX MONTHS ENDED 03/31/05	THREE MONTHS ENDED 03/31/05
Sales		
Equipment	$ 8,781,461	$ 4,280,075
Service	1,158,859	566,257
Total Sales	$ 9,940,320	$ 4,846,332

Cost of Sales		
Equipment	$ 5,080,861	$ 2,533,720
Service	456,665	203,007
Total Cost of Sales	$ 5,537,526	$ 2,736,727

9. Recent Accounting Pronouncements:

In January 2003, the FASB issued interpretations No. 46, *Consolidation of Variable Interest Entities*. FIN No. 46 addresses consolidation by business enterprises of variable interest entities (formerly Special Purpose Entities or SPES). The Company does not have any variable interest entities as defined by FIN No. 46 and therefore the interpretation did not affect the Company s financial position, results of operations or cash flows.

In April 2003, the FASB issued Statement No. 149, *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities*. This statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under Statement No. 133, Accounting for Derivatives Instruments and Hedging Activities. The provisions of this statement are effective for all derivatives and hedging activities entered into after June 30, 2003. The Company did not have any derivatives or hedging activities and therefore the standard did not affect the Company s financial position, results of operations or cash flows.

In May 2003, the FASB issued SFAS No. 150 *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. SFAS No. 150 establishes standards on the classification and measurement of certain instruments with characteristics of both liabilities and equity. The provisions of SFAS No. 150 are effective for financial instruments entered into or modified after May 31, 2002 and to all other instruments that exist as of the beginning of the first interim financial reporting period beginning after June 15, 2003. SFAS No. 150 did not have a material effect on the Company s financial Statements.

In December 2004, the FASB issued FASB No. 123 Accounting for Stock-Based Compensation Revised

In December 2004, the FASB issued SFAS No. 123R, Accounting for Stock-Based Compensation . This statement is a revision to SFAS No. 123, Accounting for Stock-Based Compensation and supersedes APB Opinion No. 25, Accounting for stock issued to employees. This statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service, the requisite service period (usually the vesting period). The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models.

In addition, a public entity is required to measure the cost of employee services received in exchange for an award of liability instruments based on its current fair value. The fair value of that award will be remeasured subsequently at each reporting date through the settlement date. Changes in fair value during the requisite

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service period will be recognized as compensation cost over that period.

For public entities that do not file as small business issuers, this statement is effective as of the beginning of the first annual reporting period that begins after June 15, 2005.

For public entities that file as small business issuers, this statement is effective as of the beginning of the first annual reporting period that begins after December 15, 2005.

At the required effective date, all public entities that used the fair value based method for either recognition or disclosure under Statement 123 are required to apply this statement using a modified version of prospective application. Under that transition method, compensation cost is recognized on or after the required effective date for the portion of outstanding awards for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards calculated under Statement 123 for either recognition or pro-forma disclosures. For periods before the required effective date, those entities may elect to apply the modified version of retrospective application under which financial statements for prior periods are adjusted on a basis consistent with the pro forma disclosures required for those periods by Statement 123. The Company has not yet determined which methodology it will adopt but believes that the impact that the adoption of SFAS No. 123R will have on its financial position or results of operations will approximate the magnitude of the stock-based employee compensation cost pursuant to the disclosure requirements of SFAS No. 148.

EITF 03-11, Reporting Gains and Losses on Derivative Instruments that are Subject to FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and Not Held for Trading Purposes .

In July 2003, the EITF reached a consensus that all gains and losses (realized and unrealized) on derivative instruments within the scope of SFAS 133 should be shown net in the income statement, whether or not settled physically, if the derivative instruments are held for trading purposes. However, the EITF recognized that there may be contracts within the scope of SFAS 133 considered not held for trading purposes that warrant further consideration as to the appropriate income statement classification of the gains and losses. In EITF 03 11, the EITF clarified certain criteria to use in determining whether gains and losses related to non-trading derivative instruments should be shown net in the income statement. The adoption of EITF 03-11 did not have a material effect on the Company s financial position, results of operations or cash flows.

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Item 2. Management s Discussion and Analysis or Plan of Operation

Cautionary statement regarding forward looking information:

Some of the statements in this quarterly report, including those that contain the words anticipate, believe, plan, estimate, expect, should, intend and other similar expressions, are forward-looking statements within the meanir the Private Securities Litigation Reform Act of 1995. Those forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements or those of our industry to be materially different from any future results, performance or achievements expressed or implied by those forward-looking statements. Among the factors that could cause actual results, performance or achievement to differ materially from those described or implied in the forward-looking statements are general economic conditions, competition, potential technology changes, changes in or the lack of anticipated changes in the regulatory environment in various countries, the risks inherent in new product and service introductions and the entry into new geographic markets and other factors included in our filings with the Securities and Exchange Commission (the SEC). Copies of our SEC filings are available from the SEC or may be obtained upon request from us. We do not undertake any obligation to update the information contained herein, which speaks only as of this date.

General:

Sunair Electronics, Inc. (Sunair, the Company, us, we or our) is a Florida corporation organized in 1956. The Company is engaged in the design, manufacture and sale of high frequency single sideband communications equipment and the software development, design, integration testing and documentation of C^4ISR systems utilized for long range voice and data communications in fixed station, mobile and marine military and governmental applications.

Percipia, Inc. (Percipia), an Ohio corporation, is a wholly owned subsidiary which provides installation and maintenance of telephony systems, and develops and customizes software for telephony systems to various industries, most notably hospitality.

Telecom FM Limited (Telecom), a United Kingdom corporation, is a wholly owned subsidiary which distributes and installs telecommunication devices providing fixed wireless access to network and data service providers.

Sunair products and engineering capabilities are marketed both domestically and internationally and are primarily intended for strategic military and other governmental applications. Sales are executed direct through systems engineering companies, worldwide commercial and foreign governmental agencies or direct to the U.S. Government.

Sunair s line of equipment is composed of proprietary HF/SSB radio equipment and ancillary items sold as operating units or combined into sophisticated systems that may interface with workstations, antennae, power sources, modems, message switching devices, cryptographic equipment software and the like provided by others. Sunair products employ advanced solid state designs with computer controlled networking capabilities. In addition, the Company custom designs systems incorporating various combinations of equipment into racks and control consoles that may interface with value added products and systems of

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other manufacturers. With the acquisitions of Percipia and Telecom, the Company now installs and maintains telephony and fixed wireless systems.

Pursuant to the previously announced purchase agreement dated as of November 17,2004 (the Purchase Agreement) by and between the Company and Coconut Palm Capital Investors 11, Ltd., a Florida limited partnership (Coconut Palm), on February 8, 2005, Coconut Palm completed its purchase of 5 million units. The units consist of 5 million newly issued shares of common stock of the Company and warrants to purchase an additional 10 million shares of common stock at exercise prices ranging from $6.00 per share to $7.00 per share. The warrants are immediately exercisable and will expire at times of three and five years from closing. The aggregate purchase price for the units was $25 million. Following the closing of the transaction, Coconut Palm beneficially owns 15 million shares, or 78.9%, of the common stock of the Company (assuming exercise of the warrants).

The Company intends to use the proceeds from the sale of the units to fund initial acquisitions that have operations in the pest and termite control services sector and to form a new pest and termite control services division. Ultimately, the Company anticipates that with the sale of the units and the formation of its new pest and termite control services division, it will no longer operate solely through its traditional business segments. Furthermore, as the Company is able to grow its new pest and termite control services division through acquisitions and, eventually through internal organic growth, it is contemplated that this new segment will become the Company s dominant operation. Accordingly, if the Company is successful in implementing this strategy, it will represent a fundamental shift in the nature of the Company s business.

In connection with the investment by Coconut Palm, the Company entered into an employment agreement with John J. Hayes under which he became the Company s President and Chief Executive Officer beginning February 15, 2005. The Company anticipates that as it acquires pest and termite control companies, it will enter into employment agreements with additional persons for the new termite control services division. In addition, James E. Laurent, the Company s then current President and Chief Executive Officer, Synnott B. Durham, the Company s then current corporate Secretary and Chief Financial Officer, and Henry A. Budde, the Company s then current Vice President of Operations, have entered into employment agreements with the Company, which became effective upon the closing of the transaction. Mr. Laurent serves as the President of the high frequency single sideband communications business. Mr. Durham will remain the Chief Financial Officer of the Company and now serves as the Vice President of Finance of the high frequency single sideband communications business. Mr. Budde serves as the Vice President of Operations of the high frequency single sideband communications business.

In connection with this change in business strategy, and in accordance with the Purchase Agreement, the Company also agreed to use its best efforts to enter into a definitive agreement as soon as practicable to divest itself of certain non-core assets acquired in connection with the Company s purchase of: (i) Percipia; and (ii) the assets of Telecom, at a purchase price equal to the amount the Company paid for such assets plus the amount of any intercompany debt incurred and advances made in connection with such purchases.

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Liquidity:

For the first six months ended March 31, 2005, the Company had positive cash flow from operations of $503,182 due to reductions in accounts receivable and reductions in inventories for shipments made from inventory purchased in prior periods. Accounts receivable decreased on payments against large shipments made toward 2004 fiscal year end.

Cash flows provided by investing activities for the six months ended March 31, 2005 were $1,119,220 due to proceeds from the sale of held-to-maturity investments less amounts paid for the purchase of property, plant, and equipment, software development and cash paid for the acquisition of the assets of Telecom.

Cash flows provided by financing activities for the six months ended March 31, 2005 were $22,250,426 which consisted of proceeds from the sale of stock pursuant to the closing of the Purchase Agreement with Coconut Palm and the exercise of stock options less the repayment of the line of credit and paydown of notes payable.

During the first six months of fiscal 2005, the Company had short term investments and cash or cash equivalents more than adequate to cover known requirements, unforeseen events or uncertainties that might occur. The Company s known requirements consist of normal operating expenses. During this six month period, cash and cash equivalents had an average balance of $18,228,000 as opposed to an average balance of $1,738,000 for the twelve months ended September 30, 2004. Cash equivalents are money market funds that are readily available for immediate use should the occasion arise. The current ratio of the Company as of March 31, 2005 was 14.8 compared to 2.6 as of September 30, 2004.

The Company records reserves for inventory shrinkage and obsolescence, when considered necessary. For the six months just ended, inventory shrinkage and obsolescence reserves increased $52,571 due to expected inventory shrinkage. Accounts receivable consist of balances due from sales. The Company monitors accounts receivables and provides allowances when considered necessary. As of March 31, 2005, the Company had an allowance of $48,485.

Non cash interim reserves are maintained to cover items such as warranty repairs in process and other charges that may be in dispute.

Capital Resources:

During the first six months of fiscal 2005, $67,410 was spent for capital assets. These funds were primarily used for new computer hardware. $226,971 was spent for software development costs. No expenditures are contemplated for plant expansion or extensive maintenance in fiscal 2005. The Company has no long term debt and none is contemplated, except the Company may incur debt or use cash to finance acquisitions although there are currently no definitive agreements in connection with any acquisitions. Liabilities consist of current accounts payable, accrued expenses related to the current accounting period, the current and long term portion of income taxes payable, amounts due under the management services agreement described below and compensation to management.

Effective upon the closing of the Purchase Agreement with Coconut Palm, the Company entered into a five-year management services agreement with RPC Financial Advisors, LLC (RPC), pursuant to which RPC agreed to provide management services for the Company s newly created pest and termite control services division. The Company has agreed to pay a management fee during the first year of the management services agreement in the amount of $1,562,500. Following the first year and thereafter, the management fee will be equal to 1% of the gross revenues from operations of the pest and termite control services division. Richard Rochon and Mario Ferrari, both of whom are affiliates of Coconut Palm and each of whom are members of the Company s board of directors, are also affiliates of RPC.

Results of Operations:

First six months of fiscal year ending 2005 compared to first six months of fiscal year ended 2004.

During the first six months of the current fiscal year ended March 31, 2005, sales of $9,940,320 were up 119.4% or $5,409,864 from the same period one year ago due to increased shipments on orders received in fiscal 2004, the first six months of fiscal 2005 and the added revenues produced by the two subsidiaries acquired in the fourth quarter of fiscal year ended September 30, 2004. Backlog of $5,283,000 was higher at March 31, 2005 compared to $3,331,000 at March 31, 2004.

Cost of sales was slightly higher at 55.7% of sales in the first six months of fiscal 2005 as compared to 55.6% of sales for the same period one year ago due to a change in the product mix. Inventories decreased 2.1% or $152,656 for the first six months of fiscal 2005 due to increased shipments against orders received in the fourth quarter of fiscal 2004 and the first six months of fiscal 2005. The Company continues its efforts to reduce inventories to lower levels.

Selling, general and administrative expenses increased 231.9% or $2,389,293 due to increased overhead expenses associated with the operation of Percipia and Telecom. Expenses continue to be incurred for expanded market exposure.

Interest income increased $25,943 due to the investment of proceeds received on the sale of stock in February of 2005 less the redemption of the PEFCO notes in the first quarter of fiscal 2005. Interest expense was incurred on a $2,000,000 bank line of credit. Other expenses incurred were due to a loss on the redemption of the PEFCO notes.

The Company s marketing efforts continue to follow up on opportunities in the Middle East, Asia, North Africa, and India. Projects are being pursued and we believe progress is showing strong major order prospects in India and a Persian gulf country. We believe that we may receive a production order (valued at $1 million) in the Middle East which is projected to close within the next quarter for deliveries in fiscal year 2006. These major opportunities include system integration requirements which match our focused growth area of the radio communications group. Forecasts are promising in the new telecom software and wireless telecommunications areas as well. The Company has received orders for HF radio systems to be installed into shelters for the U.S. Marine Corps. Deliveries under the U.S. Coast Guard orders are scheduled to continue through the first three months of fiscal year 2006.

Item 3. Controls and procedures

(a) Evaluation of disclosure controls and procedures. The term disclosure controls and procedures is defined in Rule 13a 15(e) of the Securities Exchange Act of 1934, or the Exchange Act. This term refers to the controls and procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods. Our chief executive officer and our chief financial officer have concluded, based on their evaluation as of March 31, 2005, that our disclosure controls and procedures are effective.

(b) Changes in internal control over financial reporting. There have been no changes in our internal control over financial reporting during the quarter ended March 31, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II Other Information

Item 1. Legal Proceedings

None

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

None

Item 3. Defaults Upon Senior Securities

None

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

The Company held its 2004 Annual Meeting of Stockholders on February 4, 2005. At the meeting, the following persons were elected or re-elected to serve as directors, with the votes indicated:

Director	Affirmative Votes	Withheld Votes
Michael D. Herman	3,504,241	188,908
Dr. Arnold Heggestad	3,608,113	168,736
James E. Laurent	3,589,213	187,636
Steven P. Oppenheim	3,588,913	187,936
Richard C. Rochon	3,607,229	169,620
Mario B. Ferrari	3,587,941	188,908

Also at the meeting the stockholders approved the following proposals, with the votes indicated:

1. The issuance of shares of the Company s common stock in connection with the proposed sale to Coconut Palm of up to 5,000,000 units at a purchase price of $5.00 per unit.

FOR: 2,754,240 AGAINST: 65,098 ABSTAIN: 2,530 BROKER NON-VOTES: 3,072,881

2. An increase in the size of the Company s Board of Directors from 5 to 7 members.

FOR: 2,754,886 AGAINST: 65,422 ABSTAIN: 1,560 BROKER NON-VOTES: 3,072,881

3. Amendments to the Company s Articles of Incorporation to: (i) change the Company s corporate name to Sunair, Inc.; (ii) allow the Company to engage in any lawful business; and (iii) increase the number of the Company s authorized shares of capital stock to 108,000,000 shares, of which 100,000,000 shares will be common stock and 8,000,000 shares will be preferred stock.

FOR: 2,663,946 AGAINST: 136,526 ABSTAIN: 1,396 BROKER NON-VOTES: 3,072,881

4. The issuance of an aggregate of 60,000 options to purchase shares of the Company s common stock to 3 of the Company s current directors outside of the Company s existing stock option plan;

FOR: 2,628,975 AGAINST: 188,367 ABSTAIN: 4,526 BROKER NON-VOTES: 3,072,881

5. The Company s 2004 Stock Incentive Plan.

FOR: 2,650,500 AGAINST: 168,238 ABSTAIN: 3,130 BROKER NON-VOTES: 3,072,881

6. To act upon such other business as may properly come before the Annual Meeting of Shareholders and any and all adjournments or postponements of the Annual Meeting of Shareholders.

FOR: 3,576,963 AGAINST: 174,148 ABSTAIN: 4,738 BROKER NON-VOTES: 0

Item 5. Other Information

None

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Part II Other Information (Continued)

Item 6. Exhibits

3.1	Articles of Amendment to the Articles of Incorporation.
4.1	First Tranche Warrant, dated February 8, 2005, issued by Sunair Electronics, Inc. to Coconut Palm Capital Investors II, Ltd.
4.2	Second Tranche Warrant, dated February 8, 2005, issued by Sunair Electronics, Inc. to Coconut Palm Capital Investors II, Ltd.
10.6	2004 Stock Incentive Plan (incorporated by reference to the Definitive Proxy Statement filed with the SEC on January 18, 2005).*
10.7	Employment Agreement between Sunair Electronics, Inc. and John Hayes.*
10.8	Employment Agreement between Sunair Electronics, Inc. and James E. Laurent.*
10.9	Employment Agreement between Sunair Electronics, Inc. and Synnott B. Durham.*
10.10	Employment Agreement between Sunair Electronics, Inc. and Henry A. Budde.*
31.1	Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification by Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification by Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Management Compensatory Plan

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SIGNATURES

Pursuant to the requirements of the securities and exchange act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Sunair Electronics, Inc.

Date May 16, 2005

/s/ John J. Hayes

John J. Hayes, President
and Chief Executive Officer

Date May 16, 2005

/s/ Synnott B. Durham

Synnott B. Durham,
Chief Financial Officer