ARRHYTHMIA RESEARCH TECHNOLOGY INC /DE/
Form 10-Q
November 23, 2012

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, 2012 or

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from ______ to ______

001-9731
(Commission file No.)

ARRHYTHMIA RESEARCH TECHNOLOGY, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	72-0925679
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)

25 Sawyer Passway
Fitchburg, Massachusetts 01420
(Address of principal executive offices)

(978) 345-5000
(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes X No__

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

Large Accelerated filer [ ] Accelerated filer [ ] Non-Accelerated filer [ ] Smaller reporting company [X]

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

As of November 10, 2012 there were 2,790,514 shares of the Company’s common stock outstanding.
Explanatory Note: The registrant is filing its Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2012 (the “Form 10-Q”) in reliance upon the Securities and Exchange Commission's Release No. 68224 issued on November 14, 2012. Analysis of the Company's discontinued operations and goodwill, to be conducted in conjunction with a valuation firm based in New York City, was delayed as a result of Hurricane Sandy and its aftermath causing delay in the timely completion of certain reviews and analysis with respect to the financial statements and related disclosures to be included in the Form 10-Q.

ARRHYTHMIA RESEARCH TECHNOLOGY, INC.

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Item 1. Consolidated Financial Statements
ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARIES
Consolidated Balance Sheets

	September 30, 2012 (Unaudited)	December 31, 2011 (Audited)
Current assets:		
Cash	$278,377	$1,358,223
Trade and other accounts receivable, net of allowance for doubtful accounts of $103,496 and $58,496, respectively	3,221,221	3,460,369
Inventories, net	3,220,480	3,267,482
Deferred income taxes	—	23,700
Prepaid tax	193,596	188,640
Deposits, prepaid expenses and other current assets	745,531	495,889
Current assets from discontinued operations	303,485	215,968
Total current assets	7,962,690	9,010,271
Property and equipment, net of accumulated depreciation of $10,737,157 and $10,168,679, respectively	7,322,589	7,641,309
Goodwill	—	1,479,727
Other intangible assets, net	193,211	149,763
Long-term deferred tax asset, net	1,862,600	—
Non-current assets from discontinued operations	291,403	946,361
Total assets	$17,632,493	$19,227,431
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$2,534,110	$2,128,447
Accrued payroll and expenses and customer deposits	393,631	513,131
Current portion of equipment note	264,484	—
Demand line of credit	800,000	—
Performance guarantee liability	1,000,000	—
Current liabilities from discontinued operations	603,067	250,016
Total current liabilities	5,595,292	2,891,594
Long-term liabilities:		
Long-term portion of deferred gain on lease	10,051	13,401
Long-term deferred tax liability, net	—	470,000
Long-term portion of equipment note	1,058,941	—
Total long-term liabilities	1,068,992	483,401
Total liabilities	6,664,284	3,374,995
Shareholders' equity:		
Preferred stock, $1 par value; 2,000,000 shares authorized, none issued	—	—
Common stock, $0.01 par value; 10,000,000 shares authorized,	39,265	39,265

3,926,491 shares issued, 2,790,514 outstanding		
Additional paid-in-capital	10,846,988	10,762,338
Common stock held in treasury, 1,135,977 shares at cost	(3,099,842)	(3,099,842)
Accumulated other comprehensive income from foreign currency translation	42,502	42,502
Retained earnings	3,139,296	8,108,173
Total shareholders' equity	10,968,209	15,852,436
Total liabilities and shareholders' equity	$17,632,493	$19,227,431

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The accompanying notes are an integral part of the consolidated financial statements.

ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Loss

(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Revenue	$4,839,812	$6,756,850	$15,881,161	$18,929,495
Cost of sales	4,112,599	5,266,184	13,106,456	14,827,889
Gross profit	727,213	1,490,666	2,774,705	4,101,606
Selling and marketing	186,178	196,768	692,272	694,273
General and administrative	720,515	657,021	2,141,089	1,994,282
Research and development	115,034	99,173	380,266	287,037
Goodwill impairment	1,479,727	—	1,479,727	—
Income (loss) from operations	(1,774,241)	537,704	(1,918,649)	1,126,014
Other income (expense), net	(8,328)	2,749	(23,131)	12,220
Income (loss) from continuing operations before income taxes	(1,782,569)	540,453	(1,941,780)	1,138,234
Income tax provision (benefit)	(309,500)	—	(580,400)	103,000
Income (loss) from continuing operations	(1,473,069)	540,453	(1,361,380)	1,035,234
Discontinued Operations				
Loss from discontinued operations, net of taxes	(1,083,744)	(614,466)	(2,611,067)	(1,336,658)
Loss on sale of assets of discontinued operations including impairment charge of $1,282,787, net of taxes (see note 9)	(912,311)	—	(912,311)	—
Loss from discontinued operations, net of taxes	(1,996,055)	(614,466)	(3,523,378)	(1,336,658)
Net loss	$(3,469,124)	$(74,013)	$(4,884,758)	$(301,424)
Other comprehensive income (loss)				
Foreign currency translation adjustments	—	(1,829)	—	23,690
Other comprehensive income (loss)	—	(1,829)	—	23,690
Comprehensive loss	$(3,469,124)	$(75,842)	$(4,884,758)	$(277,734)
Earnings or (loss) per share - basic and diluted				
Continuing operations	(0.53)	0.19	(0.49)	0.37
Discontinued operations	(0.71)	(0.22)	(1.26)	(0.48)
Loss per share - basic and diluted	(1.24)	(0.03)	(1.75)	(0.11)
Weighted average common shares outstanding - basic and diluted	2,790,514	2,790,514	2,790,514	2,790,514

The accompanying notes are an integral part of the consolidated financial statements.

ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity

(Unaudited)

	Common Stock		Additional paid-in capital	Treasury stock	Accumulated other comprehensive income	Retained earnings	Total
	Shares	Amount					
December 31, 2011	3,926,491	$39,265	$10,762,338	$(3,099,842)	$ 42,502	$8,108,173	$15,852,436
Share based compensation			84,650				84,650
Cash dividends						(84,119)	(84,119)
Net loss						(4,884,758)	(4,884,758)
September 30, 2012	3,926,491	$39,265	$10,846,988	$(3,099,842)	$ 42,502	$3,139,296	$10,968,209

The accompanying notes are an integral part of the consolidated financial statements.

ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Unaudited)

	Nine months ended September 30, 2012	2011
Cash flows from operating activities:		
Net loss	$(4,884,758)	$(301,424)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Loss from discontinued operations including loss on sale of assets net of taxes	3,523,378	1,336,658
Amortization of the gain on lease	(3,350)	(3,350)
Goodwill impairment	1,479,727	—
Depreciation and amortization	1,074,764	1,047,670
Provision for doubtful accounts	45,000	(40,480)
Deferred income taxes	(575,900)	29,500
Share based compensation	84,650	85,385
Changes in operating assets and liabilities:		
Trade and other accounts receivable	194,148	(895,274)
Inventories	47,002	340,553
Deposits, prepaid expenses and other assets	(254,598)	(2,927)
Accounts payable and accrued expenses	286,168	(54,502)
Net cash used in operating activities of discontinued operations	(2,514,592)	(1,307,065)
Net cash provided by operating activities of continuing operations	1,016,231	1,541,809
Net cash (used in) provided by operating activities	(1,498,361)	234,744
Cash flows from investing activities:		
Capital expenditures	(893,887)	(1,271,807)
Proceeds received from sale of fixed asset	306,285	—
Net cash used in investing activities of discontinued operations	(484,481)	(172,907)
Net cash used in investing activities of continuing operations	(587,602)	(1,271,807)
Net cash used in investing activities	(1,072,083)	(1,444,714)
Cash flows from financing activities:		
Proceeds from line of credit	800,000	—
Proceeds from equipment note	262,960	—
Principal payments on equipment note	(48,119)	—
Cash dividend paid	(84,119)	(336,472)
Net cash provided by financing activities of discontinued operations	631,897	—
Net cash provided by (used in) financing activities of continuing operations	930,722	(336,472)
Net cash provided by (used in) financing activities	1,562,619	(336,472)
Effect of currency translation on cash and cash equivalents	—	9,347
Net decrease in cash and cash equivalents	(1,007,825)	(1,537,095)
Cash at beginning of period	1,358,223	3,796,637
Cash at end of period	$350,398	$2,259,542
Less cash of discontinued operations at end of period	72,021	$185,573
Cash of continuing operations at end of period	$278,377	$2,073,969

The accompanying notes are an integral part of the consolidated financial statements.

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ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Unaudited)

Supplemental Cash Disclosures

	Nine months ended September 30,	
	2012	2011
Cash paid for interest	$15,097	$—
Cash paid for income taxes	—	130,000
Acquisition of fixed assets with an equipment note	476,687	—
Non-cash adjustments to discontinued operations included the following items:		
Accrual of performance guarantee liability	$1,000,000	—
Impairment of fixed assets to estimated fair value	1,063,321	—

The accompanying notes are an integral part of the consolidated financial statements.

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Notes to the Consolidated Financial Statements

1. Basis of Presentation:

The unaudited interim consolidated financial statements and related notes have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Accordingly, certain information and footnote disclosures normally included in complete financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been omitted pursuant to such rules and regulations. The accompanying unaudited interim consolidated financial statements and related notes should be read in conjunction with the consolidated financial statements and notes thereto included in the Arrhythmia Research Technology, Inc. ("ART") and subsidiaries (the "Company") Annual Report on Form 10-K for the year ended December 31, 2011 filed with the SEC on April 25, 2012.

The information presented reflects, in the opinion of the management of the Company, all adjustments necessary for a fair presentation of the financial results for the interim periods presented.

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. Operating results for interim periods are not necessarily indicative of results that may be expected for the entire fiscal year.

Principles of Consolidation

The consolidated financial statements include the accounts of ART, Micron Products, and the discontinued operations of WirelessDx. All intercompany balances and transactions have been eliminated in consolidation.

Operating matters and liquidity

The Company has experienced net operating losses from June 2011 through September 30, 2012, including a net loss of $4.9 million for the nine months then ended. The Company has borrowings of $800,000 under its line of credit with a bank at September 30, 2012 and $880,000 of available funds under this line of credit based upon its borrowing base formula. Borrowings under the line of credit become due in April 2013.

In an effort to better control costs and overall operations, the Company decided to discontinue operations of its WirelessDx segment. For the nine months ended September 30, 2012, WirelessDx incurred a cash flow deficit of over $3 million. As the Company resumes its focus on its core business, Micron, further cost savings will be identified and cost savings actions will be implemented if necessary.

The Company expects that its current and anticipated financial resources, including the $880,000 available under its credit facility with its bank, are adequate to maintain current and planned operations through December 31, 2013. However, if the Company is not successful in generating sufficient revenues to fund its operations or if the Company is unable to obtain additional debt funding, it may not be able to fund operations beyond December 31, 2013. The Company expects to continue to expand its product offerings and extend the due date of its debt and improve sales with new and existing channels. The Company expects to meet its goals in these areas and generate the additional cash needed to fund operations into 2013 and beyond; however, there can be no assurance that it will be able to do so. The ability of the Company to realize the carrying value of its assets depends on its ability to successfully execute on its long-term business plan.

Reclassifications

Certain reclassifications have been made to the 2011 financial statements to conform them with the presentation used in 2012 (primarily to reflect discontinued operations). Such reclassifications had no impact on the Company's reported results of operations.

2. Accounts Receivable

Management regularly reviews accounts receivable to determine if any receivables will potentially be uncollectible. The Company includes any accounts receivable balances that are determined to be uncollectible, along with a general reserve, in our overall allowance for doubtful accounts. After all attempts to collect a receivable have failed, the receivable is written off against the allowance. Based on the information available to us, management believes the allowance for doubtful accounts of $103,496 as of September 30, 2012 is adequate.

3. Inventories:

Inventories consist of the following as of:	September 30, 2012	December 31, 2011
Raw materials	$806,774	$647,906
Work-in-process	220,467	395,176
Finished goods	2,193,239	2,224,400
Total	$3,220,480	$3,267,482

The value of silver in inventory at September 30, 2012 and December 31, 2011 as a part of finished goods as plated sensors, work in process, or raw materials was $735,570 and $886,002, respectively. Inventories are stated at their net realizable value, and net of a reserve for slow moving and obsolete inventory of $199,235 and $137,500 at September 30, 2012 and December 31, 2011, respectively.

4. Goodwill and Intangible Assets

Goodwill

The Company's annual goodwill impairment test is conducted at December 31 of each calendar year and interim evaluations are performed when the Company determines that a triggering event has occurred that would more likely than not reduce the fair value of its goodwill below it carrying value. During the third quarter of 2012, due to a decline in the market price of the Company's stock, the market capitalization of the Company was below the carrying value which management considered a triggering event and therefore performed an interim impairment test.

Management has updated the annual impairment and year-end analysis as of September 30, 2012. Based on the step 1 analysis performed, management, with the assistance of a third party valuation specialist, determined on November 17, 2012 that the Company's fair value was below the carrying value of its equity as of September 30, 2012. Based on the prolonged decline in the Company's stock price, management determined that the market approach would not be a good indicator of fair value. The Company's step 1 analysis was performed using the income approach in which the Company utilized a discounted cash flow analysis to determine the fair value of its reporting unit. The income approach requires management to estimate a number of factors which are considered Level 3 inputs, including projected future operating results, economic projections, anticipated future cash flows and discount rates. As part of its valuation to determine the total impairment charge, the Company is also required to perform a step 2 analysis which includes estimating the fair value of significant tangible and intangible long-lived assets.

As a result, the Company has preliminarily determined that the full value of its goodwill was impaired and has recorded in the third quarter of 2012 an estimated preliminary impairment charge of $1,479,727. Due to the timing and complexity of step 2 of the impairment test, which is required to determine the actual impairment, the Company was unable to finalize the amount of impairment prior to filing the Form 10-Q for the quarter ended September 30, 2012. Step 2 of the impairment test will be completed in the fourth quarter of 2012. Any adjustment to the estimated impairment charge made in the third quarter of 2012 will be recorded in the fourth quarter of 2012.

As a result of the triggering events described above in our goodwill impairment analysis, the Company reviewed its long-lived assets for recoverability. The long-lived asset from continuing operations did not require an impairment.

Intangible Assets

Intangible assets consist of the following:

	September 30, 2012				December 31, 2011		
	Weighted average remaining life (years)	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Patents and Trademarks	13	$436,021	$(419,406)	$16,615	$381,605	$(361,942)	$19,663
Patents and Trademarks*	—	155,012	—	155,012	106,766	—	106,766
Trade names	9	33,250	(11,666)	21,584	33,250	(9,916)	23,334
Total Intangible assets:		$624,283	$(431,072)	$193,211	$521,621	$(371,858)	$149,763

* Patents and Trademarks not yet in service.

5. Debt:

At September 30, 2012, the Company has an demand line of credit that provides for borrowings up to 80% of eligible accounts receivable, and eligible finished goods inventory up to $700,000 to a maximum of $3,000,000. Borrowings are charged an interest rate of 2% over LIBOR. The interest rate at September 30, 2012 was 2.33%. This facility has no borrowing base charge. During the nine months ended September 30, 2012, an aggregate of $800,000 was drawn on this line and remains outstanding at September 30, 2012. The demand line of credit was renewed in April 2012 and expires in April 2013.

On March 16, 2011, ART obtained a $1,000,000 letter of credit against the line of credit in favor of the Bank of Nova Scotia. This letter replaced the Province of Prince Edward Island's performance guarantee in conjunction with the now discontinued operations of WirelessDx.

The agreement contains covenants that apply upon drawing on the line. The covenants relate to various matters including notice prior to executing further borrowings and security interests, merger or consolidation, acquisitions, guarantees, sales of assets other than in the normal course of business, leasing, changes in ownership and payment of dividends.

The Company has a master lease agreement with its bank that allows for money to be drawn on standard terms for the purchase of equipment. During the nine months ended September 30, 2012, a total of $523,269 was drawn down to acquire production equipment for Micron and $888,649 for the discontinued operations capital equipment needs. At September 30, 2012, the current balance of these notes were $475,150 and $848,275, respectively. The term of these capital leases is five years.

6. Income Taxes:

The following table sets forth certain information regarding income tax benefit for the three months ended September 30, 2012 and 2011:

	September 30, 2012	September 30, 2011	$ Change
Income tax provision/(benefit)	$(309,500)	$—	$(309,500)

The following table sets forth certain information regarding income tax provision (benefit) for the nine months ended September 30, 2012 and 2011:

	September 30, 2012	September 30, 2011	$ Change
Income tax provision/(benefit)	$(580,400)	$103,000	$(683,400)

The Company accounts for income taxes in accordance with ASC 740 “Income Taxes,” which requires recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities using tax rates in effect for the year in which the differences are expected to reverse.

As of December 31, 2011, the Company had recorded a valuation allowance against the Canadian portion of its deferred tax assets, consisting of a net operating loss carry forward. Based on the Company's pre-tax losses for the years since the acquisition of WirelessDx, management determined that realization of the assets cannot be considered more likely than not at this time. As of September 30, 2012, management assessed the valuation allowance and determined a full valuation allowance was still necessary. If and when management determines the valuation allowance should be reversed, the adjustment would result in a tax benefit in the consolidated statements of comprehensive income (loss).

As of September 30, 2012, management assessed whether a valuation allowance was necessary for the US portion of its deferred tax assets resulting from the net operating losses. Management believes that no valuation allowance is required as the assets are expected to be used by income from continuing operations over the next three years.

The Company has completed its carry back claim of the federal 2011 loss to offset taxable income previously reported in 2009 and 2010 . As a result of the carry back claim, federal research and development credits and corporate alternative minimum tax credits of $86,000 and $3,000, respectively, are now available in future periods. The Company has also claimed a refund of $282,000 for taxes previously remitted in these periods which is recorded as an other current asset.

The Company files income tax returns in the U.S. Federal jurisdiction and various state and foreign jurisdictions. The periods from 2008 to 2011 remain open to examination by the IRS, state, and foreign jurisdictions. The Company believes it is not subject to any significant tax risks related to uncertain tax positions. The Company does not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the nine months ended September 30, 2012 and 2011.

7. Share-Based Compensation:

The Company accounts for non-cash share based compensation under Accounting Standards Codification ("ASC") 718 “Stock Compensation”, which establishes accounting for equity instruments exchanged for employee services. Under the provisions of ASC 718, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee’s requisite service period (generally the vesting period of the equity grant).

The Company recognized share-based compensation expense of $20,148 and $23,521 for the three months ended September 30, 2012 and 2011, and $84,650 and $85,385 for the nine months ended September 30, 2012 and 2011, respectively.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option-pricing model. Key assumptions used to estimate the fair value of the stock options include the exercise price of the award, the expected option term, and the expected volatility of the Company’s stock over the option’s expected term, the risk free interest rate over the option’s expected term, and the Company’s expected annual dividend yield. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the Company’s stock options for the nine months ended September 30, 2012 and 2011. Estimates of fair values are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

Two grants totaling 160,000 options to 9 persons, including directors and management, were made during the nine months ended September 30, 2011. There were no grants for the nine months ended September 30, 2012.

The following is a weighted average of the assumptions used to estimate the fair market value of options granted using the Black Scholes valuation method:

	Nine months ended September 30, 2011
Dividend Yield	2.1%
Expected Volatility	31.24%
Risk Free Interest Rate	0.98%
Expected Option Terms (in years)	6.5

Share-based Incentive Plan

At September 30, 2012, the Company had one stock option plan that provides for both incentive and non-qualified stock options to be granted to certain eligible employees, non-employee directors, or consultants. On March 10, 2010, the Company's Board of Directors adopted the Arrhythmia Research Technology, Inc. 2010 Equity Incentive Plan (the “2010 Plan”) upon the recommendation of the Compensation Committee. The 2010 Plan was approved by stockholders at the 2010 Annual Meeting. The 2010 Plan authorizes the issuance of an aggregate of 500,000 shares, namely, 400,000 shares of our common stock plus an aggregate of 100,000 shares previously reserved for issuance under the Company's 2005 Stock Award Plan (the “2005 Plan”). The 2010 Plan replaced in its entirety the 2005 Plan, under which no grants have been made. The Company's 2001 Stock Option Plan (the "2001 Plan"), which expired in 2011, will continue to govern outstanding options but no further options will be granted under the 2001 Plan. The options granted have either six or ten year contractual terms and either vest immediately or vest annually over a five-year term.

At September 30, 2012, there were 340,000 shares available for future grants under the above stock option plan.

The following table sets forth the stock option transactions for the nine months ended September 30, 2012:

	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (years)	Aggregate intrinsic value
Outstanding at December 31, 2011	409,000	$6.78	5.2	$—
Granted	—	—	—	—
Exercised	—	—	—	—