SUNAIR SERVICES CORP
Form 10-Q
February 14, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

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

For the quarterly period ended December 31, 2006

OR

o **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 I-4334
SUNAIR SERVICES CORPORATION

(Exact name of Registrant as specified in its charter)

Florida	59-0780772
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

595 South Federal Highway, Suite 500 Boca Raton, Florida	33432
(Address of principal executive offices)	*(Zip Code)*

(561) 208-7400

(Registrant s telephone number, including area code)
None

(Former name, former address and former fiscal year, if changed since last report)

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 þ No o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

Yes o No þ

As of February 7, 2007, the Registrant had outstanding 13,091,088 shares of common stock.

SUNAIR SERVICES CORPORATION AND SUBSIDIARIES
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PART I
FINANCIAL INFORMATION

Item 1. ***Financial Statements***

SUNAIR SERVICES CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS
AS OF DECEMBER 31, 2006 AND SEPTEMBER 30, 2006
(UNAUDITED)

	December 31, 2006	September 30, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 1,580,897	$ 1,601,110
Accounts receivable, net	6,077,875	4,919,595
Income tax receivable	352,393	352,393
Interest receivable	21,539	11,084
Inventories, net	2,318,454	2,328,205
Deferred tax asset	137,387	137,387
Prepaid and other current assets	932,430	1,163,508
Note receivable current	334,986	334,986
Total Current Assets	11,755,961	10,848,268
PROPERTY, PLANT, AND EQUIPMENT, net	2,370,940	2,538,434
OTHER ASSETS:		
Note receivable	2,000,000	2,000,000
Software costs, net	3,897,164	3,938,465
Customer list, net	11,944,754	11,247,099
Goodwill	55,517,787	52,818,269
Other assets	655,190	522,427
Total Other Assets	74,014,895	70,526,260
TOTAL ASSETS	$ 88,141,796	$ 83,912,962
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 3,654,634	$ 2,743,523
Accrued expenses	2,493,780	2,831,162

Unearned revenues	1,266,222	589,365
Customer deposits	2,348,345	2,677,364
Capitalized leases, current portion	26,742	8,796
Notes payable, current portion	135,006	138,374
Total Current Liabilities	9,924,729	8,988,584
LONG TERM LIABILITIES:		
Capitalized leases, net of current portion		20,027
Notes payable, net of current portion	3,182,233	1,723,642
Note payable -related party	5,000,000	5,000,000
Revolving line of credit	8,456,477	8,000,000
Deferred tax liability	564,628	112,226
Total Long Term Liabilities	17,203,338	14,855,895
Total Liabilities	27,128,067	23,844,479
STOCKHOLDERS EQUITY:		
Preferred stock, no par value, 8,000,000 shares authorized, none issued and outstanding		
Common stock, $.10 par value, 100,000,000 shares authorized, 13,017,559 and 13,007,559 shares issued and outstanding at December 31, 2006 and September 30, 2006, respectively	1,301,757	1,300,757
Additional paid-in capital	51,809,752	51,548,768
Retained earnings	7,799,888	7,200,197
Accumulated other comprehensive gain cumulative translation adjustment	102,332	18,761
Total Stockholders Equity	61,013,729	60,068,483
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 88,141,796	$ 83,912,962

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

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SUNAIR SERVICES CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED DECEMBER 31, 2006 AND 2005
(UNAUDITED)

	For the Three Months Ended December 31, 2006	For the Three Months Ended December 31, 2005
SALES	$ 15,886,255	$ 11,225,575
COST OF SALES	6,892,013	4,614,085
GROSS PROFIT	8,994,242	6,611,490
SELLING AND ADMINISTRATIVE EXPENSES	9,881,703	7,176,680
LOSS FROM OPERATIONS	(887,461)	(565,190)
OTHER INCOME (EXPENSES):		
Interest income	67,774	1,469
Interest expense	(288,323)	(411,175)
Other	(22,801)	(4,789)
Total Other Income (Expenses)	(243,350)	(414,495)
LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(1,130,811)	(979,685)
INCOME TAX BENEFIT	369,026	420,495
LOSS FROM CONTINUING OPERATIONS	(761,785)	(559,190)
INCOME FROM DISCONTINUED OPERATIONS, NET OF INCOME TAX PROVISION OF $821,426 AND $100,272 FOR DECEMBER 31, 2006 AND 2005, RESPECTIVELY	1,361,476	194,647
NET INCOME (LOSS)	$ 599,691	$ (364,543)
BASIC AND DILUTED INCOME (LOSS) PER SHARE:		
CONTINUING OPERATIONS	$ (0.06)	$ (0.05)
DISCONTINUED OPERATIONS	$ 0.11	$ 0.02
NET INCOME (LOSS)	$ 0.05	$ (0.03)
WEIGHTED AVERAGE SHARES OUTSTANDING:		
BASIC	13,017,233	10,512,464
DILUTED	13,017,233	10,512,464

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

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SUNAIR SERVICES CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED DECEMBER 31, 2006 AND 2005
(UNAUDITED)

	For the Three Months Ended December 31, 2006	For the Three Months Ended December 31, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 599,691	$ (364,543)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation	235,918	202,734
Amortization	561,406	466,172
Deferred taxes	452,400	(320,223)
Bad debt reserve	5,747	1,936
Inventories reserve	77,962	(2,774)
(Gain) loss on sale of assets	(2,346,367)	9,789
Equity based compensation	216,984	
Stock based compensation	45,000	
(Increase) decrease in Assets:		
Accounts receivable	(1,130,709)	56,680
Interest receivable	(10,453)	8,479
Inventories	(64,710)	93,889
Prepaid and other current assets	410,289	(12,367)
Other assets	(108,785)	(19,544)
Increase (decrease) in Liabilities:		
Accounts payable and accrued expenses	84,429	296,519
Unearned revenue	(682)	81,480
Customer deposits	(369,825)	(125,884)
Net Cash Provided By (Used In) Operating Activities	(1,341,705)	372,343
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property, plant, and equipment	(98,204)	(161,289)
Software development costs	(95,768)	(91,316)
Cash paid for business acquisitions	(1,500,000)	(5,733,419)
Net proceeds from sale of property	2,522,274	
Net Cash Provided by (Used In) Investing Activities	$ 828,302	$ (5,986,024)

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

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SUNAIR SERVICES CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED DECEMBER 31, 2006 AND 2005
(UNAUDITED)

	For the Three Months Ended December 31, 2006		For the Three Months Ended December 31, 2005	
CASH FLOWS FROM FINANCING ACTIVITIES:				
Proceeds from (repayment of) line of credit	$	456,477	$	(3,500,000)
Repayment of notes payable		(44,777)		(12,204)
Payment on capital leases		(2,081)		(23,351)
Net proceeds from sale of common stock, net				9,457,515
Net Cash Provided By Financing Activities		409,619		5,921,960
Effect of exchange rate fluctuations on cash		83,571		(50,495)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS		(20,213)		257,784
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD		1,601,110		3,220,699
CASH AND CASH EQUIVALENTS, END OF PERIOD	$	1,580,897	$	3,478,483
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:				
Cash paid during the period for income taxes	$		$	
Cash paid during the period for interest	$	257,463	$	406,497
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:				
Debt incurred in acquisition of Archer Exterminators, Inc.	$	1,500,000	$	

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

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SUNAIR SERVICES CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
For the three months ended December 31, 2006 and December 31, 2005
(UNAUDITED)

1. Basis of Consolidated Financial Statement Presentation

The accompanying unaudited consolidated condensed financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission and in accordance with the instructions to Form 10-Q and do not include all the information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America. The information furnished in the interim financial statements includes normal recurring adjustments and reflects all adjustments, which, in the opinion of management, are necessary for a fair presentation of such financial statements. For further information refer to the consolidated financial statements and footnotes thereto included in the Company s most recent audited consolidated financial statements and notes thereto included in its September 30, 2006 annual report on Form 10-KSB. Operating results for the three months ended December 31, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2007.

2. Significant Accounting Policies

Use of Estimates

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

Accounts Receivable

Accounts receivable consist of balances due from sales. The Company performs periodic credit evaluations of its customers and maintains an allowance for potential credit losses based on historical experience and other information available to management. As of December 31, 2006 and September 30, 2006, the Company established an allowance of $351,640 and $365,730 respectively.

Inventories

Inventories, which consist of raw materials, work-in-process, and finished goods, are stated at the lower of cost or market value, cost being determined using the first in, first out method. The Company records reserves for inventory shrinkage and obsolescence when considered necessary.

Property, Plant, and Equipment

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

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

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

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SUNAIR SERVICES CORPORATION AND SUBSIDIARIES
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(UNAUDITED)

Software Costs

The Company capitalizes certain costs associated with software development in accordance with Statement of Financial Accounting Standard No. 86 (FASB No. 86) Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed. The Company amortizes software costs for periods of 5 to 10 years, the estimated useful life of the asset.

Goodwill and other intangible assets

Goodwill represents the excess of costs over fair value of assets of businesses acquired. Pursuant to FASB Statement No. 142 (FASB 142), goodwill acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of FASB 142. The Company tests goodwill for impairment as of September 30 of each year.

FASB 142 also requires that customer lists and intangible assets with estimable useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with FASB Statement No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets.*

Customer lists are stated at fair value based on the discounted cash flows over the estimated life of the customer contracts and relationships. The Company used an independent appraisal firm to perform a valuation study at the time of acquisition of Middleton Pest Control, Inc. to determine the value and estimated life of customer lists purchased in order to assist management in determining an appropriate method in which to amortize the asset. The amortization life is based on historic analysis of customer relationships combined with estimates of expected future revenues from customer accounts. The Company amortizes customer lists on a straight-line basis over the expected life of the customer of 8 years.

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

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the assets exceed the fair value. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. There were no assets impaired during the three months ended December 31, 2006 and 2005.

Revenue Recognition

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

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(UNAUDITED)

Advertising Costs

The Company expenses advertising costs as incurred.

Research and Development

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

Foreign Currency Translation

Telecom FM Ltd. (Telecom), a United Kingdom corporation, is a wholly owned subsidiary of the Company that distributes and installs telecommunication devices providing fixed wireless access to network and data service providers. Telecom s functional currency is the British pound sterling, its local currency. Accordingly, balance sheet accounts are translated at exchange rates in effect at the end of the period and income statement accounts are translated at average exchange rates for the period. Translation gains and losses are included as a separate component of stockholders equity as cumulative translation adjustments. Foreign currency transaction gains and losses are included in other income and expenses.

Comprehensive Income

Comprehensive income is comprised of net income and other comprehensive income. Other comprehensive income includes certain changes in equity that are excluded from net income. At December 31, 2006 and September 30, 2006, accumulated other comprehensive income was comprised of cumulative foreign currency translation adjustments.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued statement No. 123 (SFAS No. 123) (revised 2004), Share-Based Payment. SFAS No. 123(R) will require the Company to recognize compensation expense for all stock-based compensation in its consolidated statements of operations. Pro forma disclosure will no longer be an alternative.

SFAS No. 123(R) will also require the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow, as required under current guidance. The new requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. SFAS No. 123(R) is effective for fiscal year beginning after June 15, 2005, with early adoption permitted. The Company implemented the new standard beginning with the first quarter of fiscal 2006.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections , a replacement of APB Opinion No. 20 and FASB Statement No. 3. This Statement provides guidance on accounting for reporting of accounting changes and error corrections. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not expect the statement to have a material effect on its financial statements.

In June 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes, (FIN 48) a clarification of FASB Statement No. 109, Accounting for Income Taxes. This interpretation clarifies recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company has not yet determined the impact of this interpretation on its financial statements.

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For the three months ended December 31, 2006 and December 31, 2005 (Continued)
(UNAUDITED)

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108), to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that the Company quantify misstatements based on their impact on each of its financial statements and related disclosures. SAB 108 is effective as of the end of the Company s 2007 fiscal year, allowing a one-time transitional cumulative effect adjustment to retained earnings as of October 1, 2006 for errors that were not previously deemed material, but are material under the guidance in SAB 108. The Company is currently evaluating the impact of adopting SAB 108 on its financial statements.

In September 2006, the FASB issued SFAS 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective as of the beginning of the Company s 2008 fiscal year. The Company is currently evaluating the impact of adopting SFAS 157 on its financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, which requires employers to recognize the over funded or under funded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity. The Company has determined that this standard will not have a material effect on its financial statements.

3. Acquisitions

Acquisition of Spa Creek

On December 16, 2005 the Company, through its wholly-owned subsidiary, Middleton entered into an Asset Purchase Agreement to acquire substantially all the assets of Spa Creek for $5,500,000.

In addition, the Company incurred $233,419 of transaction costs consisting of legal and accounting fees.

The following table sets forth the allocation of the purchase price to Spa Creek tangible and intangible assets acquired and liabilities assumed as of December 16, 2005:

Goodwill