

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC

Form 10-Q

May 13, 2005

Table of Contents

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

FORM 10-Q

**Quarterly Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934**

For the quarterly period ended March 31, 2005

Commission File Number 1-10367

Advanced Environmental Recycling Technologies, Inc.

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

71-0675758

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

914 N Jefferson Street

Post Office Box 1237

Springdale, Arkansas

(Address of principal executive offices)

72765

(Zip Code)

(479) 756-7400

(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:

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of May 12, 2005, the number of shares outstanding of the Registrant's Class A common stock, which is the class registered under the Securities Exchange Act of 1934, was 33,767,832 and the number of shares outstanding of the Registrant's Class B Common Stock was 1,465,530.

Form 10-Q Index

| | Page |
|--|-------|
| PART I FINANCIAL INFORMATION | |
| Item 1. Financial Statements | |
| <u>Balance Sheets, March 31, 2005 (unaudited) and December 31, 2004</u> | 1-2 |
| <u>Statements of Operations (unaudited) Three Months Ended March 31, 2005 and 2004</u> | 3 |
| <u>Statements of Cash Flows (unaudited) Three Months Ended March 31, 2005 and 2004</u> | 4 |
| <u>Notes to Financial Statements</u> | 5-11 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 12-18 |
| <u>Item 3. Quantitative and Qualitative Disclosure about Market Risk</u> | 18 |
| <u>Item 4. Controls and Procedures</u> | 19 |
| <u>PART II OTHER INFORMATION</u> | |
| <u>Item 1. Legal Proceedings</u> | 19 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 20 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 20 |
| <u>Item 6. Exhibits</u> | 20 |
| <u>Signatures</u> | 21 |
| <u>Index to Exhibits</u> | 22 |
| <u>Certification Pursuant to Section 302</u> | |
| <u>Certification Pursuant to Section 302</u> | |
| <u>Certification Pursuant to Section 302</u> | |
| <u>Certification Pursuant to Section 906</u> | |
| <u>Certification Pursuant to Section 906</u> | |
| <u>Certification Pursuant to Section 906</u> | |

Table of Contents**ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.****Balance Sheets****ASSETS**

| | March 31, 2005 (unaudited) | December 31, 2004 |
|--|---|------------------------------|
| Current assets: | | |
| Cash and cash equivalents | \$ 2,116,687 | \$ 1,078,536 |
| Restricted cash | 1,025,697 | 679,635 |
| Trade accounts receivable, net of allowance of \$127,827 at March 31, 2005 and \$153,536 at December 31, 2004 | 4,199,465 | 2,554,594 |
| Inventories | 6,284,895 | 7,392,838 |
| Prepaid expenses | 238,757 | 586,637 |
| Total current assets | 13,865,501 | 12,292,240 |
| Land, buildings and equipment: | | |
| Land | 1,612,243 | 1,612,243 |
| Buildings and leasehold improvements | 5,501,366 | 5,413,115 |
| Machinery and equipment | 34,251,867 | 33,524,077 |
| Transportation equipment | 890,299 | 775,669 |
| Office equipment | 747,047 | 755,000 |
| Construction in progress | 3,066,122 | 2,363,936 |
| | 46,068,944 | 44,444,040 |
| Less accumulated depreciation | 19,995,150 | 18,963,479 |
| Net land, buildings, and equipment | 26,073,794 | 25,480,561 |
| Other assets: | | |
| Debt issuance costs, net of accumulated amortization of \$416,902 at March 31, 2005 and \$373,336 at December 31, 2004 | 3,168,199 | 3,211,766 |
| Debt service reserve fund | 2,150,750 | 2,057,792 |
| Other assets, net of accumulated amortization of \$342,733 at March 31, 2005 and \$335,590 at December 31, 2004 | 231,365 | 298,434 |
| Total other assets | 5,550,314 | 5,567,992 |
| | \$ 45,489,609 | \$ 43,340,793 |

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

Table of Contents**ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.****Balance Sheets****LIABILITIES AND STOCKHOLDERS EQUITY**

| | March 31, 2005 (unaudited) | December 31, 2004 |
|--|---|------------------------------|
| Current liabilities: | | |
| Accounts payable trade | \$ 7,805,819 | \$ 8,486,792 |
| Accounts payable related parties | 3,723,281 | 2,280,781 |
| Current maturities of long-term debt | 1,046,301 | 1,133,168 |
| Accrued payroll expense | 713,442 | 401,183 |
| Other accrued liabilities | 2,628,534 | 2,533,605 |
| Notes payable related parties | 975,000 | 600,000 |
| Notes payable other | 52,491 | 327,682 |
| Total current liabilities | 16,944,868 | 15,763,211 |
| Long-term debt, less current maturities | 15,558,775 | 15,571,068 |
| Accrued premium on convertible preferred stock | 69,000 | 276,000 |
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Preferred stock, \$1 par value; 5,000,000 shares authorized; 2,760 shares issued and outstanding at March 31, 2005 and December 31, 2004 | 2,760 | 2,760 |
| Class A common stock, \$.01 par value; 75,000,000 shares authorized; 33,742,832 and 32,032,123 shares issued and outstanding at March 31, 2005 and December 31, 2004, respectively | 337,428 | 320,322 |
| Class B convertible common stock, \$.01 par value; 7,500,000 shares authorized, 1,465,530 shares issued and outstanding at March 31, 2005 and December 31, 2004 | 14,655 | 14,655 |
| Warrants outstanding; 13,430,400 at March 31, 2005 and 14,890,867 at December 31, 2004 | 6,120,861 | 6,917,544 |
| Additional paid-in capital | 28,677,117 | 27,376,565 |
| Accumulated deficit | (22,235,855) | (22,901,332) |
| Total stockholders equity | 12,916,966 | 11,730,514 |
| Total liabilities and stockholders equity | \$ 45,489,609 | \$ 43,340,793 |

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

Table of Contents**ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.****STATEMENTS OF OPERATIONS (UNAUDITED)**

| | Three months ended March | |
|---|---------------------------------|---------------|
| | 2005 | 2004 |
| | 31 | |
| Net sales | \$ 19,943,530 | \$ 13,221,121 |
| Cost of goods sold | 15,623,910 | 10,632,911 |
| Gross margin | 4,319,620 | 2,588,210 |
| Selling and administrative costs | 3,055,653 | 2,383,718 |
| Research and development | | 95,619 |
| | 3,055,653 | 2,479,337 |
| Operating income | 1,263,967 | 108,873 |
| Other income (expense): | | |
| Insurance proceeds related to lost income | | 8,720 |
| Interest income | 3,112 | 918 |
| Interest expense | (532,602) | (512,824) |
| | (529,490) | (503,186) |
| Income (loss) before extraordinary item and accrued premium on preferred stock | 734,477 | (394,313) |
| Accrued premium on preferred stock | (69,000) | (69,000) |
| Income (loss) before extraordinary item | 665,477 | (463,313) |
| Extraordinary gain on involuntary conversion of non-monetary assets due to fire | | 173,536 |
| Net income (loss) applicable to common stock | \$ 665,477 | \$ (289,777) |
| Income (loss) per share of common stock before extraordinary item (Basic) | \$ 0.02 | \$ (0.01) |
| Income (loss) per share of common stock before extraordinary item (Diluted) | \$ 0.01 | \$ (0.01) |
| Extraordinary gain per share of common stock (Basic and Diluted) | | \$ 0.01 |
| Income (loss) per share of common stock after extraordinary item (Basic) | \$ 0.02 | \$ (0.01) |
| Income (loss) per share of common stock after extraordinary item (Diluted) | \$ 0.01 | \$ (0.01) |
| Weighted average number of common shares outstanding (Basic) | 34,360,219 | 31,100,068 |

| | | |
|--|------------|------------|
| Weighted average number of common shares outstanding (Diluted) | 44,872,346 | 31,100,068 |
|--|------------|------------|

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

Table of Contents**ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES, INC.****STATEMENTS OF CASH FLOWS (UNAUDITED)**

| | Three months ended March | |
|--|---------------------------------|--------------|
| | 31 | |
| | 2005 | 2004 |
| Cash flows from operating activities: | | |
| Net income (loss) applicable to common stock | \$ 665,477 | \$ (289,777) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,038,814 | 1,021,426 |
| Premium accrued on preferred stock | 69,000 | 69,000 |
| Extraordinary gain on involuntary conversion of non-monetary assets due to fire | | (173,536) |
| (Increase) decrease in other assets | 10,535 | (3,962) |
| Increase in cash restricted for letter of credit and internal costs | (170,149) | (252,466) |
| Changes in current assets and current liabilities | (1,055,925) | (179,755) |
| Net cash provided by operating activities | 557,752 | 190,930 |
| Cash flows from investing activities: | | |
| Purchases of land, buildings and equipment | (874,903) | (1,067,251) |
| Insurance proceeds from involuntary disposition of property and equipment | | 669,012 |
| Net cash used in investing activities | (874,903) | (398,239) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of notes | 700,000 | 800,000 |
| Payments on notes | (699,352) | (773,103) |
| Increase in cash restricted for payment of long-term debt | (175,914) | (175,297) |
| Increase in outstanding advances on factored receivables | 1,285,593 | 426,183 |
| Debt acquisition costs | | 11,100 |
| Proceeds from exercise of stock options and warrants, net | 244,975 | 414,070 |
| Net cash provided by financing activities | 1,355,302 | 702,953 |
| Increase in cash | 1,038,151 | 495,644 |
| Cash and cash equivalents, beginning of period | 1,078,536 | 1,509,124 |
| Cash and cash equivalents, end of period | \$ 2,116,687 | \$ 2,004,768 |

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

Table of Contents

NOTES TO FINANCIAL STATEMENTS

Note 1: Unaudited Information

Advanced Environmental Recycling Technologies, Inc. (the Company or AERT) has prepared the financial statements included herein without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). However, all adjustments have been made to the accompanying financial statements which are, in the opinion of the Company's management, of a normal recurring nature and necessary for a fair presentation of the Company's operating results. Certain information and footnote 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 such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented herein not misleading. It is recommended that these financial statements be read in conjunction with the financial statements and the notes thereto included in the Company's latest annual report on Form 10-K. The Company has reclassified certain prior period amounts to conform to the current period presentation.

Note 2: Description of the Company

Advanced Environmental Recycling Technologies, Inc. (AERT) develops, manufactures and markets composite building materials that are used in place of traditional wood products for exterior applications in building and remodeling homes and for certain other industrial or commercial building purposes. Our products are made from approximately equal amounts of waste wood fiber and reclaimed polyethylene plastics, have been extensively tested, and are sold by leading national companies such as the Weyerhaeuser Company (Weyerhaeuser), Lowe's Companies, Inc. (Lowe's) and Therma-Tru Corporation. Our composite building materials are marketed as a substitute for wood and plastic filler materials for standard door components, windowsills, brick mould, fascia board, decking and heavy industrial flooring under the trade names LifeCycle®, MoistureShield®, MoistureShield® CornerLoc®, Weyerhaeuser ChoiceDek® Classic, Weyerhaeuser ChoiceDek® Plus, Weyerhaeuser ChoiceDek® Premium, ChoiceDek® Classic Colors, ChoiceDek® Premium Colors and MoistureShield® outdoor decking. We operate manufacturing facilities in Springdale, Lowell, and Tontitown, Arkansas; Junction, Texas and Alexandria, Louisiana. Our customers are primarily regional and national door and window manufacturers, Weyerhaeuser, our primary decking customer, and various building product distributors.

Note 3: Extraordinary Items

On March 28, 2003, there was an accidental fire at the Junction, Texas plant. The Company began demolition and partial rebuilding in April 2003. The initial restoration project, completed in May 2003, included the rebuilding of one extrusion line that had been partially damaged, electrical system replacement, and roof replacement. The second extrusion line recommenced operations in May 2004. The Junction plant is fully insured for fire damage and business interruption.

Through March 31, 2005 and 2004, the Company had received \$6.0 million in insurance proceeds related to this incident, including amounts for lost income reimbursement. Due to the fire, gross assets were written down by approximately \$4.91 million, along with the associated accumulated depreciation on those

Table of Contents

assets in the amount of \$3.96 million, resulting in a net book value decrease in assets of about \$950,000. Insurance proceeds received to reimburse costs incurred to reconstruct the facility resulted in a gain of \$173,536 for the three months ended March 31, 2004. Additionally, the Company recorded \$11,213 in business interruption insurance during the first quarter of 2004, including \$8,720 to replace lost income and \$2,493 to cover fixed expenses. In addition, we had initially booked an additional receivable of approximately \$864,000 and related income in the first quarter of 2004 for additional amounts we expect to collect from the insurers related to such matter. However, such claims are now being contested by the insurer and, although we intend to vigorously pursue the collection of such claims, we have, in accordance with generally accepted accounting principles, reversed any receivable and income for the first quarter of 2004 attributable to such disputed claims unless and until such claims are collected.

Note 4: Statements of Cash Flows

In order to determine net cash provided by operating activities, net income has been adjusted by, among other things, changes in current assets and current liabilities, excluding changes in cash and cash equivalents, current maturities of long-term debt and current notes payable. Those changes, shown as an (increase) decrease in current assets and an increase (decrease) in current liabilities, are as follows:

| | 2005 (unaudited) | 2004 (unaudited) |
|--|-----------------------------------|-----------------------------------|
| Receivables | \$ (1,644,871) | \$ (456,720) |
| Inventories | 1,107,943 | (600,160) |
| Prepaid expenses and other | 347,881 | 318,382 |
| Accounts payable - Trade and related parties | (1,274,066) | 255,640 |
| Accrued liabilities | 407,188 | 303,103 |
| | \$ (1,055,925) | \$ (179,755) |
| Cash paid for interest | \$ 351,047 | \$ 324,513 |

Supplemental Disclosures of Non-Cash Investing and Financing Activities:

| | 2005 (unaudited) | 2004 (unaudited) |
|---|-----------------------------------|-----------------------------------|
| Accounts / notes payable for equipment | \$ 750,000 | \$ 1,067,252 |
| Accrued premium on preferred stock paid with Class A common stock | 276,000 | 276,000 |

Table of Contents**Note 5: Significant Accounting Policies****Revenue Recognition Policy**

The Company recognizes revenue in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements* (SAB 104). Under SAB 104, revenue is recognized when the title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, delivery has occurred or services have been rendered, the sales price is determinable and collectibility is reasonably assured. The Company typically recognizes revenue at the time product is shipped or when segregated and billed under a bill and hold arrangement. The terms of this agreement qualify for revenue recognition under SAB 104. Sales are recorded net of discounts, rebates, and returns.

Estimates of expected sales discounts are calculated by applying the appropriate sales discount rate to all unpaid invoices that are eligible for the discount. The Company's sales prices are determinable given that the Company's sales discount rates are fixed and given the predictability with which customers take sales discounts.

Shipping and Handling

In accordance with Emerging Issues Task Force (EITF) Issue 00-10, *Accounting for Shipping and Handling Fees and Costs*, the Company records shipping fees billed to customers in net sales and records the related expenses in cost of goods sold.

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market. Inventories consisted of the following:

| | March 31, 2005 (unaudited) | December 31, 2004 |
|-----------------|---|------------------------------|
| Raw materials | \$ 4,470,432 | \$ 5,479,344 |
| Work in process | 598,995 | 891,473 |
| Finished goods | 1,215,468 | 1,022,021 |
| | \$ 6,284,895 | \$ 7,392,838 |

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 of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Table of Contents**Research and Development**

Expenditures relating to the development of new products and processes, including significant improvements to existing products, are expensed as incurred.

Stock-Based Compensation

The Company adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS 123). The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation for the following:

| | Three Months Ended | | |
|--|---------------------------|--|---|
| | March 31, 2005 | March 31, 2004 | |
| | | Before Extra- ordinary Item | After Extra- ordinary Item |
| Net income (loss) applicable to common stock, as reported | \$ 665,477 | \$ (463,313) | \$ (289,777) |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards | 7,147 | 31,499 | 31,499 |
| Net income (loss) applicable to common stock, proforma | \$ 658,330 | \$ (494,812) | \$ (321,276) |
| Net income (loss) per share of common stock: | | | |
| Basic as reported | \$ 0.02 | \$ (0.01) | \$ (0.01) |
| Basic pro forma | \$ 0.02 | \$ (0.02) | \$ (0.01) |
| Diluted as reported | \$ 0.01 | \$ (0.01) | \$ (0.01) |
| Diluted pro forma | \$ 0.01 | \$ (0.02) | \$ (0.01) |

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 151, *Inventory Costs, an Amendment of ARB No. 43, Chapter 4* (SFAS 151). SFAS 151 amends the guidance in ARB No. 43, Chapter 4, *Inventory Pricing*, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Additionally, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The Company is required to adopt the provisions of this statement no later than the beginning of the first fiscal year beginning after June 15, 2005. The Company does not expect the adoption of SFAS 151 to have a material effect on the Company's financial statements and related disclosures.

Table of Contents

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (SFAS 123R). SFAS 123R is a revision of SFAS 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. 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) and requires that cost to be recognized in the financial statements. In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107, which includes interpretations that express views of the SEC staff regarding the interaction between SFAS 123R and certain SEC rules and regulations and provide the staff's views regarding the valuation of share-based payment arrangements for public companies. The Company is required to adopt the provisions of SFAS 123R no later than the beginning of the first interim or annual reporting period of the Company's first fiscal year that begins on or after June 15, 2005. The Company does not expect the adoption of SFAS 123R to have a material effect on the Company's financial statements and related disclosures.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 153, *Exchanges of Nonmonetary Assets, an Amendment of APB Opinion No. 29* (SFAS 153). The guidance in APB Opinion 29, *Accounting for Nonmonetary Transactions*, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. SFAS 153 amends APB Opinion 29 to eliminate an exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The Company is required to adopt the provisions of this statement no later than the beginning of the first fiscal period beginning after June 15, 2005. The Company does not expect the adoption of SFAS 153 to have any effect on the Company's financial statements and related disclosures.

Note 6: Income Taxes

No income tax provision was recorded for the three months ended March 31, 2005, due to the realization of previously unrecognized net operating loss carryforwards. The Company continues to provide a valuation allowance against the deferred tax asset resulting from net operating loss carryforwards.

Note 7: Segment Information

SFAS No. 131 *Disclosures About Segments of an Enterprise and Related Information* (SFAS 131), establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports issued to shareholders. SFAS 131 requires that a public business enterprise report financial and descriptive information about its reportable operating segments. A reportable operating segment is defined as a component of an enterprise:

That engages in business activities from which it may earn revenues and expenses,

Whose operating results are regularly reviewed by the enterprise's chief operating decision maker, and

For which discrete financial information is available.

As of March 31, 2005, the Company does not have available discrete financial information to disclose gross margin by product line. All operating expenses are allocated primarily on capacity. Corporate overhead is not allocated by product line and neither are selected assets. Net sales segregated by product line and gross

Table of Contents

margin by plant location are as follows:

| Net Sales - Three months ended March 31 | 2005 | 2004 |
|---|---------------|---------------|
| Commercial and residential decking surface components | \$ 16,488,362 | \$ 11,016,362 |
| Exterior door, window and housing trim components | 3,455,168 | 2,204,759 |
| | \$ 19,943,530 | \$ 13,221,121 |

| Gross Margin - Three months ended March 31, | 2005 | | 2004 | |
|--|-------------------|-----------------|-------------------|-----------------|
| | Springdale | Junction | Springdale | Junction |
| Net sales | \$ 15,251,398 | \$ 4,692,132 | \$ 10,202,727 | \$ 3,018,394 |
| Cost of goods sold | 11,907,649 | 3,716,261 | 7,735,613 | 2,897,298 |
| Gross margin | \$ 3,343,749 | \$ 975,871 | \$ 2,467,114 | \$ 121,096 |

Note 8: Earnings Per Share

The Company calculates and discloses earnings per share (EPS) in accordance with SFAS No. 128, *Earnings Per Share* (SFAS 128). SFAS 128 replaces the presentation of Primary EPS with Basic EPS and requires dual presentation of Basic and Diluted EPS on the face of the statements of operations and requires a reconciliation of the numerator and denominator of the Basic EPS computation to the numerator and denominator of the Diluted EPS computation. Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company. Diluted EPS is computed similarly to Fully Diluted EPS pursuant to Accounting Principles Board Opinion No. 15, *Earnings Per Share*.

In computing Diluted EPS, only potential common shares that are dilutive those that reduce earnings per share or increase loss per share are included. Exercise of options and warrants or conversion of convertible securities is not assumed if the result would be antidilutive, such as when a loss from continuing operations is reported. The control number for determining whether including potential common shares in the diluted EPS computation would be antidilutive is income from continuing operations. As a result, if there were a loss from continuing operations, Diluted EPS would be computed in the same manner as Basic EPS is computed, even if an entity has net income after adjusting for discontinued operations, an extraordinary item or the cumulative

Table of Contents

effect of an accounting change.

| | Three Months Ended | | |
|---|---------------------------|--|---|
| | March 31, 2005 | March 31, 2004 | |
| | | Before Extra- ordinary Item | After Extra- ordinary Item |
| Net income (loss) applicable to common stock (A) | \$ 665,477 | \$ (463,313) | \$ (289,777) |
| Assumed exercise of stock options and warrants | 18,244,664 | | |
| Application of assumed proceeds toward repurchase of stock at average market price. | (7,732,537) | | |
| Net additional shares issuable | 10,512,127 | | |
| Adjustment of shares outstanding: | | | |
| Weighted average common shares outstanding | 34,360,219 | 31,100,068 | 31,100,068 |
| Net additional shares issuable | 10,512,127 | | |
| Adjusted shares outstanding (B) | 44,872,346 | 31,100,068 | 31,100,068 |
| Net income (loss) per common share - Diluted (A) divided by (B) | \$ 0.01 | \$ (0.01) | \$ 0.02 |
| Antidilutive and/or non-exercisable options | 1,207,500 | N/A | N/A |
| Antidilutive and/or non-exercisable warrants | 2,333,933 | N/A | N/A |

The Company has additional options and warrants that were not included in the calculation of diluted earnings per share for the quarter ended March 31, 2005, as indicated in the table above. Those options and warrants were antidilutive and/or not exercisable at March 31, 2005. Although the above financial instruments were not included due to being antidilutive and/or not exercisable, such financial instruments may become dilutive and would then need to be included in future calculations of Diluted EPS. Except in the case the Company incurs a loss from continuing operations, the conversion of all series of preferred stock is assumed in calculating Diluted EPS.

Note 9: Commitments and Contingencies

We have been sued by certain underwriters at Lloyd's, London (Lloyd's) in connection with a pending final settlement of our Junction, Texas fire claim.

Lloyd's filed suit January 19, 2005 in the Circuit Court of Washington County, Arkansas seeking a declaratory judgment that they are not liable to reimburse us for certain costs of rebuilding the AERT Junction, Texas facility. Lloyd's alleges that we did not rebuild the facility exactly as it had existed prior to the March 2003 fire and that we committed fraud in seeking reimbursement for alleged improvements made to the facility. Lloyd's also seeks to retroactively cancel its portion of the insurance policy. The filing was unexpected by us because we have cooperated fully with the claims underwriting process and negotiations toward a final settlement of the claim seemed to be progressing prior to the lawsuit.

We believe the Lloyd's lawsuit is without merit. We filed an answer to the complaint and a counterclaim on January 24, 2005 in which we denied all material allegations that we had deliberately and fraudulently submitted a claim and had wrongfully classified our losses, and are affirmatively seeking to recover actual damages of at least \$1.8 million plus attorney and court fees. We are also having our lawyers investigate whether we can establish a claim that Lloyd's acted in bad faith, which claim if established, pled, and proven would expose Lloyd's to punitive damages.

Table of Contents

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

As a growing business in an expanding market, we faced many challenges over the last year, including:

To fund our growth, we require increasing amounts of working capital. We suffered from a lack of adequate working capital during 2004, the effect of which was to hold back our capital expansion and efficiency programs. A major contributor to this inadequacy was the failure of our insurance carrier to pay the full amount of our fire insurance claim on the Junction, Texas plant (See Item 1. Legal Proceedings). This limited our ability to meet our customer's needs by slowing the reconstruction of the Texas plant.

We were overly dependent for raw materials on outside plastic recycling companies and virgin resin producers. As some of our suppliers faced their own challenges in the face of rapidly rising plastic scrap prices, AERT was periodically left without adequate quantity and quality materials for our composite board extrusion lines. This negatively affected our ability to keep up with growing customer orders. We were forced to purchase alternative feedstock, such as virgin polyethylene, to keep our factories running and meet our obligations to our customers. The higher priced input materials pushed up our cost of goods sold and depressed our gross margin. Our ability to respond to the shifting market conditions was hampered by insufficient capital resources when the insurance carrier failed to pay the fire claim.

Attempting to use lower cost and lower quality feedstock sometimes reduced efficiencies and generated higher overall costs.

We were overly dependent on one customer. Since 1995, we have sold our decking products exclusively to Weyerhaeuser, who resold it through their distribution system. Over time, Weyerhaeuser's business strategy has shifted and we believed that their distribution system was not allowing us to grow and adequately compete in some attractive market segments. In particular, their reluctance to take and hold independent lumber dealer inventory each year during the fourth quarter has limited our growth and tied up our working capital.

Our aggressive growth objectives have increased the need for human capital and we are working to hire, train, and staff additional supervisory and management personnel.

We believe that an excessive overhang of common stock warrants limits institutional participation in the market for our stock in the near term, which depresses our stock price and limits our access to additional equity capital.

During 2005 and beyond, we are focused on alleviating these structural impediments to our growth and profitability. For example:

We are completing the reconstruction of the Texas plant;

We are investing in additional in-house plastic recycling capacity;

We are further automating our manufacturing facilities;

Table of Contents

We continue to focus on increasing gross margins through price increases and increased efficiencies;

We are re-evaluating the margin and profit contribution of all our product lines;

We have renegotiated the distribution arrangements with Weyerhaeuser to allow us to sell decking products to other customers, though Weyerhaeuser retains an exclusive right to purchase ChoiceDek products for re-sale to Lowe's Home Improvement stores. Over 80% of Weyerhaeuser's 2004 purchases from us were for re-sale to Lowe's. For 2005, we have introduced our MoistureShield line of decking and will have more focus on its production and sale in this and coming years;

We are in discussions with additional sources of working capital. We expect to finalize at least one new working capital arrangement in 2005;

We are aggressively recruiting new AERT associates for senior and middle management levels. Some highly qualified new people have already joined the AERT team in 2005.

Many of the outstanding stock warrants will expire in 2005 and 2006, with the balance expiring in 2007.

In 2004, we invested \$7.4 million in manufacturing infrastructure (plant and equipment) and plan to spend \$8 million in 2005. Most of the capital expansion was, and will be, funded through cashflow. (See Liquidity and Capital Resources.)

We continue to build brand recognition and our reputation with the quality of our products.

Our building program is intended to provide the capacity necessary to achieve higher sales levels, improve operating efficiency, and sustain our growth. Our expansion plans currently are prioritized around increasing plastic recycling capacity and lowering raw material costs, in conjunction with further automating our production processes to improve efficiencies and increase margins. We are currently adding plastic recycling equipment in Lowell, which is designed to increase our internal capability of processing scrap plastic. We have completed the site work for the addition of a production facility on the property adjacent to our Springdale plant, and construction on a second raw material system to service both plants has commenced and is intended to become operational starting in phases during the second quarter of 2005.

Table of Contents**Results of Operations****Three Months Ended March 31, 2005 Compared to Three Months Ended March 31, 2004**

The following table sets forth selected information from our statements of operations.

Quarterly Comparison

| | Three Months Ended March 31: | | |
|---|-------------------------------------|---------------------|---------------|
| | 2005 | % Change | 2004 |
| Net sales | \$ 19,943,530 | 50.8% | \$ 13,221,121 |
| Cost of goods sold | 15,623,910 | 46.9% | 10,632,911 |
| % of net sales | 78.3% | -2.1% | 80.4% |
| Gross margin | 4,319,620 | 66.9% | 2,588,210 |
| % of net sales | 21.7% | 2.1% | 19.6% |
| Selling and administrative costs | 3,055,653 | 28.2% | 2,383,718 |
| % of net sales | 15.3% | -2.7% | 18.0% |
| Research and development | | -100.0% | 95,619 |
| Subtotal | 3,055,653 | 23.2% | 2,479,337 |
| % of net sales | 15.3% | -3.5% | 18.8% |
| Operating income | 1,263,967 | 1061.0% | 108,873 |
| % of net sales | 6.3% | 5.5% | 0.8% |
| Other income (expense): | | | |
| Insurance proceeds related to lost income | | -100.0% | 8,720 |
| Net interest expense | (529,490) | 3.4% | (511,906) |
| Income (loss) before extraordinary item and accrued premium on preferred stock | 734,477 | * | (394,313) |
| % of net sales | 3.7% | 6.7% | -3.0% |
| Accrued premium on preferred stock | (69,000) | | (69,000) |
| Income (loss) before extraordinary item | \$ 665,477 | * | (463,313) |
| % of net sales | 3.3% | 6.8% | -3.5% |
| Extraordinary gain on involuntary conversion of non-monetary assets due to fire | | -100.0% | 173,536 |
| Net income (loss) applicable to common stock | \$ 665,477 | * | \$ (289,777) |
| % of net sales | 3.3% | 5.5% | -2.2% |

* Not meaningful as a percentage change.

Table of Contents***Net Sales***

Our net sales for the three months ended March 31, 2004 and 2005 are summarized as follows:

| | Three months ended March 31: | | |
|---------------------|-------------------------------------|---------------------|---------------|
| | 2005 | % Change | 2004 |
| Springdale facility | \$ 15,251,398 | 49.5% | \$ 10,202,727 |
| Junction facility | 4,692,132 | 55.5% | 3,018,394 |
| Total net sales | \$ 19,943,530 | 50.9% | \$ 13,221,121 |

Net sales for the quarter ended March 31, 2005 increased through a combination of factors, including:

Product mix consisted of a higher percentage of value added products, including the new ChoiceDek Premium Embossed and MoistureShield embossed decking. This accounts for approximately 17% of the increase;

We implemented a price increase in December 2004, which accounts for approximately 20% of the increase;

Progress towards restoration of the Junction plant to its pre-fire capacity accounts for approximately 11% of the increase; and

Increased productivity resulting from capital improvement projects increased output and reduced manufacturing waste. Productivity gains account for approximately 52% of the increase.

Further modest price increases are planned for second quarter 2005. Customer orders received in the first quarter 2005 exceeded manufacturing capacity.

Cost of Goods Sold

Our cost of goods sold, as a percent of sales, decreased for the quarter ended March 31, 2005 compared to the same period of 2004. The gross profit margin for the quarter increased to 21.7% from 19.6% in the same quarter last year. Labor and overhead costs were down, as a percent of sales, due to increased plant automation installed over the last year, higher factory utilization in the quarter compared to last year, efficiency improvements at the Springdale, Arkansas plant and increased capacity resulting from progress with the Junction plant reconstruction following the fire. Material costs were up significantly due to higher costs of polyethylene scrap prices. Polyethylene costs continued to rise in the first quarter 2005 and remain unpredictable. Sustained upward price movement for our raw materials has an adverse effect on our profitability.

Table of Contents

Selling and Administrative Costs

Selling and administrative costs decreased from 18% of sales in the quarter ended March 31, 2004 to 15.3% of sales in the quarter ended March 31, 2005 as we increased sales at a faster rate than overhead expenses. Compensation, repair and maintenance, depreciation, utilities, and rents together comprise 75% of sales and administrative expenses.

Income

As a result of the above, earnings before and after the extraordinary gain increased for the quarter ended March 31, 2005 as compared to the same period of 2004.

Extraordinary Item

The extraordinary gain in the first quarter of 2004 is due to the major fire at the Junction facility in March 2003. The Junction facility was, and is, fully insured. Insurance proceeds received to reimburse costs incurred to reconstruct the facility resulted in a gain of \$173,536 for the quarter ended March 31, 2004; in addition we recognized a gain of approximately \$2.96 million in 2003 attributable to such insurance proceeds as the facility and equipment damaged had been nearly fully depreciated. In addition, we had initially booked a receivable of approximately \$864,000 and related income in the first quarter of 2004 for additional amounts we expect to collect from the insurers related to such matter. However, such claims are now being contested by the insurer and, although we intend to vigorously pursue the collection of such claims, we have, in accordance with generally accepted accounting principles, reversed any receivable and income for the first quarter of 2004 attributable to such disputed claims unless and until such claims are collected.

Liquidity and Capital Resources

At March 31, 2005, we had a working capital deficit of \$3.1 million compared to a working capital deficit of \$3.5 million at December 31, 2004. The working capital deficit included total current liabilities of approximately \$16.94 million, of which \$3.34 million was for accrued payroll expense and other accrued liabilities, \$11.53 million was in payables and \$2.07 million was a combination of short-term notes payable and the current portion of long-term debt. The working capital deficit reflects management's decision to pay for its capital expansion using cash generated from operations and also reflects delays and difficulties in obtaining reimbursement by the insurance carrier for rebuilding the Junction plant from fire damage. Additionally, pursuant to our bond agreement, we are required to maintain a debt service reserve fund in the amount of approximately \$2.1 million, which is classified as a non-current asset in our balance sheet. We spent approximately \$1.6 million on capital expansion during the first quarter of 2005. Expenditures were primarily for construction at our second Springdale manufacturing site, which we plan to complete by the end of 2005, and machinery at our existing Springdale manufacturing facility.

Unrestricted cash increased \$1.0 to \$2.1 million at March 31, 2005 from December 31, 2004. Significant components of that increase were: (i) cash provided by operating activities of \$557,752, which

Table of Contents

consisted of the net income for the period of \$665,477 increased by depreciation and amortization of \$1.04 million and decreased by other uses of cash of approximately \$1.15 million; (ii) cash used in investing activities of \$874,903; and (iii) cash provided by financing activities of approximately \$1.36 million. Payments on notes during the period were \$699,352, including \$325,000 to Brooks Investment Company, a related party. Proceeds from the issuances of notes amounted to \$700,000, which was completely comprised of amounts received from Brooks Investment Company. At March 31, 2005, we had bonds and notes payable in the amount of \$17.6 million, of which \$2.1 million was current notes payable and the current portion of long-term debt.

We believe that funds generated from operations will be adequate for us to pay operating expenses and meet our fixed obligations for the balance of 2005 and into the future. New capital projects are funded primarily from cash flow available after meeting our operating and fixed obligations, so there is no assurance as to when, or if, funds will be available to complete our planned capital projects. Our capital improvement budget for 2005 is currently estimated at \$8 million, of which we believe we can finance \$2 million through long-term debt and operating leases; the balance of required funds must come from cash flow. We have no commitment from long term debt or leasing sources and there is no assurance that such funding will be available. If we are unable to complete our 2005 capital expansion program as planned, it will affect our ability to grow sales and profit margins in 2005 and future years.

We have proceeded with reconstruction of the fire-damaged Junction, Texas facility despite a dispute with our third tier insurance carrier, Lloyds of London, and have been required to invest \$1.4 million from cash flow. We have filed a claim seeking \$1.8 million from Lloyds (see Legal Proceedings).

Under the 2003 bond agreement, AERT covenants that it will maintain certain financial ratios. If we fail to comply with the covenants, or to secure a waiver therefrom, the bond trustee would have the option of demanding immediate repayment of the bonds. In such an event, it could be difficult for us to refinance the bonds, which would give the bond trustee the option to take us into bankruptcy.

We were not in compliance with two of the quarterly covenants as of March 31, 2005. The bond trustee has waived these covenants as of December 31, 2004 through, and including, December 31, 2005. We expect to be in compliance with all bond covenants by December 31, 2005.

| Bonds payable and Allstate Notes Payable Debt Covenants | March 31, 2005 | Compliance |
|---|---------------------------|-------------------|
| Long-term debt service coverage ratio for last four quarters of at least 2.00 to 1.00 | 2.88 | Yes |
| Current ratio of not less than 1.00 to 1.00 (as adjusted ¹) | 0.95 | No-Waived |
| Not more than 10% of accounts payable in excess of 75 days past invoice date | 17.4% | No-Waived |
| Not more than 20% of accounts receivable in excess of 90 days past invoice date | 0.8% | Yes |

(1) The current ratio calculation was modified to include the debt service reserve fund of \$2,150,750 in current assets.

Table of Contents

Uncertainties, Issues and Risks

There are many factors that could adversely affect AERT's business and results of operations. These factors include, but are not limited to, general economic conditions, decline in demand for our products, business or industry changes, critical accounting policies, government rules and regulations, environmental concerns, litigation, new products / product transition, product obsolescence, competition, acts of war, terrorism, public health issues, concentration of customer base, loss of a significant customer, availability of raw material (plastic) at a reasonable price, management's failure to execute effectively, inability to obtain adequate financing (i.e. working capital), equipment breakdowns, low stock price, and fluctuations in quarterly performance.

Item 3. Quantitative and Qualitative Disclosure About Market Risk.

We have no material exposures relating to our long-term debt because all of our long-term debt bears interest at fixed rates. We depend on the market for favorable long-term mortgage rates to help generate sales of our product for use in the residential construction industry. Should mortgage rates increase substantially, our business could be impacted by a reduction in the residential construction industry. Important raw materials that we purchase are recycled plastic and wood fiber, which are subject to price fluctuations. We attempt to limit the impact of price increases on these materials by negotiating with each supplier on a term basis.

Forward-Looking Information

An investment in our securities involves a high degree of risk. Prior to making an investment, prospective investors should carefully consider the following factors, among others, and seek professional advice. In addition, this Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. Such forward-looking statements, which are often identified by words such as believes, anticipates, expects, estimates, should, may, will and similar expressions, represent our expectations and beliefs concerning future events. Numerous assumptions, risks, and uncertainties could cause actual results to differ materially from the results discussed in the forward-looking statements. Prospective purchasers of our securities should carefully consider the information contained herein or in the documents incorporated herein by reference.

The foregoing discussion contains certain estimates, predictions, projections and other forward-looking statements (within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934) that involve various risks and uncertainties. While these forward-looking statements, and any assumptions upon which they are based, are made in good faith and reflect management's current judgment regarding the direction of the business, actual results will almost always vary, sometimes materially, from any estimates, predictions, projections, or other future performance suggested herein. Some important factors (but not necessarily all factors) that could affect the sales volumes, growth strategies, future profitability and operating results, or that otherwise could cause actual results to differ materially from those expressed in any forward-looking statement include the following: market, political or other forces affecting the pricing and availability of plastics and other raw materials; accidents or other unscheduled shutdowns affecting us, our suppliers or their customers' plants, machinery, or equipment; competition from products and services offered by other enterprises; state and federal environmental, economic, safety and other policies and regulations, any changes therein, and any legal or regulatory delays or other factors beyond our control; execution of planned capital projects; weather conditions affecting our operations or the areas in which our products are marketed;

Table of Contents

adverse rulings, judgments, or settlements in litigation or other legal matters. We undertake no obligation to publicly release the result of any revisions to any such forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Item 4. Controls and Procedures.

Each of our Co-Chief Executive Officers, Joe G. Brooks and Stephen W. Brooks, and our Chief Financial Officer, Edward J. Lysen, have reviewed and evaluated the disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) that we have in place as of March 31, 2005 with respect to, among other things, the timely accumulation and communication of information to management and the recording, processing, summarizing and reporting thereof for the purpose of preparing and filing this quarterly report on Form 10-Q. Based upon their review, these executive officers have concluded that, as of March 31, 2005, we have an effective system of disclosure controls and procedures and an effective means for timely communication of information required to be disclosed in this Report. During the first quarter ended March 31, 2005, there have been no changes in our internal controls over financial reporting that have materially affected, or that are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Lloyd s London

We have been sued by certain underwriters at Lloyd s, London (Lloyd s) in connection with a pending final settlement of our Junction, Texas fire claim.

Lloyd s filed suit January 19, 2005 in the Circuit Court of Washington County, Arkansas seeking a declaratory judgment that they are not liable to reimburse us for certain costs of rebuilding the AERT Junction, Texas facility. Lloyd s alleges that we did not rebuild the facility exactly as it had existed prior to the March 2003 fire and that we committed fraud in seeking reimbursement for alleged improvements made to the facility. Lloyd s also seeks to retroactively cancel its portion of the insurance policy. The filing was unexpected by us because we have cooperated fully with the claims underwriting process and negotiations toward a final settlement of the claim seemed to be progressing prior to the lawsuit.

We believe the Lloyd s lawsuit is without merit. We filed an answer to the complaint and a counterclaim on January 24, 2005 in which we denied all material allegations that we had deliberately and fraudulently submitted a claim and had wrongfully classified our losses, and are affirmatively seeking to recover actual damages of at least \$1.8 million plus attorney and court fees. We are also having our lawyers investigate whether we can establish a claim that Lloyd s acted in bad faith, which claim if established, pled, and proven would expose Lloyd s to punitive damages.

Table of Contents

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

Recent Sales of Unregistered Securities

On February 7, 2005, we issued an aggregate of 976,398 shares of our Class A common stock to Zanett Lombardier, Ltd. upon the cashless exercise of 1,253,784 Consulting warrants with an exercise price of \$0.375. We believe, due to the nature of the relationship of this firm to us and the isolated nature of the transaction, that the issuance and sale of the shares of Class A common stock underlying such warrants was exempt from registration under the Securities Act of 1933, as amended, as a private placement pursuant to Section 4(2) of that Act.

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

There were no matters submitted to a vote of security holders during the first quarter ended March 31, 2005.

Item 6. Exhibits

The exhibits listed in the accompanying Index to Exhibits are filed and incorporated by reference as part of this report.

Table of Contents

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 by the undersigned, thereunto duly authorized.

**ADVANCED ENVIRONMENTAL
RECYCLING TECHNOLOGIES, INC.**

By: /s/ JOE G. BROOKS

Joe G. Brooks,
Chairman, Co-Chief Executive Officer and President

/s/ STEPHEN W. BROOKS

Stephen W. Brooks,
Co-Chief Executive Officer

/s/ EDWARD J. LYSEN

Edward J. Lysen,
Senior Vice President and Chief Financial Officer

Date: May 13, 2005

Table of Contents

Index to Exhibits

| Exhibit Number | Description |
|---------------------------|--|
| 31.1 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, by the Company's chairman, co-chief executive officer and president |
| 31.2 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, by the Company's co-chief executive officer |
| 31.3 | Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, by the Company's chief financial officer |
| 32.1 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, by the Company's chairman, co-chief executive officer and president |
| 32.2 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, by the Company's co-chief executive officer |
| 32.3 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, by the Company's chief financial officer |