

ADVANCED ENVIRONMENTAL RECYCLING TECHNOLOGIES INC

Form 10-Q

November 12, 2004

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**(X) QUARTERLY REPORT  
PURSUANT TO SECTION 13 OR  
15(D)  
OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2004**

**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**

**Springdale, Arkansas**

*(Address of Principal Executive Office)*

**72764**

*(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: (X) NO: ( )

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of November 10, 2004, 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 31,944,751 and the number of shares outstanding of the Registrant's Class B common stock was 1,465,530.

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

|  | <b>September 30,<br/>2004</b> | <b>December 31,<br/>2003</b> |
|--|-------------------------------|------------------------------|
|  | <b>(unaudited)</b>            |                              |
| Current assets:  |                               |                              |
| Cash and cash equivalents  | \$ 2,644,268                  | \$ 1,509,124                 |
| Accounts receivable, net of allowance of \$180,143 at September 30, 2004 and \$92,207 at December 31, 2003                 | 3,800,088                     | 2,647,665                    |
| Inventories  | 5,293,436                     | 3,871,268                    |
| Prepaid expenses   | 952,292                       | 579,163                      |
|  | <hr/>                         | <hr/>                        |
| Total current assets   | 12,690,084                    | 8,607,220                    |
|  | <hr/>                         | <hr/>                        |
| Land, buildings and equipment:   |                               |                              |
| Land   | 1,612,243                     | 1,612,243                    |
| Buildings and leasehold improvements   | 5,355,489                     | 4,943,462                    |
| Machinery and equipment  | 31,698,605                    | 25,753,179                   |
| Transportation equipment   | 775,670                       | 675,208                      |
| Office equipment   | 733,813                       | 698,802                      |
| Construction in progress   | 2,602,405                     | 3,346,298                    |
|  | <hr/>                         | <hr/>                        |
|  | 42,778,225                    | 37,029,192                   |
| Less accumulated depreciation  | 17,931,414                    | 14,905,242                   |
|  | <hr/>                         | <hr/>                        |
| Net land, buildings and equipment  | 24,846,811                    | 22,123,950                   |
|  | <hr/>                         | <hr/>                        |
| Other assets:  |                               |                              |
| Debt issuance costs, net of accumulated amortization of \$329,768 at September 30, 2004 and \$199,067 at December 31, 2003 | 3,255,333                     | 3,397,134                    |
| Debt service reserve fund  | 2,051,499                     | 1,946,643                    |
| Other assets, at cost less accumulated amortization of \$328,446 at September 30, 2004 and \$307,017 at December 31, 2003  | 250,753                       | 331,654                      |
|  | <hr/>                         | <hr/>                        |

|                    |                     |                     |
|--------------------|---------------------|---------------------|
| Total other assets | <u>5,557,585</u>    | <u>5,675,431</u>    |
|                    | <u>\$43,094,480</u> | <u>\$36,406,601</u> |

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**

|   | <b>September 30,<br/>2004</b> | <b>December 31,<br/>2003</b> |
|---|-------------------------------|------------------------------|
|   | <b>(unaudited)</b>            |                              |
| Current liabilities:  |                               |                              |
| Accounts payable - trade  | \$ 6,802,426                  | \$ 5,321,317                 |
| Accounts payable - related parties  | 2,417,491                     | 1,799,405                    |
| Current maturities of long-term debt  | 1,117,789                     | 1,142,525                    |
| Accrued payroll expense   | 991,744                       | 603,134                      |
| Other accrued liabilities   | 1,823,603                     | 1,291,183                    |
| Notes payable - other   | 603,546                       | 365,351                      |
|   | <hr/>                         | <hr/>                        |
| Total current liabilities   | 13,756,599                    | 10,522,915                   |
|   | <hr/>                         | <hr/>                        |
| Long-term debt, less current maturities   | 16,403,264                    | 16,659,241                   |
|   | <hr/>                         | <hr/>                        |
| Accrued premium on convertible preferred stock  | 207,000                       | 276,000                      |
|   | <hr/>                         | <hr/>                        |
| Commitments and contingencies   |                               |                              |
| Stockholders' equity:   |                               |                              |
| Preferred stock, \$1 par value; 5,000,000 shares authorized;<br>2,760 shares issued and outstanding   | 2,760                         | 2,760                        |
| Class A common stock, \$.01 par value; 75,000,000 shares<br>authorized; 30,363,085 and 29,275,147 shares issued and<br>outstanding at September 30, 2004 and December 31, 2003,<br>respectively | 303,631                       | 292,752                      |
| Class B convertible common stock, \$.01 par value; 7,500,000<br>shares authorized, 1,465,530 shares issued and outstanding  | 14,655                        | 14,655                       |
| Warrants outstanding; 16,472,806 at September 30, 2004 and<br>16,580,722 at December 31, 2003   | 7,767,288                     | 7,818,834                    |
| Additional paid-in capital  | 25,876,230                    | 24,988,295                   |
| Accumulated deficit   | (21,236,947)                  | (24,168,851)                 |
|   | <hr/>                         | <hr/>                        |
| Total stockholders' equity  | 12,727,617                    | 8,948,445                    |
|   | <hr/>                         | <hr/>                        |

|  |               |               |
|--|---------------|---------------|
| Total liabilities and stockholders' equity | \$ 43,094,480 | \$ 36,406,601 |
|--|---------------|---------------|

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

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

|   | <b>Three Months Ended<br/>September 30,</b> |               | <b>Nine Months Ended<br/>September 30,</b> |               |
|---|---|---------------|--|---------------|
|   | <b>2004</b>                                 | <b>2003</b>   | <b>2004</b>                                | <b>2003</b>   |
| Net sales   | \$ 18,975,717                               | \$ 11,379,799 | \$ 48,359,413                              | \$ 32,576,037 |
| Cost of goods sold  | 13,279,972                                  | 9,023,305     | 35,890,957                                 | 25,386,439    |
| Gross margin  | 5,695,745                                   | 2,356,494     | 12,468,456                                 | 7,189,598     |
| Selling and administrative costs  | 3,573,535                                   | 2,411,873     | 8,684,107                                  | 6,739,384     |
| Research and development  |   | 23,732        | 97,207                                     | 49,230        |
| Operating income (loss)   | 2,122,210                                   | (79,111)      | 3,687,142                                  | 400,984       |
| Other income (expense)  |   |               |  |               |
| Insurance proceeds related to lost income                                       |   | 248,013       | 8,720                                      | 1,072,312     |
| Interest income   | 1,877                                       | 37,693        | 3,774                                      | 142,170       |
| Interest expense  | (554,589)                                   | (394,554)     | (1,598,309)                                | (1,043,156)   |
|   | (552,712)                                   | (108,848)     | (1,585,815)                                | 171,326       |
| Income (loss) before accrued premium on preferred stock                         | 1,569,498                                   | (187,959)     | 2,101,327                                  | 572,310       |
| Accrued premium on preferred stock  | (69,000)                                    | (69,000)      | (207,000)                                  | (207,000)     |
| Net income (loss) applicable to common stock before extraordinary item          | \$ 1,500,498                                | \$ (256,959)  | \$ 1,894,327                               | \$ 365,310    |
| Extraordinary gain on involuntary conversion of non-monetary assets due to fire |   | 52,926        | 1,037,577                                  | 1,931,147     |
| Net income (loss) applicable to common stock after extraordinary item           | \$ 1,500,498                                | \$ (204,033)  | \$ 2,931,904                               | \$ 2,296,457  |



|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Income (loss) per share of common stock before extraordinary item (Basic)   | \$ 0.05    | \$ (0.01)  | \$ 0.06    | \$ 0.01    |
| Income (loss) per share of common stock before extraordinary item (Diluted) | \$ 0.04    | \$ (0.01)  | \$ 0.05    | \$ 0.01    |
| Extraordinary gain per share of common stock (Basic)                        |            | \$ 0.00    | \$ 0.03    | \$ 0.06    |
| Extraordinary gain per share of common stock (Diluted)                      |            | \$ 0.00    | \$ 0.02    | \$ 0.05    |
| Income (loss) per share of common stock after extraordinary item (Basic)    | \$ 0.05    | \$ (0.01)  | \$ 0.09    | \$ 0.08    |
| Income (loss) per share of common stock after extraordinary item (Diluted)  | \$ 0.04    | \$ (0.01)  | \$ 0.07    | \$ 0.06    |
| Weighted average number of common shares outstanding Basic                  | 31,666,791 | 30,005,619 | 31,460,989 | 29,893,298 |
| Weighted average number of common shares outstanding Diluted                | 42,808,000 | 30,005,619 | 41,721,301 | 40,800,332 |

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

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

|   | <b>Nine Months Ended<br/>September 30,</b> |                    |
|---|--|--------------------|
|   | <b>2004</b>                                | <b>2003</b>        |
| Cash flows from operating activities:   |  |                    |
| Net income applicable to common stock   | \$ 2,931,905                               | \$ 2,296,457       |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |                    |
| Depreciation and amortization   | 3,047,602                                  | 2,660,004          |
| Premium accrued on preferred stock  | 207,000                                    | 207,000            |
| Extraordinary gain on involuntary conversion of non-monetary assets due to fire   | (1,037,577)                                | (1,931,147)        |
| Decrease in other assets  | 85,315                                     | 129,315            |
| Changes in current assets and current liabilities                                 | (542,752)                                  | 442,319            |
|   | <u>4,691,493</u>                           | <u>3,803,948</u>   |
| Net cash provided by operating activities   |  |                    |
| Cash flows from investing activities:   |  |                    |
| Purchases of land, buildings and equipment  | (4,142,009)                                | (5,400,140)        |
| Insurance proceeds from involuntary disposition of property and equipment         | 669,012                                    | 2,876,159          |
|   | <u>(3,472,997)</u>                         | <u>(2,523,981)</u> |
| Net cash used in investing activities   |  |                    |
| Cash flows from financing activities:   |  |                    |
| Proceeds from issuance of notes   | 1,350,000                                  |                    |
| Payments on notes   | (2,519,121)                                | (1,296,835)        |
| Increase in outstanding advances on factored receivables                          | 503,401                                    | 15,942             |
| Debt acquisition costs  | 11,100                                     | (207,472)          |
| Proceeds from exercise of stock options and warrants, net                         | 571,268                                    | 27,850             |
|   | <u>(83,352)</u>                            | <u>(1,460,515)</u> |
| Net cash used in financing activities   |  |                    |
| Increase (decrease) in cash   | 1,135,144                                  | (180,548)          |
| Cash and cash equivalents, beginning of period                                    | 1,509,124                                  | 504,365            |

|  |              |            |
|--|--------------|------------|
|  | _____        | _____      |
| Cash and cash equivalents, end of period | \$ 2,644,268 | \$ 323,817 |
|  | _____        | _____      |

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

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**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. 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. Since inception in 1989, the Company has sold in excess of \$254 million of products into the North American marketplace. The Company's products are made from approximately equal amounts of waste wood fiber and reclaimed polyethylene plastic, 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. The Company's growing line of non-wood alternative building materials include standard door components, windowsills, brick mould, fascia board, and heavy industrial flooring sold under the trade names LifeCycle®, MoistureShield®, and MoistureShield® CornerLoc®, and a variety of composite decking products under the trade name Weyerhaeuser ChoiceDek®. AERT operates five manufacturing facilities. The composite building products are manufactured in Junction, Texas and Springdale, Arkansas. There are two plastic processing plants—one in Lowell, Arkansas and one in Alexandria, Louisiana—and a painting, finishing and packaging plant in Tontitown, Arkansas.

**Note 3: Current Operations**

On March 28, 2003, there was an accidental fire at the Junction, Texas plant. The Company began demolition and partial rebuilding on April 16, 2003. The initial restoration project, completed on May 20, 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 April 2004. The Company expects complete restoration, including replacement of the raw material system, to be finished by the end of 2004. Although

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work is still ongoing, there is no assurance as to the timing of the completion of the remaining portion of the plant, which is dependent upon the availability of additional funds. The Junction plant was, and is, fully insured for fire damage and business interruption. Through September 30, 2004, the Company had received \$6.0 million in insurance proceeds related to the March 2003 fire, including amounts for lost income reimbursement, and had invested approximately \$6.1 million in reconstructing the Junction facility. Insurance proceeds received to reimburse costs incurred to reconstruct the facility resulted in a gain of \$1,037,577 for the nine months ended September 30, 2004. At September 30, 2004, approximately \$864,000 was included in accounts receivable for expected insurance reimbursements. We believe the insurance claim for the replacement of the building and contents will be settled by the end of 2004. Since the Junction facility has reached the production level at which it operated prior to the fire, the Company will no longer receive business interruption insurance proceeds for lost income reimbursement.

The Company is currently adding additional plastic recycling equipment in Lowell, which is designed to increase our internal capability of processing scrap plastic. In addition, we have completed the site work for the addition of a production facility on the property adjacent to our Springdale plant and will commence work on the building. Construction on a second raw material system to service both plants has commenced and is intended to become operational starting in phases during the first quarter 2005. The building program will provide the capacity necessary to achieve higher sales levels and sustain our growth.

**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:

|  | <b>2004</b><br><b>(unaudited)</b> | <b>2003</b><br><b>(unaudited)</b> |
|--|-----------------------------------|-----------------------------------|
|  | <hr/>                             | <hr/>                             |
| Receivables                                | \$ (783,857)                      | \$ (61,733)                       |
| Inventories                                | (1,422,168)                       | (1,226,837)                       |
| Prepaid expenses and other                 | 692,954                           | 594,608                           |
| Accounts payable Trade and related parties | 49,289                            | 906,331                           |
| Accrued liabilities                        | 921,030                           | 229,950                           |
|  | <hr/>                             | <hr/>                             |
|  | \$ (542,752)                      | \$ 442,319                        |
|  | <hr/>                             | <hr/>                             |
| Cash paid for interest                     | \$ 1,296,431                      | \$ 726,313                        |
|  | <hr/>                             | <hr/>                             |

**Table of Contents****Supplemental Disclosure of Non-Cash Investing and Financing Activities:**

|   | <b>2004</b><br><b>(unaudited)</b> | <b>2003</b><br><b>(unaudited)</b> |
|---|-----------------------------------|-----------------------------------|
| Notes payable for financing of insurance policies | \$ 1,066,083                      | \$ 903,309                        |
| Accounts / notes payable for equipment            | 1,607,025                         | 1,652,101                         |
| Accrued premium paid with Class A common stock    | 276,000                           | 214,709                           |

**Note 5: Significant Accounting Policies****Revenue Recognition Policy**

The Company recognizes revenue in accordance with SEC Staff Accounting Topic 13, *Revenue Recognition*. 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 time of shipment. Sales are recorded net of discounts, rebates and returns.

**Inventories**

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

|                 | <b>September 30,</b><br><b>2004</b><br><b>(unaudited)</b> | <b>December 31,</b><br><b>2003</b> |
|-----------------|---|------------------------------------|
| Raw materials   | \$2,981,803   | \$2,722,682                        |
| Work in process | 1,655,467   | 566,503                            |
| Finished goods  | 656,166   | 582,083                            |
|                 | <u>\$5,293,436</u>  | <u>\$3,871,268</u>                 |

**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.

**Research and Development**

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

**Table of Contents****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 (loss) and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation.

|  | <b>Three Months Ended September 30,</b> |                                   |                                  |
|--|---|-----------------------------------|----------------------------------|
|  | <b>2004</b>                             | <b>2003</b>                       |                                  |
|  |   | <b>Before Extra-ordinary Item</b> | <b>After Extra-ordinary Item</b> |
| Net income (loss) applicable to common stock, as reported  | \$1,500,498                             | \$(256,959)                       | \$(204,033)                      |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards | <u>108,005</u>                          | <u>146,145</u>                    | <u>146,145</u>                   |
| Net income (loss) applicable to common stock, pro forma  | \$1,392,493                             | \$(403,104)                       | \$(350,178)                      |
| Net income (loss) per share of common stock:   |   |                                   |                                  |
| Basic as reported  | \$ 0.05                                 | \$ (0.01)                         | \$ (0.01)                        |
| Basic pro forma  | \$ 0.04                                 | \$ (0.01)                         | \$ (0.01)                        |
| Diluted as reported  | \$ 0.04                                 | \$ (0.01)                         | \$ (0.01)                        |
| Diluted pro forma  | \$ 0.03                                 | \$ (0.01)                         | \$ (0.01)                        |

**Nine Months Ended September 30,**

|  | <b>2004</b>                       |                                  | <b>2003</b>                       |                                  |
|--|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|  | <b>Before Extra-ordinary Item</b> | <b>After Extra-ordinary Item</b> | <b>Before Extra-ordinary Item</b> | <b>After Extra-ordinary Item</b> |
| Net income applicable to common stock, as reported   | \$1,894,327                       | \$2,931,904                      | \$365,310                         | \$2,296,457                      |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards | <u>243,267</u>                    | <u>243,267</u>                   | <u>341,967</u>                    | <u>341,967</u>                   |
| Net income applicable to common stock, pro forma   | \$1,651,060                       | \$2,688,637                      | \$ 23,343                         | \$1,954,490                      |





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|                                       | <b>Nine Months Ended September 30,</b>         |   |  |   |
|---------------------------------------|--|---|--|---|
|                                       | <b>2004</b>                                    |   | <b>2003</b>                                    |   |
|                                       | <b>Before<br/>Extra-<br/>ordinary<br/>Item</b> | <b>After<br/>Extra-<br/>ordinary<br/>Item</b> | <b>Before<br/>Extra-<br/>ordinary<br/>Item</b> | <b>After<br/>Extra-<br/>ordinary<br/>Item</b> |
| Net income per share of common stock: |  |   |  |   |
| Basic as reported                     | \$0.06   | \$ 0.09                                       | \$0.01   | \$ 0.08                                       |
| Basic pro forma                       | \$0.05   | \$ 0.09                                       | \$0.00   | \$ 0.07                                       |
| Diluted as reported                   | \$0.05   | \$ 0.07                                       | \$0.01   | \$ 0.06                                       |
| Diluted pro forma                     | \$0.04   | \$ 0.06                                       | \$0.00   | \$ 0.05                                       |

**Recent Accounting Pronouncements**

In December 2003, the FASB issued revised Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46R), an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, which replaced FIN 46. FIN 46R clarifies the application of Accounting Research Bulletin No. 51 to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. The Company is required to adopt the provisions of FIN 46R by the beginning of the first annual period beginning after December 15, 2004. The adoption of FIN 46R is not expected to have a material effect on the Company's consolidated financial statements.

In March 2004, the FASB issued an exposure draft entitled *Share-Based Payment-An Amendment of Statements No. 123 and 95* (Proposed Statement of Financial Accounting Standards). The proposed Statement would eliminate the ability to account for share-based compensation transactions using APB Opinion No. 25 and generally require instead that such transactions be accounted for using a fair-value-based method. This accounting, if approved, could result in significant compensation expense charges to our future results of operations. The exposure draft, if adopted as presently drafted, would be applied to public entities prospectively for fiscal years beginning after December 15, 2004, as if all share-based compensation awards granted, modified, or settled after December 15, 1994, had been accounted for using the fair-value method of accounting. Retrospective application of the proposed Statement is not permitted.

**Note 6: Income Taxes**

No income tax provision was recorded for the nine months ended September 30, 2004, due to the realization of previously unrecognized net operating loss carryforwards.

**Table of Contents****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. 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 September 30, 2004, 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 margin by plant location are as follows:

| <b>Net Sales Three months ended September 30,</b>                         | <b>2004</b>         | <b>2003</b>         |
|---|---------------------|---------------------|
| Commercial and residential decking surface components                     | \$15,428,179        | \$ 9,027,611        |
| Exterior door, window and housing trim components and industrial flooring | 3,547,538           | 2,352,188           |
|   | <u>\$18,975,717</u> | <u>\$11,379,799</u> |

| <b>Net Sales Nine months ended September 30,</b>                          | <b>2004</b>         | <b>2003</b>         |
|---|---------------------|---------------------|
| Commercial and residential decking surface components                     | \$39,584,990        | \$26,506,799        |
| Exterior door, window and housing trim components and industrial flooring | 8,774,423           | 6,069,238           |
|   | <u>\$48,359,413</u> | <u>\$32,576,037</u> |

| <b>Gross Margin Three months ended September 30,</b> | <b>2004</b>         |                    | <b>2003</b>        |                   |
|--|---------------------|--------------------|--------------------|-------------------|
|  | <b>Springdale</b>   | <b>Junction</b>    | <b>Springdale</b>  | <b>Junction</b>   |
| Net sales  | \$13,678,454        | \$5,297,263        | \$9,203,768        | \$2,176,031       |
| Cost of goods sold                                   | 9,660,893           | 3,619,079          | 7,254,456          | 1,768,849         |
| Gross margin   | <u>\$ 4,017,561</u> | <u>\$1,678,184</u> | <u>\$1,949,312</u> | <u>\$ 407,182</u> |



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| <b>Gross Margin</b> | <b>Nine months ended September 30,</b> | <b>2004</b>         |                     | <b>2003</b>         |                    |
|---------------------|--|---------------------|---------------------|---------------------|--------------------|
|                     |  | <b>Springdale</b>   | <b>Junction</b>     | <b>Springdale</b>   | <b>Junction</b>    |
| Net sales           |  | \$36,326,022        | \$12,033,391        | \$26,158,541        | \$6,417,496        |
| Cost of goods sold  |  | 25,912,379          | 9,978,578           | 20,323,890          | 5,062,549          |
| Gross margin        |  | <u>\$10,413,643</u> | <u>\$ 2,054,813</u> | <u>\$ 5,834,651</u> | <u>\$1,354,947</u> |

**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 effect of an accounting change.

**Three Months Ended September 30,**

|  | <b>2004</b>  |  | <b>2003</b>                       |                                  |
|--|--------------|--|-----------------------------------|----------------------------------|
|  |              |  | <b>Before Extra-ordinary Item</b> | <b>After Extra-ordinary Item</b> |
| Net income (A)                                 | \$ 1,500,498 |  | \$(256,959)                       | \$(204,033)                      |
| Assumed exercise of stock options and warrants | 20,014,003   |  |                                   |                                  |
|  | (8,872,794)  |  |                                   |                                  |

Application of assumed proceeds toward  
repurchase of stock

\_\_\_\_\_

**Table of Contents****Three Months Ended September 30,**

|  | <b>2004</b> |  | <b>2003</b>                       |                                  |
|--|-------------|--|-----------------------------------|----------------------------------|
|  |             |  | <b>Before Extra-ordinary Item</b> | <b>After Extra-ordinary Item</b> |
| Net additional shares issuable   | 11,141,209  |  |                                   |                                  |
| Adjustment of shares outstanding:<br>Weighted average common shares<br>outstanding | 31,666,791  |  | 30,005,619                        | 30,005,619                       |
| Net additional shares issuable   | 11,141,209  |  |                                   |                                  |
| Adjusted shares outstanding (B)  | 42,808,000  |  | 30,005,619                        | 30,005,619                       |
| Net income per common share Diluted (A)<br>divided by (B)                          | \$ 0.04     |  | \$ (0.01)                         | \$ (0.01)                        |
| Antidilutive and/or non-exercisable options  | 1,107,500   |  | 1,572,500                         | 1,572,500                        |
| Antidilutive and/or non-exercisable warrants                                       | 2,333,933   |  | 2,333,933                         | 2,333,933                        |

**Nine Months Ended September 30,**

|  | <b>2004</b>                       |                                  | <b>2003</b>                       |                                  |
|--|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|  | <b>Before Extra-ordinary Item</b> | <b>After Extra-ordinary Item</b> | <b>Before Extra-ordinary Item</b> | <b>After Extra-ordinary Item</b> |
| Net income (A)   | \$ 1,894,327                      | \$ 2,931,904                     | \$ 365,310                        | \$ 2,296,457                     |
| Assumed exercise of stock<br>options and warrants                | 19,965,503                        | 19,965,503                       | 20,817,819                        | 20,817,819                       |
| Application of assumed<br>proceeds toward repurchase of<br>stock | (9,705,191)                       | (9,705,191)                      | (9,910,785)                       | (9,910,785)                      |

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|  |                   |                   |                   |                   |
|--|-------------------|-------------------|-------------------|-------------------|
| Net additional shares issuable                         | <u>10,260,312</u> | <u>10,260,312</u> | <u>10,907,034</u> | <u>10,907,034</u> |
| Adjustment of shares outstanding:                      |                   |                   |                   |                   |
| Weighted average common shares outstanding             | 31,460,989        | 31,460,989        | 29,893,298        | 29,893,298        |
| Net additional shares issuable                         | <u>10,260,312</u> | <u>10,260,312</u> | <u>10,907,034</u> | <u>10,907,034</u> |
| Adjusted shares outstanding (B)                        | <u>41,721,301</u> | <u>41,721,301</u> | <u>40,800,332</u> | <u>40,800,332</u> |
| Net income per common share Diluted (A) divided by (B) | <u>\$ 0.05</u>    | <u>\$ 0.07</u>    | <u>\$ 0.01</u>    | <u>\$ 0.06</u>    |
| Antidilutive and/or non-exercisable options            | 1,156,000         | 1,156,000         | 1,621,000         | 1,621,000         |
| Antidilutive and/or non-exercisable warrants           | 2,333,933         | 2,333,933         | 2,333,933         | 2,333,933         |

The Company has additional options and warrants that were not included in the calculation of diluted earnings per share for the quarters and nine months ended September 30,



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2004 and 2003, as indicated in the above tables. Those options and warrants were either antidilutive and/or not exercisable during those periods. 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.

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

**General**

Advanced Environmental Recycling Technologies, Inc. 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. Since inception in 1989, we have sold in excess of \$254 million of products into the North American marketplace. Our products are made from approximately equal amounts of waste wood fiber and reclaimed polyethylene plastic, 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 growing line of non-wood alternative building materials include standard door components, windowsills, brick mould, fascia board, and heavy industrial flooring sold under the trade names LifeCycle®, MoistureShield®, and MoistureShield® CornerLoc®, and a variety of composite decking products under the trade name Weyerhaeuser ChoiceDek®. We operate five manufacturing facilities. Our composite building products are manufactured in Junction, Texas and Springdale, Arkansas. Our Springdale plant also recycles some plastic. We have two plastic processing plants—one in Lowell, Arkansas and one in Alexandria, Louisiana—and a painting, finishing and packaging plant in Tontitown, Arkansas.

**Products**

Using the same basic material, we manufacture product lines as:

Commercial and residential decking planks and accessories such as balusters and handrails (MoistureShield and Weyerhaeuser ChoiceDek), and

Exterior door, window and housing trim components and industrial flooring (MoistureShield)

The wood fiber content of our products gives them many properties similar to all-wood products, but we believe the plastic content makes our products superior to either all-wood or all-plastic alternatives because:

Beginning January 1, 2004, the wood industry no longer sells chromated copper arsenic (CCA) treated lumber for residential and construction applications. The primary replacement chemical treatment for lumber is alkaline copper quat (ACQ), and this treated lumber is approximately 20% higher in price than CCA treated lumber and also requires additional handling and fastening techniques. Unlike wood, our products do not require preservatives or treatment with toxic chemicals such as CCA or ACQ, nor do they require yearly water sealing or staining.

They are less subject to thermal contraction or expansion and have greater dimensional stability than competing all-plastic products.

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They are engineered for superior moisture-resistance and will not swell or expand like wood.

They can be designed and extruded through dies to a desired shape in accordance with customer specifications, which helps the customer to minimize waste. They are less subject to rotting, cracking, warping, splintering, insect infestation and water absorption than conventional wood materials.

When combined with our unique tie coat primer, the life of exterior paint can be greatly enhanced, thus creating a low-maintenance non-wood trim and fascia system designed to enhance and complement fiber cement siding.

Our composites manufacturing process involves proprietary technologies, certain of which are patented. We also use manufacturing equipment that has been custom-built or modified to our specifications. Our composite building material became a patented product in June 1998 under U.S. Patent No. 5,759,680.

Beginning in 2004, we introduced a line of fade-resistant colored decking products, some of which also have an embossed wood-grain texture. We initiated the introduction of a new matching handrail system for the colored decking during the second quarter of 2004.

Due to our extensive product testing and successful extended field history of over a decade, we offer a limited lifetime replacement warranty on our products against rot and fungal decay, and termite and insect damage.

## **Manufacturing**

We operate the following manufacturing and recycling facilities:

Our Junction, Texas facility manufactures primarily decking. There was a fire in March 2003 at the Junction plant which caused substantial damage and temporarily shut down plant operations. One rebuilt extrusion line recommenced operations in May 2003, and the second line recommenced operations in April 2004.

Our door, window and housing trim components are manufactured at our Springdale, Arkansas facility. The Springdale facility also manufactures the LifeCycle, MoistureShield and Weyerhaeuser ChoiceDek brands including new colored lines of decking products. Springdale currently has four extrusion lines with a plastic recycling facility. Additional automation, including downstream handling and packaging equipment was installed for a portion of the facility during the first quarter of 2004, and is scheduled to be completed by the end of 2004.

During the first quarter of 2004, we relocated and expanded our paint system and

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added some finishing and packaging operations to an additional 70,000 square foot facility near Tonitown, Arkansas. This was done in order to allow for additional extrusion production increases and to maximize efficiencies at the existing Springdale facility. We believe this will also streamline, simplify and focus manufacturing operations and allow for further production increases in the future at the existing Springdale facility.

In late 2003, we started a second plastics processing facility in Northwest Arkansas. We have completed the initial phases of adding additional plastic recycling equipment and capacity to that plant. The facility is used for plastic recycling, blending and storage, and includes a railroad loading/unloading spur, truck scale, receiving station, and finished goods storage. In October 2004, we entered into a 7-year lease agreement to utilize an adjoining 20 acre site which will include a rail spur and two 100,000 square foot warehouses.

We lease plastic recycling equipment and factory space in Alexandria, Louisiana and commenced operations in June 2003. We have made improvements and installed additional equipment to increase the facility's throughput. The upgrades provide flexibility to economically process different types of scrap plastic and to provide plastic feedstock of a quality and consistency required in order to more efficiently operate our extrusion facilities.

During the first quarter of 2003, we began road and bridge infrastructure work on an 18.8-acre tract that adjoins the existing Springdale, Arkansas facility. In the second quarter of 2004, we completed a portion of the infrastructure site work and roadwork at that location for a second composite manufacturing facility in Springdale. We plan to have the building and initial portion of the manufacturing facility completed and operational in the third quarter of 2005. Work on the raw material system for both plants has commenced and is scheduled to become operational in stages beginning in the first quarter of 2005.

In the third quarter of 2004, we invested approximately \$1.8 million in property, plant and equipment, which includes approximately \$300,000 for the rebuilding of the Junction, Texas facility. 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. Due to strong demand for our composite products, these projects will be followed by the construction of a second warehouse and manufacturing facility in Springdale, Arkansas and additional composite extrusion capacity. New capital projects are currently being paid for from cash flow, and there is no assurance as to when additional funds will be available or as to when the projects will be completed.

**Table of Contents****Results of Operations****Three Months Ended September 30, 2004 Compared to Three Months Ended September 30, 2003**

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

**Quarterly Comparison**

|   | <b>Three Months Ended September 30:</b> |                 |               |
|---|---|-----------------|---------------|
|   | <b>2004</b>                             | <b>% Change</b> | <b>2003</b>   |
| Net sales   | \$ 18,975,717                           | 66.7%           | \$ 11,379,799 |
| Cost of goods sold  | 13,279,972                              | 47.2%           | 9,023,305     |
| % of net sales  | 70.0%                                   | -9.3%           | 79.3%         |
| Gross margin  | 5,695,745                               | 141.7%          | 2,356,494     |
| % of net sales  | 30.0%                                   | 9.3%            | 20.7%         |
| Selling and administrative costs  | 3,573,535                               | 48.2%           | 2,411,873     |
| % of net sales  | 18.8%                                   | -2.4%           | 21.2%         |
| Research and development  |   | -100.0%         | 23,732        |
| Subtotal  | 3,573,535                               | 46.7%           | 2,435,605     |
| Operating income (loss)   | 2,122,210                               |                 | (79,111)      |
| % of net sales  | 11.2%                                   | 11.9%           | -0.7%         |
| Other income (expense)  |   |                 |               |
| Insurance proceeds related to lost income                                       |   | -100.0%         | 248,013       |
| Net interest expense  | (552,712)                               | 54.9%           | (356,861)     |
| Income (loss) before extraordinary item and accrued premium on preferred stock  | 1,569,498                               |                 | (187,959)     |
| Accrued premium on preferred stock  | (69,000)                                | 0.0%            | (69,000)      |
| Income (loss) before extraordinary item   | 1,500,498                               |                 | (256,959)     |
| % of net sales  | 7.9%                                    | 10.2%           | -2.3%         |
| Extraordinary gain on involuntary conversion of non-monetary assets due to fire |   | -100.0%         | 52,926        |
| Net income (loss) applicable to common stock after extraordinary item           | \$ 1,500,498                            |                 | \$ (204,033)  |

|                |      |      |       |
|----------------|------|------|-------|
| % of net sales | 7.9% | 9.7% | -1.8% |
|----------------|------|------|-------|

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*Net Sales*

Our net sales for the three months ended September 30, 2004 and 2003 are summarized as follows:

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|                        | <b>Three months ended September 30:</b> |                     |                      |
|------------------------|---|---------------------|----------------------|
|                        | <b>2004</b>                             | <b>%<br/>Change</b> | <b>2003</b>          |
| Springdale facility    | \$ 13,678,454                           | 48.6%               | \$ 9,203,768         |
| Junction facility      | 5,297,263                               | 143.4%              | 2,176,031            |
| <b>Total net sales</b> | <b>\$ 18,975,717</b>                    | <b>66.7%</b>        | <b>\$ 11,379,799</b> |

Net sales for the quarter ended September 30, 2004 increased compared to the same period of 2003 due to the rebuilding of the Junction, Texas facility, increases in production efficiency and continued strong demand for our products. Net sales at the Junction facility were much lower in 2003 due to the major fire in March 2003 that temporarily shut down plant operations. The facility resumed operations with one extrusion line in May 2003, and we re-commenced the second extrusion line in April 2004. We plan to have Junction fully rebuilt by the end of 2004.

***Cost of Goods Sold***

Our cost of goods sold, as a percent of sales, decreased for the quarter ended September 30, 2004 compared to the same period of 2003 primarily due to decreases in direct labor and manufacturing overhead. To help offset rising material costs, we added a plastic recycling facility in Alexandria, Louisiana, expanded our plastic processing capacity at the second Northwest Arkansas facility and are seeking new sources of waste plastic materials. We are also working to improve material handling techniques and efficiencies in order to attempt to further reduce costs and offset significantly higher and ever increasing petrochemical related costs.

***Selling and Administrative Cost***

Selling and administrative cost increased for the quarter ended September 30, 2004 compared to the same period of 2003 as a result of increases in sales, customer service and corporate personnel expenses, along with general increases in corporate costs to manage our growing business. However, as a percentage of net sales, selling and administrative costs decreased.

***Income***

Earnings increased for the quarter ended September 30, 2004 as compared to the same period of 2003 due to increased sales, lower manufacturing costs as a percentage of sales and lower selling and administrative costs as a percentage of sales. The lower manufacturing costs were primarily associated with increased utilization of internally produced lower cost plastic materials, which were generated with plastic scrap that had been previously accumulated at prices significantly lower than current levels.

**Table of Contents*****Nine Months Ended September 30, 2004 Compared to Nine Months Ended September 30, 2003***

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

|   | <b>Nine Months Ended September 30:</b> |                     |              |
|---|--|---------------------|--------------|
|   | <b>2004</b>                            | <b>%<br/>Change</b> | <b>2003</b>  |
| Net sales   | \$48,359,413                           | 48.5%               | \$32,576,037 |
| Cost of goods sold  | 35,890,957                             | 41.4%               | 25,386,439   |
| % of net sales  | 74.2%                                  | -3.7%               | 77.9%        |
| Gross margin  | 12,468,456                             | 73.4%               | 7,189,598    |
| % of net sales  | 25.8%                                  | 3.7%                | 22.1%        |
| Selling and administrative costs  | 8,684,107                              | 28.9%               | 6,739,384    |
| % of net sales  | 18.0%                                  | -2.7%               | 20.7%        |
| Research and development  | 97,207                                 | 97.5%               | 49,230       |
| Subtotal  | 8,781,314                              | 29.4%               | 6,788,614    |
| Operating income  | 3,687,142                              | 819.5%              | 400,984      |
| % of net sales  | 7.6%                                   | 6.4%                | 1.2%         |
| Other income (expense)  |  |                     |              |
| Insurance proceeds related to lost income                                       | 8,720                                  | -99.2%              | 1,072,312    |
| Net interest expense  | (1,594,535)                            | 77.0%               | (900,986)    |
| Income before extraordinary item and accrued premium on preferred stock         | 2,101,327                              | 267.2%              | 572,310      |
| Accrued premium on preferred stock  | (207,000)                              |                     | (207,000)    |
| Income before extraordinary item  | 1,894,327                              | 418.6%              | 365,310      |
| % of net sales  | 3.9%                                   | 2.8%                | 1.1%         |
| Extraordinary gain on involuntary conversion of non-monetary assets due to fire | 1,037,577                              | -46.3%              | 1,931,147    |
| Net income applicable to common stock after extraordinary item                  | \$ 2,931,904                           | 27.7%               | \$ 2,296,457 |
| % of net sales  | 6.1%                                   | -0.9%               | 7.0%         |





**Table of Contents****Net Sales**

Our net sales for the nine months ended September 30, 2004 and 2003 are summarized as follows:

|                        | <b>Nine months ended September 30:</b> |                     |                     |
|------------------------|--|---------------------|---------------------|
|                        | <b>2004</b>                            | <b>%<br/>Change</b> | <b>2003</b>         |
| Springdale facility    | \$36,326,022                           | 38.9%               | \$26,158,541        |
| Junction facility      | 12,033,391                             | 87.5%               | 6,417,496           |
| <b>Total net sales</b> | <b>\$48,359,413</b>                    | <b>48.5%</b>        | <b>\$32,576,037</b> |

Net sales for the nine months ended September 30, 2004 increased compared to the same period of 2003 due to the rebuilding of the Junction, Texas facility, increases in production efficiency and continued strong demand for our products. Net sales at the Junction facility during the nine months ended September 30, 2003 were much lower than the same period of 2004 due to the major fire in March 2003 that temporarily shut down plant operations. The facility resumed operations with one extrusion line in May 2003, and we re-commenced the second extrusion line on April 29, 2004. We plan to have Junction fully rebuilt by the end of 2004.

**Cost of Goods Sold**

Our cost of goods sold, as a percent of sales, decreased for the nine months ended September 30, 2004 compared to the same period of 2003 primarily due to decreases in direct labor and manufacturing overhead. To help offset rising material costs, we added a plastic recycling facility in Alexandria, Louisiana, expanded our plastic processing capacity at the second Northwest Arkansas facility and are seeking new sources of waste plastic materials. We are also working to improve material handling techniques and efficiencies in order to further offset increasing raw material costs and improve margins.

**Selling and Administrative Cost**

Selling and administrative cost increased for the nine months ended September 30, 2004 compared to the same period of 2003 as a result of increases in sales, customer service and corporate personnel expenses, along with general increases in corporate costs to manage our growing business. However, as a percentage of net sales, selling and administrative costs decreased.

**Extraordinary Item**

The extraordinary gain in the first nine months of 2004 and 2003 was 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 gains of \$1,037,577 and \$1,931,147 for the nine months ended September 30, 2004 and 2003,



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respectively. In addition, we recognized a total gain of approximately \$2.96 million in 2003 attributable to such insurance proceeds as the facility and equipment damaged had been nearly fully depreciated. At September 30, 2004, approximately \$864,000 was included in accounts receivable for expected insurance reimbursements.

### ***Income***

Earnings before the extraordinary gain increased for the nine month period ended September 30, 2004 as compared to the same period of 2003.

### **Liquidity and Capital Resources**

At September 30, 2004, we had a working capital deficit of \$1.1 million compared to a working capital deficit of \$1.9 million at December 31, 2003. Excluding the \$1.9 million spent to reconstruct the Junction facility, we spent approximately \$3.8 million on capital expansion during the first nine months of 2004. Expenditures were primarily for increasing our plastic processing capacity at our Lowell and Alexandria facilities in order to better control our raw material costs, and for automation related equipment needed to improve the production of our new decking products. At September 30, 2004, the working capital deficit involved total current liabilities of approximately \$13.76 million, of which \$2.82 million was for accrued payroll expense and other accrued liabilities, \$9.22 million was in payables and \$1.72 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. Additionally, pursuant to our bond agreement, we are required to maintain a debt service reserve fund in the amount of \$2 million, which is classified as a non-current asset in our balance sheet.

Cash increased \$1.1 million to \$2.6 million at September 30, 2004 from December 31, 2003. Significant components of that increase were: (i) cash provided by operating activities of \$4.7 million, which consisted of the net income for the period of \$2.9 million increased by depreciation and amortization of \$3.0 million and decreased by other uses of cash of approximately \$1.2 million; (ii) cash used in investing activities of \$3.5 million; and (iii) cash used in financing activities of approximately \$83,000. Payments on notes during the period were \$2.5 million, and proceeds from the issuances of notes amounted to \$1.35 million. At September 30, 2004, we had bonds and notes payable in the amount of \$18.1 million, of which \$1.7 million was current notes payable and the current portion of long-term debt.

### **Uncertainties, Issues and Risks**

There are many factors that could adversely affect our 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, fire, flood or other casualty damage, litigation, new products/product transition, product obsolescence, competition, acts of war, terrorism, public health issues, concentration of customer

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base, loss of a significant customer, significant increases in prices of petrochemical products and 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, due to virtually all of our long-term debt bearing interest at fixed rates. We depend on the market for favorable long-term mortgage rates to help generate sales of our product to our customers for use in the residential construction industry. Should mortgage rates increase substantially, we could be impacted by a reduction in the residential construction industry. Important raw materials purchased by us 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 of our suppliers on a term basis, and by internally recycling a majority of our plastic raw materials.

### **Forward-Looking Information**

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 our current judgment regarding the direction of our 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 our 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 our 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; and 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.

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 analyzing us. 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

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similar expressions, represent our expectations or 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.

**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 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. Such review was conducted as of the end of the period covered by this Form 10-Q. Based upon their review, these executive officers have concluded that 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. Subsequent to this evaluation, there have been no significant changes in our internal controls or in other factors that could significantly affect such controls.

**PART II. OTHER INFORMATION**

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

**Recent Sales of Unregistered Securities**

On September 16, 2004, we sold an aggregate of 100,000 shares of our Class A common stock to three middle management employees upon the exercise of stock options at an exercise price of \$0.813. We believe, due to the nature of the relationship of these persons to us and the isolated nature of the transactions, that each issuance and sale of the shares of Class A common stock underlying such options 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**

We held our 2004 annual meeting of stockholders on July 22, 2004. The following matters proposed by the board of directors were voted upon at that meeting.

Proposal 1: The stockholders approved the proposal to elect to the board of directors each of the nominees listed below.

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| <b>Nominees</b>    | <b>Votes For</b> | <b>Votes<br/>Withheld</b> |
|--------------------|------------------|---------------------------|
| Joe G. Brooks      | 34,720,305       | 545,544                   |
| Marjorie S. Brooks | 34,718,136       | 547,713                   |
| Stephen W. Brooks  | 34,719,236       | 546,613                   |
| Jerry B. Burkett   | 34,822,372       | 443,477                   |
| Melinda Davis      | 34,791,072       | 474,777                   |
| Samuel L. Milbank  | 34,817,632       | 448,217                   |
| Sal Miwa           | 34,818,372       | 447,477                   |
| Jim Robason        | 34,791,072       | 474,777                   |
| Michael M. Tull    | 34,820,632       | 445,217                   |

Proposal 2: The stockholders approved the proposal to ratify the appointment of Tullius Taylor Sartain and Sartain as our independent auditors.

| <b>For</b> | <b>Against</b> | <b>Abstain</b> |
|------------|----------------|----------------|
| 34,955,340 | 59,424         | 251,085        |

**Item 6. Exhibits**

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

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**ADVANCED ENVIRONMENTAL  
RECYCLING TECHNOLOGIES, INC.**

By: /s/ JOE G. BROOKS

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

/s/ EDWARD J. LYSEN

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Edward J. Lysen,  
*Chief Financial Officer*

Date: November 12, 2004



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**Index to Exhibits**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 10.46                     | Wood-Plastic Composite Decking Agreement between AERT and Weyerhaeuser Company, et al. effective October 12, 2004*   |
| 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                                |
| *                         | Confidential treatment has been requested with respect to certain portions of the exhibit. Omitted portions have been filed with the Securities and Exchange Commission. |