CPI AEROSTRUCTURES INC
Form 10-Q
November 10, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 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 September 30, 2014

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ___________ to __________

Commission File Number: 1-11398

CPI AEROSTRUCTURES, INC.

(Exact name of registrant as specified in its charter)

New York	11-2520310
(State or other jurisdiction	(IRS Employer Identification Number)

of incorporation or organization)

91 Heartland Blvd., Edgewood, NY 11717
(Address of principal executive offices) (zip code)

(631) 586-5200

(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company

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

As of November 3, 2014 the number of shares of common stock, par value $.001 per share, outstanding was 8,483,111.

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Part I - Financial Information

Item 1 – Financial Statements

CONDENSED BALANCE SHEETS

	September 30, 2014 (Unaudited)	December 31, 2013 (Note 1)
ASSETS		
Current Assets:		
Cash	$831,057	$2,166,103
Accounts receivable, net	8,902,024	4,392,254
Costs and estimated earnings in excess of billings on uncompleted contracts	77,791,327	112,597,136
Deferred income taxes	417,000	417,000
Prepaid expenses and other current assets	844,007	609,268
Total current assets	**88,785,415**	**120,181,761**
Plant and equipment, net	2,806,174	2,849,753
Recoverable and deferred income taxes	14,196,910	1,133,000
Other assets	108,080	108,080
Total Assets	**$105,896,579**	**$124,272,594**
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$8,361,775	$7,614,755
Accrued expenses	554,317	654,868
Accrued losses on uncompleted contracts	1,528,921	----
Billings in excess of costs and estimated earnings on uncompleted contracts	208,428	276,170
Current portion of long-term debt	973,793	1,020,349
Line of credit	28,350,000	21,350,000
Income tax payable	---	736,536
Deferred income taxes	89,000	89,000
Total current liabilities	**40,066,234**	**31,741,678**
Long-term debt, net of current portion	1,531,751	2,198,187
Deferred income taxes	788,000	788,000
Other liabilities	591,307	593,210
Total Liabilities	**42,977,292**	**35,321,075**
Shareholders' Equity:		
	8,483	8,410

Common stock - $.001 par value; authorized 50,000,000 shares, 8,483,111 and 8,410,493 shares, respectively, issued and outstanding		
Additional paid-in capital	51,265,850	50,381,348
Retained earnings	11,656,342	38,582,876
Accumulated other comprehensive loss	(11,388)	(21,115)
Total Shareholders' Equity	**62,919,287**	**88,951,519**
Total Liabilities and Shareholders' Equity	**$105,896,579**	**$124,272,594**

See Notes to Condensed Financial Statements

CONDENSED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
	(Unaudited)		(Unaudited)	
Revenue	$21,487,677	$20,664,645	$19,619,571	$61,702,530
Cost of sales	17,016,373	16,188,518	53,620,290	48,549,586
Gross profit (loss)	4,471,304	4,476,127	(34,000,719)	13,152,944
Selling, general and administrative expenses	1,800,878	1,508,656	5,424,581	4,882,851
Income (loss) from operations	2,670,426	2,967,471	(39,425,300)	8,270,093
Interest expense	67,879	195,371	370,234	492,443
Income (loss) before provision for (benefit from) income taxes	2,602,547	2,772,100	(39,795,534)	7,777,650
Provision for (benefit from) income taxes	905,000	861,000	(12,869,000)	2,411,000
Net income (loss)	1,697,547	1,911,100	(26,926,534)	5,366,650
Other comprehensive income (loss), net of tax - Change in unrealized gain interest rate swap	5,095	---	9,727	17,390
Comprehensive income (loss)	$1,702,642	$1,911,100	$(26,916,807)	$5,384,040
Income (loss) per common share – basic	$0.20	$0.23	$(3.18)	$0.64
Income (loss) per common share – diluted	$0.20	$0.23	$(3.18)	$0.63
Shares used in computing income (loss) per common share:				
Basic	8,483,111	8,391,954	8,459,028	8,387,240
Diluted	8,545,889	8,490,711	8,459,028	8,464,350

See Notes to Condensed Financial Statements

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CONDENSED STATEMENTS OF SHAREHOLDERS' EQUITY

	Common Stock Shares	Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance at January 1, 2013	8,371,439	$ 8,371	$ 49,780,673	$ 30,845,982	$ (40,827)	$ 80,594,199
Net Income	----	----	----	5,366,650	----	5,366,650
Change in unrealized loss from interest rate swap	----	----	----	----	17,390	17,390
Common stock issued upon exercise of options	2,645	3	(3)	----	----	---
Tax provision for stock option exercise	---	---	(26,000)	---	---	(26,000)
Common stock issued for bonuses	17,870	18	152,056	----	----	152,074
Stock based compensation expense	----	----	379,808	----	----	379,808
Balance at September 30, 2013	8,391,954	$ 8,392	$ 50,286,534	$ 36,212,632	$ (23,437)	$ 86,484,121
Balance at January 1, 2014	8,410,493	$ 8,410	$ 50,381,348	$ 38,582,876	$ (21,115)	$ 88,951,519
Net loss	----	----	----	(26,926,534)	----	(26,926,534)
Change in unrealized loss from interest rate swap	----	----	----	----	9,727	9,727
Common stock issued upon exercise of options	72,618	73	447,678	----	----	447,751
Tax benefit of stock option exercise	---	---	86,000	---	---	86,000
Stock based compensation expense	----	----	350,824	----	----	350,824
Balance at September 30, 2014	8,483,111	$ 8,483	$ 51,265,850	$ 11,656,342	$ (11,388)	$ 62,919,287

See Notes to Condensed Financial Statements

CONDENSED STATEMENTS OF CASH FLOWS

For the Nine Months Ended September 30,	**2014**	**2013**
Cash flows from operating activities:		
Net income (loss)	$(26,926,534)	$5,366,650
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	556,580	518,048
Deferred rent	12,823	36,414
Loss on disposal of fixed asset	1,042	---
Stock based compensation	350,824	379,808
Deferred income taxes	(13,063,910)	(17,000)
Tax benefit from stock option plans	(86,000)	26,000
Changes in operating assets and liabilities:		
Increase in accounts receivable	(4,509,770)	(5,030,616)
(Increase) decrease in costs and estimated earnings in excess of billings on uncompleted contracts	34,805,809	(2,856,305)
Increase in prepaid expenses and other assets	(234,739)	(219,843)
Decrease (increase) in accounts payable and accrued expenses	641,470	(6,537,071)
Decrease in billings in excess of costs and estimated earnings on uncompleted contracts	(67,742)	(187,344)
Increase in accrued losses on uncompleted contracts	1,528,921	---
Increase (decrease) in income taxes payable	(650,536)	103,800
Net cash used in operating activities	(7,641,762)	(8,417,459)
Cash used in investing activities - purchase of plant and equipment	(514,043)	(600,810)
Cash flows from financing activities:		
Payments on long-term debt	(712,992)	(824,851)
Proceeds from line of credit	8,500,000	10,000,000
Payments on line of credit	(1,500,000)	(2,000,000)
Proceeds from exercise of stock options	447,751	----
Tax benefit from stock option plans	86,000	(26,000)
Net cash provided by financing activities	6,820,759	7,149,149
Net decrease in cash	(1,335,046)	(1,869,120)
Cash at beginning of period	2,166,103	2,709,803
Cash at end of period	$831,057	$840,683
Supplemental disclosures of cash flow information:		
Noncash investing and financing activities:		

Common stock issued for bonuses	$---	$152,074
Cash paid during the period for:		
Interest	$708,504	$638,767
Income taxes	$855,000	$2,250,000

See Notes to Condensed Financial Statements

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NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

1. INTERIM FINANCIAL STATEMENTS

The condensed financial statements of CPI Aerostructures, Inc. (the “Company”) as of September 30, 2014 and for the three and nine months ended September 30, 2014 and 2013 have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) . Certain information and note disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading.

The condensed balance sheet at December 31, 2013 has been derived from the audited financial statements at that date, but does not include all of the information and notes required by accounting principles generally accepted in the United States for complete financial statements. All adjustments that, in the opinion of management, are necessary for a fair presentation for the periods presented have been reflected as required by the SEC. Such adjustments are of a normal, recurring nature. It is suggested that these condensed financial statements be read in conjunction with the financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013. The results of operations for interim periods are not necessarily indicative of the operating results to be expected for the full year or any other interim period.

The Company maintains its cash in two financial institutions. The balances are insured by the Federal Deposit Insurance Corporation. From time to time, the Company’s balances may exceed these limits. As of September 30, 2014, the Company had approximately $1,210,000 of uninsured balances. The Company limits its credit risk by selecting financial institutions considered to be highly creditworthy.

The Company has identified certain immaterial errors in previously issued financial statements for the three and six months ended June 30, 2014 related to an overstatement of its tax benefit and deferred tax assets in the amount of $661,000. The Company reviewed the accounting errors utilizing SEC Staff Accounting Bulletin No. 99, “Materiality” and SEC Staff Accounting Bulletin No. 108, “Effects of Prior Year Misstatements on Current Year Financial Statements” and determined that the impact of the errors to be immaterial to any prior period’s presentation. The accompanying condensed statement of operations and comprehensive income (loss) for the nine months ended September 30, 2014 reflects the corrections of the aforementioned immaterial error.

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NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

The Company recognizes revenue from the Company's contracts over the contractual period under the percentage-of-completion ("POC") method of accounting. Under the POC method of accounting, sales and gross profit are recognized as work is performed based on the relationship between actual costs incurred and total estimated costs at the completion of the contract. Recognized revenues that will not be billed under the terms of the contract until a later date are recorded as an asset captioned "Costs and estimated earnings in excess of billings on uncompleted contracts." Contracts where billings to date have exceeded recognized revenues are recorded as a liability captioned "Billings in excess of costs and estimated earnings on uncompleted contracts." Changes to the original estimates may be required during the life of the contract. Estimates are reviewed monthly and the effect of any change in the estimated gross margin percentage for a contract is reflected in cost of sales in the period the change becomes known. The use of the POC method of accounting involves considerable use of estimates in determining revenues, costs and profits and in assigning the amounts to accounting periods. As a result, there can be a significant disparity between earnings (both for accounting and tax purposes) as reported and actual cash received by us during any reporting period. We continually evaluate all of the issues related to the assumptions, risks and uncertainties inherent with the application of the POC method of accounting; however, we cannot assure you that our estimates will be accurate. If our estimates are not accurate or a contract is terminated, we will be forced to adjust revenue in later periods. Furthermore, even if our estimates are accurate, we may have a shortfall in our cash flow and we may need to borrow money, or seek access to other forms of liquidity, to fund our work in process or to pay taxes until the reported earnings materialize as actual cash receipts.

When adjustments are required for the estimated total revenue on a contract, these changes are recognized with an inception-to-date effect in the current period. Also, when estimates of total costs to be incurred exceed estimates of total revenue to be earned, a provision for the entire loss on the contract is recorded in the period in which the loss is determined. During the nine month period ended September 30, 2014, the Company adjusted the estimated total revenue and recorded a loss on its Wing Replacement Program ("WRP") for the U.S. Air Force's A-10 Thunderbolt aircraft ("A-10").

The long term future of the A-10 has been uncertain since March 2014 when the U.S. Department of Defense released its 2015 Budget Request that called for the retirement of the entire A-10 fleet. More recent events have led the Company to conclude that our A-10 WRP will likely not continue to the full 242 aircraft as anticipated at the start of the program. The 2015 Department of Defense Appropriations Act passed by the United States House of Representatives on June 20, 2014 provides no funding for A-10 operations in U. S. Government fiscal year 2015 that commenced October 1, 2014. Further, this bill rescinds funding from the 2014 U. S. Department of Defense Budget that was to have been used for the procurement of additional wings for the A-10. The Company has no information to support a different conclusion.

Because of the probable termination of the Company's A-10 WRP, the Company has reduced its revenue estimates with respect to this program by approximately 41%. This change in estimate results in an approximate cumulative $44.7 million decrease in revenue from the inception of the program in 2008 through June 30, 2014, all of which was recorded in the quarter ended June 30, 2014 and nine months ended September 30, 2014. Also, the uncertainty of the future of the A-10 aircraft has impacted the Company’s ability to achieve normal program cost reductions at suppliers. Accordingly, in addition to the $44.7 million adjustment to revenue, we recorded a $2.6 million adjustment to cost of sales on the A-10 WRP in the quarter ended June 30, 2014 and nine months ended September 30, 2014.

NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

In May 2014, the FASB issued Accounting Standards Update No. 2014-09 (ASU 2014-09), *Revenue from Contracts with Customers (Topic 606)* , which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for annual and interim periods in fiscal years beginning after December 15, 2016. Early application is not permitted. ASU 2014-09 is effective for our first quarter of fiscal year 2017 using either the retrospective or cumulative effect transition method. We are evaluating the effect that ASU 2014-09 will have on our financial statements and related disclosures. We have not yet selected a transition method nor have we determined the effect of the standard on our ongoing financial reporting.

2. **stock-based compensation**

The Company accounts for compensation expense associated with stock options based on the fair value of the options on the date of grant.

The Company’s net income/(loss) for the three and nine months ended September 30, 2014 includes approximately $145,200 and $350,800, respectively, of non-cash compensation expense related to the Company’s stock options. The non-cash compensation expense related to all of the Company’s stock-based compensation arrangements is recorded as a component of selling, general and administrative expenses.

The estimated fair value of each option award granted was determined on the date of grant using the Black-Scholes option valuation model. No options were granted during the three months ended September 30, 2013 and 6,772 options were granted during the three months ended September 30, 2014. The following weighted-average assumptions were used for the options granted during the nine months ended September 30, 2014 and 2013:

NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

	2014	2013
Risk-free interest rate	1.45%-1.64%	0.76%
Expected volatility	83%-102%	106%
Dividend yield	0%	0%
Expected option term (years)	5	5

A summary of the status of the Company's stock option plans as of September 30, 2014 and changes during the nine months ended September 30, 2014 is as follows:

	Options	**Weighted average Exercise Price**	**Weighted average remaining contractual term (in years)**	**Aggregate Intrinsic Value**
Outstanding at beginning of period	461,919	$ 9.80		
Granted	43,064	14.67		
Exercised	(130,000)	9.00		
Outstanding and vested at end of period	374,983	$ 10.64	2.31	$ 432,747

Options to acquire 36,292 shares of common stock were granted on January 1, 2014 to members of our board of directors as part of their normal compensation. Of the 36,292 options granted on January 1, 2014, 9,075 vested immediately, 9,073 vested on April 1, 2014, 9,073 vested on July 1, 2014 and 9,071 vest on October 1, 2014. Options to acquire 6,772 shares were granted on July 1, 2014 to a new board member as part of the normal compensation. Of the 6,772 options granted on July 1, 2014, 3,386 vested immediately and 3,386 vest on October 1, 2014.

During the nine months ended September 30, 2014, 50,000 stock options were exercised for cash resulting in proceeds to the Company of $447,751. During the same period 80,000 options were exercised, pursuant to provisions of the stock option plan, where the Company received no cash and 57,381 shares of its common stock in exchange for the 80,000 shares issued in the exercise. The 57,381 shares that the Company received were valued at $727,072, the fair market value of the shares on the dates of exercise.

The intrinsic value of all options exercised during the nine months ended September 30, 2014 and 2013 was approximately $513,000 and $26,300, respectively. No options were exercised during the three months ended September 30, 2014 and 2013.

3. Derivative Instruments and Fair Value

Our use of derivative instruments has been to hedge interest rates. These derivative contracts are entered into with a financial institution. We do not use derivative instruments for trading purposes and we have procedures in place to monitor and control their use.

NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

We record these derivative financial instruments on the condensed balance sheets at fair value. For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income (loss) and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings.

Any ineffective portion of the gain or loss on the derivative instrument for a cash flow hedge is recorded in the results of operations immediately. For derivative instruments not designated as hedging instruments, the gain or loss is recognized in the results of operations immediately.

In March 2012, the Company entered into interest rate swaps with the objective of reducing our exposure to cash flow volatility arising from interest rate fluctuations associated with certain debt. The notional amount, maturity date, and currency of these contracts match those of the underlying debt. The Company has designated these interest rate swap contracts as cash flow hedges. The Company measures ineffectiveness by comparing the cumulative change in the forward contact with the cumulative change in the hedged item. No material ineffectiveness was recognized in the quarter and nine months ended September 30, 2014. As of September 30, 2014 and December 31, 2013, we had a net deferred loss associated with cash flow hedges of approximately $17,000 and $32,000, respectively, due to the interest rate swap which has been included in Other Liabilities.

As a result of the use of derivative instruments, the Company is exposed to risk that the counterparties may fail to meet their contractual obligations. Recent adverse developments in the global financial and credit markets could negatively impact the creditworthiness of our counterparties and cause one or more of our counterparties to fail to perform as expected. To mitigate the counterparty credit risk, we only enter into contracts with carefully selected major financial institutions based upon their credit ratings and other factors, and continually assess the creditworthiness of counterparties. To date, all counterparties have performed in accordance with their contractual obligations.

Fair Value

At September 30, 2014 and December 31, 2013, the fair values of cash, accounts receivable, accounts payable and accrued expenses approximated their carrying values because of the short-term nature of these instruments.

	September 30, 2014	
	Carrying Amount	Fair Value
Debt		
Short-term borrowings and long-term debt	$30,855,544	$30,855,544

	December 31, 2013	
	Carrying Amount	Fair Value
Debt		
Short-term borrowings and long-term debt	$24,568,536	$24,568,536

We estimated the fair value of debt using market quotes and calculations based on market rates.

NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the fair values of those financial liabilities measured on a recurring basis as of September 30, 2014 and December 31, 2013:

		Fair Value Measurements September 30, 2014		
Description	Total	Quoted Prices in Active Markets for Identical assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Interest Rate Swap, net	$17,388	--	$ 17,388	--
Total	$17,388	--	$ 17,388	--

		Fair Value Measurements December 31, 2013		
Description	Total	Quoted Prices in Active Markets for Identical assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Interest Rate Swap, net	$31,992	--	$ 31,992	--
Total	$31,992	--	$ 31,992	--

The fair value of the Company's interest rate swaps was determined by comparing the fixed rate set at the inception of the transaction to the "replacement swap rate," which represents the market rate for an offsetting interest rate swap with the same notional amounts and final maturity date. The market value is then determined by calculating the present value of the interest differential between the contractual swap and the replacement swap.

As of September 30, 2014 and December 31, 2013, $17,388 and $31,992, respectively, was included in Other Liabilities related to the fair value of the Company's interest rate swap, and $11,388 and $21,115, respectively, net of tax of $6,000 and $10,877, was included in Accumulated Other Comprehensive Loss.

NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

4. COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS

Costs and estimated earnings in excess of billings on uncompleted contracts consist of:

	September 30, 2014		
	U.S Government	Commercial	Total
Costs incurred on uncompleted contracts	$290,924,522	$82,332,450	$373,256,972
Estimated earnings	57,658,304	36,786,655	94,444,959
Sub-total	348,582,826	119,119,105	467,701,931
Less billings to date	303,745,077	86,373,955	390,119,032
Costs and estimated earnings in excess of billings on uncompleted contracts	$44,837,749	$32,745,150	$77,582,899

	December 31, 2013		
	U.S. Government	Commercial	Total
Costs incurred on uncompleted contracts	$259,050,407	$62,502,116	$321,552,523
Estimated earnings	95,590,879	30,694,605	126,285,484
Sub-total	354,641,286	93,196,721	447,838,007
Less billings to date	272,783,120	62,733,921	335,517,041
Costs and estimated earnings in excess of billings on uncompleted contracts	$81,858,166	$30,462,800	$112,320,966

The above amounts are included in the accompanying balance sheets under the following captions at September 30, 2014 and December 31, 2013:

	September 30, 2014	December 31, 2013
Costs and estimated earnings in excess of billings on uncompleted contracts	$77,791,327	$112,597,136
Billings in excess of costs and estimated earnings on uncompleted contracts	(208,428)	