

AEROSONIC CORP /DE/  
Form 10-Q  
September 26, 2008  
Table of Contents

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

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended August 1, 2008

OR

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

For the transition period from            to

Commission file number 1-11750

**AEROSONIC CORPORATION**

(Exact name of registrant as specified in its charter)

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**Delaware** **74-1668471**  
(State or other jurisdiction of **(I.R.S. Employer**  
**incorporation or organization)** **Identification No.)**  
**1212 North Hercules Avenue**  
**Clearwater, Florida 33765**  
(Address of principal executive offices and Zip Code)

**Registrant's telephone number, including area code: (727) 461-3000**

**Not Applicable**

**(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  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 (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

As of August 31, 2008, the issuer had 3,592,352 shares of Common Stock outstanding, net of treasury shares.

**Table of Contents**

<b>PART I</b>		<b><u>FINANCIAL INFORMATION</u></b>	
Item 1	<u>Financial Statements</u>		
	<u>Consolidated Balance Sheets as of August 1, 2008 (unaudited) and January 31, 2008</u>		4
	<u>Consolidated Statements of Operations (unaudited) for the three and six months ended August 1, 2008 and July 27, 2007</u>		5
	<u>Consolidated Statements of Cash Flows (unaudited) for the six months ended August 1, 2008 and July 27, 2007</u>		6
	<u>Notes to the Consolidated Financial Statements (unaudited)</u>		7
Item 2	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>		12
Item 3	<u>Quantitative and Qualitative Disclosures About Market Risk</u>		17
Item 4	<u>Controls and Procedures</u>		18
<b>PART II</b>		<b><u>OTHER INFORMATION</u></b>	
Item 1	<u>Legal Proceedings</u>		18
Item 1A	<u>Risk Factors</u>		18
Item 2	<u>Unregistered Sale of Equity Securities and Use of Proceeds</u>		18
Item 3	<u>Defaults Upon Senior Securities</u>		18
Item 4	<u>Submission of Matters to a Vote of Security Holders</u>		18
Item 5	<u>Other Information</u>		18
Item 6	<u>Exhibits</u>		19
	<u>Signatures</u>		20

**Table of Contents**

**PART I - FINANCIAL INFORMATION**

**Cautionary Note on Forward-Looking Statements**

Certain statements made in this Quarterly Report on Form 10-Q that are not statements of historical or current facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from historical results or from any future results expressed or implied by such forward-looking statements.

In addition to statements that explicitly describe such risks and uncertainties, readers are urged to consider statements in future or conditional tenses or, include terms such as believes, belief, expects, intends, anticipates or plans to be uncertain and forward-looking. Forward-looking statements are based on management's beliefs and assumptions, using information currently available to us as to current expectations concerning future events and trends and are necessarily subject to uncertainties, many of which are outside of the Company's control. You should specifically consider the factors identified in Part II Item 1A. RISK FACTORS of this Quarterly Report on Form 10-Q, which could cause actual results to differ from those referred to in forward-looking statements.

We claim the protection of the safe harbor for forward-looking statements provided for in the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934 (the **Exchange Act**), as amended. Except as required by applicable law, we undertake no obligation, and do not intend, to update these forward-looking statements to reflect events or circumstances that arise after the date they are made. Furthermore, as a matter of policy, we do not generally make any specific projections as to future earnings, nor do we endorse any projections regarding future performance, which may be made by others outside our company.

All subsequent written and oral forward-looking statements attributable to the Company or individuals acting on its behalf are expressly qualified in their entirety by this Cautionary Note on Forward-Looking Statements.

**Table of Contents****PART I - FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****AEROSONIC CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

	<b>August 1, 2008 (unaudited)</b>	<b>January 31, 2008</b>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 84,000	\$ 28,000
Accounts receivable, net of allowance for doubtful accounts of \$87,000 and \$131,000, respectively	3,752,000	4,593,000
Income taxes receivable	3,000	29,000
Inventories, net	7,594,000	7,760,000
Prepaid expenses	177,000	154,000
Property held for sale, net	1,712,000	1,712,000
Deferred income taxes	1,044,000	1,151,000
<b>Total current assets</b>	<b>14,366,000</b>	<b>15,427,000</b>
Property, plant and equipment, net	1,917,000	2,127,000
Deferred income taxes	2,845,000	2,479,000
Intangible assets, net	779,000	888,000
Goodwill	366,000	366,000
Other assets, net	80,000	93,000
<b>Total assets</b>	<b>\$ 20,353,000</b>	<b>\$ 21,380,000</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current liabilities:</b>		
Current maturities of long-term debt and notes payable	\$ 5,639,000	\$ 5,814,000
Accounts payable, trade	2,600,000	3,107,000
Revolving credit facility	1,674,000	1,514,000
Compensation and benefits	1,017,000	956,000
Accrued sales commissions	242,000	242,000
Accrued expenses and other liabilities	1,210,000	1,364,000
<b>Total current liabilities</b>	<b>12,382,000</b>	<b>12,997,000</b>
Unrecognized tax benefits	258,000	258,000
Deferred income taxes	311,000	331,000
<b>Total liabilities</b>	<b>12,951,000</b>	<b>13,586,000</b>
<b>Commitments and contingencies (Note 8)</b>		
<b>Stockholders equity:</b>		
Common stock, \$.40 par value: authorized 8,000,000 shares; issued 4,023,119 shares at August 1, 2008 and 4,008,053 shares at January 31, 2008; outstanding 3,592,382 shares at August 1, 2008 and 3,577,286 at January 31, 2008	1,607,000	1,605,000
Additional paid-in capital	4,893,000	4,817,000

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Retained earnings	4,065,000	4,535,000
Less treasury stock: 430,767 shares at both August 1, 2008 and January 31, 2008, at cost	(3,163,000)	(3,163,000)
Total stockholders' equity	7,402,000	7,794,000
Total liabilities and stockholders' equity	\$ 20,353,000	\$ 21,380,000

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

**Table of Contents****AEROSONIC CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)**

	Three Months Ended		Six Months Ended	
	August 1, 2008	July 27, 2007	August 1, 2008	July 27, 2007
Sales, net	\$ 5,962,000	\$ 5,292,000	\$ 12,613,000	\$ 12,117,000
Cost of sales	3,922,000	5,197,000	9,170,000	10,247,000
Gross profit	2,040,000	95,000	3,443,000	1,870,000
Selling, general and administrative expenses	(2,297,000)	(2,332,000)	(3,933,000)	(4,193,000)
Gain on sale of property, plant and equipment	2,000	51,000	4,000	315,000
Operating loss	(255,000)	(2,186,000)	(486,000)	(2,008,000)
Other income (expense):				
Interest expense, net	(90,000)	(36,000)	(246,000)	(76,000)
Other expense	(24,000)		(17,000)	
	(114,000)	(36,000)	(263,000)	(76,000)
Loss before income taxes	(369,000)	(2,222,000)	(749,000)	(2,084,000)
Income tax benefit	135,000	919,000	279,000	843,000
Net loss	\$ (234,000)	\$ (1,303,000)	\$ (470,000)	\$ (1,241,000)
Basic loss per share	\$ (0.06)	\$ (0.37)	\$ (0.13)	\$ (0.35)
Diluted loss per share	\$ (0.06)	\$ (0.37)	\$ (0.13)	\$ (0.35)

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

**Table of Contents****AEROSONIC CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**

	Six Months Ended	
	August 1, 2008	July 27, 2007
<b>Cash flows from operating activities:</b>		
Net loss	\$ (470,000)	\$ (1,241,000)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation	190,000	254,000
Amortization	121,000	11,000
Bad debt expense	100,000	26,000
Stock-based compensation	78,000	25,000
Gain on sale of property, plant and equipment	(4,000)	(315,000)
Deferred income taxes	(279,000)	(853,000)
Changes in assets and liabilities:		
Accounts receivable, net	741,000	516,000
Income taxes receivable	26,000	(37,000)
Inventories, net	166,000	(516,000)
Prepaid expenses	(23,000)	29,000
Other assets	1,000	(10,000)
Accounts payable, trade	(507,000)	440,000
Compensation and benefits	61,000	(237,000)
Accrued sales commissions		7,000
Accrued expenses and other liabilities	(154,000)	833,000
Net cash provided by (used in) operating activities	47,000	(1,068,000)
<b>Cash flows from investing activities:</b>		
Proceeds from the sale of property	24,000	510,000
Purchases of property, plant and equipment		(339,000)
Net cash provided by investing activities	24,000	171,000
<b>Cash flows from financing activities:</b>		
Net increase in revolving credit facility	160,000	
Principal payments on current maturities of long-term debt and notes payable	(175,000)	(119,000)
Net cash used in financing activities	(15,000)	(119,000)
Change in cash and cash equivalents	56,000	(1,016,000)
Cash and cash equivalents, beginning of period	28,000	1,276,000
<b>Cash and cash equivalents, end of period</b>	<b>\$ 84,000</b>	<b>\$ 260,000</b>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid during the period for:		
Interest	\$ 253,000	\$ 77,000
Income taxes	\$	\$ 50,000



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

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**Table of Contents**

**AEROSONIC CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

**Note 1. Description of Business, Basis of Presentation and Recent Accounting Pronouncements**

***Description of Business***

The primary business of Aerosonic Corporation and subsidiaries (the **Company**) is to manufacture and sell aircraft instrumentation to government and commercial users from its facilities located in Florida and Virginia. The Company's customers are located worldwide.

On August 21, 2007, the Company purchased 100% of the outstanding stock of OP Technologies, Inc. (**OP Tech**), an Oregon-based developer and manufacturer of cockpit glass display solutions.

***Financial Condition and Management's Plans***

As of both August 1, 2008 and January 31, 2008 the Company was not in compliance with certain debt covenants with our lender, Wachovia Bank, N.A. (**Wachovia**). As a result, the Company's total debt with Wachovia, which equals \$7,313,000, is subject to acceleration and is classified as current in our consolidated balance sheets at both August 1, 2008 and January 31, 2008. The Company currently has a written waiver through October 31, 2008 relating to its covenant noncompliance. The Company expects to restructure its debt. Based upon the Company's analysis of its existing contracts and its current product order backlog, the Company believes that it will be able to generate sufficient cash flows to fund its operating needs through the remainder of fiscal 2009. If certain of these events do not materialize, the Company will explore other alternatives to meet its cash requirements.

***Basis of Presentation***

The Company prepares its consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (**U.S. GAAP**). These principles require management to make estimates and judgments that affect reported and contingent amounts of assets, liabilities, revenues and expenses, including such items as (i) inventory, restructuring and environmental costs, (ii) percentage-of-completion estimates, (iii) other miscellaneous accruals and (iv) valuation allowances for accounts receivable, inventory and deferred tax assets. Actual results may differ from these estimates under different assumptions or conditions, and such differences could be material.

The accompanying consolidated financial statements include the accounts of Aerosonic Corporation and its wholly-owned subsidiaries, Avionics Specialties, Inc. (**Avionics**) and OP Tech (since the date of acquisition). All significant intercompany balances and transactions have been eliminated in consolidation. The Company operates on a fiscal year that ends on January 31. Accordingly, all references to the second quarter mean the second quarter ended on the last Friday of July or the first Friday of August of the referenced fiscal year. For example, references to the second quarter of fiscal year 2009 mean the quarter ended August 1, 2008.

These financial statements are prepared on a basis consistent with, and should be read in conjunction with, the consolidated financial statements and related notes contained in the Annual Report on Form 10-K for the fiscal year ended January 31, 2008. Operating results for the six months ended August 1, 2008 are not necessarily indicative of the results that may be expected for the year ending January 31, 2009.

Certain amounts in the prior fiscal period's consolidated financial statements have been reclassified to conform with the August 1, 2008 presentation. Such reclassification had no effect on net income or stockholders' equity as previously reported.

***Recent Accounting Pronouncements***

In February 2007, the Financial Accounting Standards Board (**FASB**) issued Statement of Financial Accounting Standards (**SFAS**) No. 159, *The Fair Value Option for Financial Assets and Liabilities* (**SFAS 159**). SFAS 159 permits companies to make an election to carry certain eligible financial assets and liabilities at fair value, even if fair value measurement has not historically been required for such assets and liabilities under U.S. GAAP. Effective February 1, 2008, the Company did not elect the fair value option for any instruments.



**Table of Contents**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( **SFAS 157** ). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP, and expands disclosures about fair value measurements. The Company was required to adopt the provisions of SFAS 157 in the first quarter of the fiscal year beginning February 1, 2008. The adoption of SFAS 157 had no effect on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations - A Replacement of FASB Statement No. 141* ( **SFAS 141(R)** ). SFAS 141(R) retains the fundamental requirements in SFAS No. 141, *Business Combinations* ( **SFAS 141** ), that the acquisition method of accounting (which SFAS 141 called the *purchase method*) be used for all business combinations and that an acquirer be identified for each business combination. It also retains the guidance in SFAS 141 for identifying and recognizing intangible assets separately from goodwill. However, SFAS 141(R) will change the accounting treatment for certain specific items, including:

All business combinations (whether full, partial, or step acquisitions) will result in all assets and liabilities of an acquired business being recorded at fair value, with limited exceptions;

Acquisition costs will be generally expensed as incurred;

The fair value of the purchase price, including the issuance of equity securities, will be determined on the acquisition date;

Purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. Upon a loss of control, the interest sold, as well as any interest retained, will be measured at fair value, with any gain or loss recognized in earnings;

Non-controlling interests (formerly known as minority interests ) will be valued at fair value at the acquisition date;

Certain acquired contingent liabilities will be recorded at fair value at the acquisition date and subsequently measured at either the higher of such amount or the amount determined under existing guidance for non-acquired contingencies;

Restructuring costs associated with a business combination will be generally expensed subsequent to the acquisition date; and

Changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally will affect income tax expense.

SFAS 141(R) also includes a substantial number of new disclosure requirements. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. SFAS 141(R) will have an effect on the Company's future acquisitions.

**Note 2. Accounts Receivable**

The allowance for doubtful accounts activity for the six months ended August 1, 2008 and July 27, 2007 was as follows:

Six Months Ended,	
August 1, 2008	July 27, 2007

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Beginning balance	\$ 131,000	\$ 10,000
Amounts written off	(144,000)	
Amounts provided for	100,000	26,000
Ending balance	\$ 87,000	\$ 36,000

**Table of Contents****Note 3. Inventories**

Inventories at August 1, 2008 and January 31, 2008 consisted of the following:

	August 1, 2008	January 31, 2008
Raw materials	\$ 6,318,000	\$ 6,414,000
Work in process	1,993,000	2,070,000
Finished goods	172,000	153,000
Reserve for obsolete and slow moving inventory	(889,000)	(877,000)
<b>Inventories, net</b>	<b>\$ 7,594,000</b>	<b>\$ 7,760,000</b>

The reserve for obsolete and slow moving inventory activity for the six months ended August 1, 2008 and July 27, 2007 was as follows:

	Six Months Ended, August 1, 2008	July 27, 2007
Beginning balance	\$ 877,000	\$ 618,000
Amounts charged (credited) to operations	12,000	25,000
<b>Ending balance</b>	<b>\$ 889,000</b>	<b>\$ 643,000</b>

**Note 4. Intangible Assets**

Amortization expense related to intangible assets for the three and six months ended August 1, 2008 was \$54,000 and \$110,000, respectively. Since these intangible assets were acquired during fiscal year 2008, there was no amortization expense related to intangible assets for both the three and six months ended July 27, 2007. Amortization expense for the three and six months ended July 27, 2007 of \$11,000 and \$11,000, respectively, was related to capitalized debt issue costs.

**Note 5. Accrued Expenses and Other Liabilities**

Accrued expenses and other liabilities as of August 1, 2008 and January 31, 2008 consisted of the following:

	August 1, 2008	January 31, 2008
Environmental liability	\$ 509,000	\$ 639,000
Warranty liability	227,000	197,000
Product development programs	141,000	141,000
Other	333,000	387,000
<b>Accrued expenses and other liabilities</b>	<b>\$ 1,210,000</b>	<b>\$ 1,364,000</b>

On March 9, 2007, the Company announced the consolidation of the manufacturing functions of its Earlsyville, Virginia, operation into its Clearwater, Florida facility. This consolidation was a continuation of the Company's actions to be more responsive to customers' demands and was completed in fiscal year 2008. Restructuring costs of \$76,000 and \$503,000, are included in selling, general and administrative expenses for the three months ended August 1, 2008 and July 27, 2007, respectively. Restructuring costs of \$142,000 and \$785,000 are included in selling, general and administrative expenses for the six months ended August 1, 2008 and July 27, 2007, respectively. Approximately \$35,000 remains to be paid as of August 1, 2008 and is included in "Other" in the preceding table.



**Table of Contents****Note 6. Long-Term Debt and Notes Payable and Revolving Credit Facility**

The Company's credit facilities are with Wachovia. In fiscal year 2008, the Company increased the maximum amount available to the Company under its credit facilities with Wachovia to \$8,420,000 and delivered to Wachovia two replacement promissory notes as follows: (i) a Renewal and Future Advance Promissory Note in the amount of \$3,920,000 (the **Future Advance Note**), and (ii) a Renewal and Amended Term Promissory Note in the amount of \$2,000,000 (the **Term Note** and together with the Future Advance Note, the **Notes**). The Future Advance Note is collateralized by the Company's real estate in Clearwater, Florida. The Term Note is collateralized by the Company's real estate in Earlysville, Virginia. The interest rate on the revolving credit facility as well as on the Notes is one-month LIBOR (which was 2.46% and 3.27% at August 1, 2008 and January 31, 2008, respectively), plus 300 basis points. Total available borrowings on the revolving credit facility at August 1, 2008 and January 31, 2008, including amounts borrowed as of those dates, were \$972,000 and \$1,762,000, respectively.

The Company's long-term debt agreements with Wachovia contain certain financial and other restrictive covenants, including the requirement to maintain: (i) at all times, a ratio of total liabilities to tangible net worth that does not exceed 1.30 to 1.00; and (ii) at the end of each fiscal quarter, a cash flow coverage ratio (with regard to the debt service) of at least 1.25 to 1.00.

As of both August 1, 2008 and January 31, 2008, the Company was not in compliance with the cash flow coverage ratio covenant and the total liability to tangible net worth covenant. Wachovia has provided a written waiver of the non-compliance to the Company through October 31, 2008. Consequently, the entire amount of long-term debt is classified as a current maturity at both August 1, 2008 and January 31, 2008.

The other restrictive covenants, among other things, require the Company to obtain consent from the lender prior to making a material change of management, guarantee or otherwise become responsible for obligations of any other person or entity or assuming or becoming liable for any debt, contingent or direct, in excess of \$100,000.

Long-term debt and notes payable at August 1, 2008 and January 31, 2008 consisted of the following:

	August 1, 2008	January 31, 2008
Future Advance Promissory Note	\$ 3,664,000	\$ 3,816,000
Term Promissory Note	1,975,000	1,998,000
	5,639,000	5,814,000
Less: current maturities	(5,639,000)	(5,814,000)
Long-term debt and notes payable, less current maturities	\$	\$

Interest expense on long-term debt, notes payable and the revolving credit facility for the three months ended August 1, 2008 and July 27, 2007 was \$90,000 and \$55,000, respectively. Interest expense on long-term debt, notes payable and the revolving credit facility for the six months ended August 1, 2008 and July 27, 2007 was \$246,000 and \$93,000, respectively. These amounts are included in interest expense, net in the Company's consolidated statements of operation.

**Note 7. Stockholders' Equity***Earnings (Loss) Per Share*

Basic earnings (loss) per share are based upon the Company's weighted average number of common shares outstanding during each period. Diluted earnings (loss) per share are based upon the weighted average number of common shares outstanding during each period, assuming the issuance of common shares for all dilutive potential common shares outstanding during the period, using the treasury stock method. Potential common stock shares resulting from stock options were not included in the computation of diluted earnings (loss) per share for the three and six months ended August 1, 2008, and for the three and six months ended July 27, 2007, because the inclusion of the potential common stock would be anti-dilutive since the Company was in a net loss position and including such shares would reduce the net loss per share.





**Table of Contents**

	Three Months Ended,		Six Months Ended,	
	August 1, 2008	July 27, 2007	August 1, 2008	July 27, 2007
Weighted average shares outstanding basic	3,581,028	3,569,516	3,579,158	3,569,516
Dilutive effect of stock options				
Weighted average shares outstanding diluted	3,581,028	3,569,516	3,579,158	3,569,516

*Options to Purchase Stock*

On April 22, 2008, the Company issued to its President and Chief Executive Officer and to its Executive Vice President of Sales and Marketing, options to purchase 75,000 and 25,000 shares, respectively, of the Company's common stock at the market price of the Company's common stock on that day. These options vest from one to three years and from one to four years, respectively, from the date of grant.

*Stock-Based Compensation*

Total equity-based compensation of approximately \$51,000 and \$13,000 for the three months ended, and \$78,000 and \$25,000 for the six months ended, August 1, 2008 and July 27, 2007, respectively, relates to stock options granted and is included in selling, general and administrative expenses.

**Note 8. Commitments and Contingencies***Litigation*

From time to time, the Company may be involved in certain claims and legal actions arising in the ordinary course of business. As of August 1, 2008, there were no claims or legal actions that will have a material adverse effect on the Company's financial position, results of operations, or liquidity.

*Environmental*

In preparation for the sale of the Earlysville, Virginia facility, the Company engaged an environmental consulting firm to survey the property for possible soil or groundwater contamination. This survey revealed impacts to both shallow soils and groundwater that may have resulted from the accidental loss of solvents. As a result of the initial and subsequent surveys, contamination treatment was determined to be necessary for an estimated total cost of \$588,000, as determined by an environmental compliance specialist, and which is included in the environmental liability. Thus, in accordance with Emerging Issues Task Force 90-8, *Capitalization of Costs to Treat Environmental Contamination*, the Company has capitalized these contamination treatment costs in its fiscal year 2008 financial statements as an increase to property held for sale, net, since such costs will be incurred in preparation for the sale of the Earlysville, Virginia facility.

*Commitments*

There have been no material changes to our purchase and lease commitments from those disclosed in our Annual Report on Form 10-K for the year ended January 31, 2008. Total rent expense under the facility lease near Earlysville, Virginia for the three and six months ended August 1, 2008 was \$45,000 and \$84,000, respectively, which is included in cost of sales. There was no such rent expense for both the three and six months ended July 27, 2007 since the Virginia facility lease commenced in September 2007.

**Note 9. Subsequent Events**

On August 8, 2008, the Company sustained significant damage to one of the buildings comprising its Clearwater, Florida facility as a result of a fire. The building was primarily used for general storage and product testing, probes and sensor manufacturing, as well as for shipping and receiving. On August 29, 2008, the Company's insurer extended a \$1,000,000 advance to the Company, the proceeds of which will be applied towards replacement of the contents of the building that were destroyed by the fire. While the Company's main operating facility was not damaged by the fire, production was affected through loss of staged incoming raw materials and outgoing finished goods. We anticipate that the business interruption impact will be recoverable, in full or in part, under the Company's insurance policy. The Company is continuing to work through the details of a comprehensive recovery plan including the effects of this event on the Company's liquidity and cash flows.



## **Table of Contents**

On August 19, 2008, Mr. Charles L. Pope submitted his resignation as Executive Vice President, Chief Financial Officer and Secretary of the Company, effective as of September 19, 2008. The resignation of Mr. Pope is unrelated to his work performed and no issues have been raised regarding the integrity of the Company's consolidated financial statements.

On September 11, 2008, Jeffrey Hummel resigned as the Company's Controller, effective as of October 3, 2008. Since Mr. Pope's resignation as Chief Financial Officer, Mr. Hummel has not acted as interim Chief Financial Officer. Douglas Hillman, the Company's President and CEO has and will continue to act as interim Chief Financial Officer until a permanent successor is hired for that position.

On September 22, 2008, Mr. Pope entered into a consulting agreement with the Company pursuant to which he has agreed during a limited transition period to provide financial advisory and consulting services to the Company. The consulting agreement shall remain in effect for a 90 day period with 30 day automatic extensions, subject to termination at any time by either party. Pursuant to the terms of the consulting agreement, the Company shall pay Mr. Pope an hourly rate for his services plus reimbursement for travel and other expenses or disbursements. Mr. Pope shall not be required to devote more than 120 hours per month in performing services to the Company.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS ( MD&A )**

### **Results of Operations**

Sales for the second quarter of fiscal year 2009 increased \$670,000, or 13%, to \$5,962,000 when compared to \$5,292,000 for the second quarter of fiscal year 2008. On a year-to-date basis, net sales were \$12,613,000 during the first six months of fiscal year 2009, an increase of \$496,000, or 4%, when compared to \$12,117,000 for the first six months of fiscal year 2008. The increases in sales for the respective periods were driven primarily by improved operating efficiencies associated with the relocation, consolidation and integration of the previously decentralized operations of the Company.

Cost of sales for the second quarter of fiscal year 2009 decreased \$1,275,000, or 25%, to \$3,922,000 when compared to \$5,197,000 for the second quarter of fiscal year 2008. On a year-to-date basis, cost of sales were \$9,170,000 during the first six months of fiscal year 2009, a decrease of \$1,077,000, or 11%, when compared to \$10,247,000 for the first six months of fiscal year 2008. Gross margin increased from 2% for the second quarter of fiscal year 2008 to 34% for the second quarter of fiscal year 2009. On a year-to-date basis, gross margin increased from 15% for the first six months of fiscal year 2008 to 27% for the first six months of fiscal year 2009.

The increase in gross margin as a percentage of sales is due to the following:

improvement in operating efficiencies associated with the consolidation of the Earlysville, Virginia operations;

a reduction in manufacturing overhead as a result of the consolidation of the operations.

Improving gross margin will require the following:

improving controls over the manufacturing process;

planning inventory purchases and movement; and

reducing costs and inefficiencies in our operations through better resource management and improved accountability.

These initiatives will be complemented with a marketing and sales strategy that addresses the highly competitive environment.

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Selling, general and administrative expenses for the second quarter of fiscal year 2009 decreased \$35,000 when compared to the second quarter of fiscal year 2008. On a year-to-date basis, selling, general and administrative expenses decreased \$260,000 for the first six months of fiscal year 2009 when compared to the first six months of fiscal year 2008. This reduction in costs is mainly related to the scale down of the Earlysville, Virginia operations in connection with the consolidation and the resulting synergies obtained from the consolidation.

Interest expense, net increased \$54,000 to \$90,000 for the second quarter of fiscal year 2009 when compared to \$36,000 for the second quarter of fiscal year 2008 and increased \$170,000 to \$246,000 for the first six months of fiscal year 2009 when compared to \$76,000 for the first six months of fiscal year 2008. These increases are a function of larger average balances outstanding on our credit facilities.

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## **Table of Contents**

Operating results for the second quarter and for the first six months of fiscal year 2008 included a gain on sale of property, plant and equipment of \$51,000 and \$315,000, respectively. These gains were due to the sale of our Wichita, Kansas property as well as the sale of certain machinery and equipment that was no longer required for operations.

Income tax benefit decreased approximately \$784,000 for the second quarter of fiscal year 2009 when compared to the second quarter of fiscal year 2008. On a year-to-date basis, income tax benefit decreased \$564,000 for the first six months of fiscal year 2009 when compared to the first six months of fiscal year 2008. These decreases were primarily due to decreased operating losses during the respective periods.

### **Liquidity and Capital Resources**

Cash provided by operating activities was \$47,000 for the first six months of fiscal year 2009, an increase of \$1,115,000 when compared to the first six months of fiscal year 2008. This increase in cash provided is primarily attributable to the buildup of inventory and the payout of executive severance in the first six months of fiscal year 2008, in anticipation of the corporate consolidation, and the reduction of inventory purchases in the first six months of fiscal year 2009.

Cash provided by investing activities for the first six months of fiscal year 2009 and for the first six months of fiscal year 2008 consisted primarily of proceeds from the sale of property.

Cash used in financing activities for the first six months of fiscal year 2009 decreased \$104,000 when compared to the first six months of fiscal year 2008. This decrease is a function of increased borrowing under our revolving credit facility. As of both August 1, 2008 and January 31, 2008 the Company was not in compliance with certain debt covenants with its lender, Wachovia. As a result, the Company's total debt with Wachovia, which equals \$7,313,000, is subject to acceleration and is classified as current in our consolidated balance sheets at both August 1, 2008 and January 31, 2008. The Company currently has a written waiver through October 31, 2008 relating to its covenant noncompliance. The Company expects to restructure its debt. Based upon the Company's analysis of its existing contracts and its current product order backlog, the Company believes that it will be able to generate sufficient cash flows to fund its operating needs through the remainder of fiscal 2009. If certain of these events do not materialize, the Company will explore other alternatives to meet its cash requirements.

Our ability to maintain sufficient liquidity in fiscal year 2009 and beyond is highly dependent upon achieving expected operating results. Failure to successfully achieve these results could have a material adverse effect on our liquidity and operations in the remainder of fiscal year 2009, and could require implementation of curative measures, including deferring planned capital expenditures, reducing discretionary spending, and/or, if necessary, selling assets.

On August 8, 2008, we sustained significant damage to one of the buildings comprising our Clearwater, Florida facility as a result of a fire. The building was primarily used for general storage and product testing, probes and sensor manufacturing, as well as for shipping and receiving. On August 29, 2008, our insurer extended a \$1,000,000 advance to us, the proceeds of which will be applied towards replacement of the contents of the building that were destroyed by the fire. While our main operating facility was not damaged by the fire, production was affected through loss of staged incoming raw materials and outgoing finished goods. We anticipate that the business interruption impact will be recoverable, in full or in part, under our insurance policy. We are continuing to work through the details of a comprehensive recovery plan including the effects of this event on our liquidity and cash flows.

### **Working Capital and Capital Expenditures**

Our working capital at August 1, 2008 was \$1,984,000 compared to \$2,430,000 at January 31, 2008, for a decrease of \$446,000. The reduction in working capital during the first six months of fiscal year 2009 related primarily to decreases in accounts receivable and inventory of \$841,000 and \$166,000, respectively, offset by a decrease in accounts payable of \$507,000. The decrease in accounts receivable was primarily the result of improved days of sales outstanding to 50 at August 1, 2008 compared to 60 at January 31, 2008. The decrease in inventory was primarily the result of improved operating efficiencies associated with the relocation, consolidation and integration of previously decentralized operations in Earlysville, Virginia. The decrease in accounts payable coincides with the decrease in accounts receivable. Credit terms provided to customers are consistent with those normally offered in our industry.

Future capital requirements depend on numerous factors, including research and development, expansion of product lines and other factors. Furthermore, we may need to develop and introduce new or enhanced products, respond to competitive pressures, invest or acquire businesses or technologies or respond to unanticipated requirements or developments, which would require additional resources. Currently, negative cash flow from operations prohibits us from meeting these challenges through organic growth.

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We had no capital expenditures for first six months of fiscal year 2009 compared to \$339,000 for first six months of fiscal year 2008. Historically, our capital budget has been intended to replace fixed asset equipment as needed and to take advantage of technological improvements that would improve productivity. We presently anticipate no additional significant capital expenditures until such time as our operating results and cash flows from operations improve.

## **Table of Contents**

### **Critical Accounting Policies**

The discussion and analysis of our financial condition and results of operations are based upon the accompanying unaudited consolidated financial statements, which have been prepared in accordance with U.S. GAAP. The preparation of those financial statements and this Quarterly Report on Form 10-Q requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure items, including disclosure of contingent assets and liabilities, at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions, and as a result of trends and uncertainties identified previously under Results of Operations and Liquidity and Capital Resources. Such differences could be material.

Set forth below is a discussion of the Company's critical accounting policies. The Company considers critical accounting policies to be those (i) that require the Company to make estimates that are highly uncertain at the time the estimate is made, (ii) for which a different estimate which could have been made would have a material impact on the Company's financial statements, (iii) that are the most important and pervasive policies utilized, and (iv) that are the most sensitive to material change from external factors. Additionally, the policies discussed below are critical to an understanding of the financial statements because their application places the most significant demands on management's judgment, with financial reporting results relying on estimates about the effect of matters that are highly uncertain. Specific risks for these critical accounting policies are described in the following paragraphs. The impact and any associated risks related to these policies on business operations is discussed throughout this MD&A where such policies affect reported and expected financial results.

Senior management has discussed the development and selection of the critical accounting estimates and the related disclosure included herein with the Audit Committee of the Board of Directors.

#### *Accounts Receivable, Allowance for Doubtful Accounts and Credit Losses*

Accounts receivable are reported at their outstanding principal balances reduced by an allowance for doubtful accounts. The Company continuously evaluates its customers and provides specific reserves for anticipated credit losses as soon as collection becomes compromised. The Company also maintains a reserve for accounts that management believes may become uncollectible based on historical experience. Measurement of such losses requires consideration of historical loss experience, including the need to adjust for current conditions, and judgments about the probable effects of relevant observable data, including present economic conditions such as delinquency rates and financial health of specific customers.

#### *Inventories*

The Company values inventory at the lower of cost (using a method that approximates the first-in, first-out method ( **FIFO** )) or net realizable value. The reserve for obsolete and slow moving inventory is based upon reviews of inventory quantities on hand, usage and sales history.

During production, the Company uses standards to estimate product costs. These standards are reviewed and updated periodically by management and approximate costing under the FIFO method. Differences between standard and actual costs have not been material.

#### *Long-Lived Assets*

Management periodically evaluates long-lived assets for potential impairment and will record an impairment charge whenever events or changes in circumstances indicate the carrying amount of the assets may not be fully recoverable.

#### *Property Held For Sale*

Property held for sale is reported at the lower of its carrying amount or fair value less cost to sell. Depreciation on property held for sale is discontinued at the time the criteria established by Statement of Financial Accounting Standards ( **SFAS** )



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## **Table of Contents**

No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets (as amended)*, are met. The Earlysville, Virginia property is presently held for sale. The property consists of a 53,000 square foot manufacturing facility on approximately 12 acres of land. In preparation for the sale of the Earlysville, Virginia facility, the Company engaged an environmental consulting firm to survey the property for any possible soil or groundwater contamination. This survey revealed impacts to both shallow soils and groundwater that may have resulted from the accidental loss of solvents by a former owner of the property. As a result of the initial and subsequent surveys, contamination treatment was determined to be necessary for an estimated total cost of \$588,000, as determined by an environmental compliance specialist. The Company has capitalized these contamination treatment costs as an increase to property held for sale, net, since such costs will be incurred in preparation for the sale of the Earlysville, Virginia facility.

### *Goodwill and Intangible Assets*

The carrying value of goodwill is reviewed at least annually for impairment and will be reviewed more frequently if current events and circumstances indicate a possible impairment. An impairment loss is charged to expense in the period identified. As current events and circumstances warrant, the Company examines the carrying value of its intangible assets with finite lives, such as capitalized software and development costs, purchased intangibles, and other long-lived assets, to determine whether there are any impairment losses. If indicators of impairment are present and future cash flows are not expected to be sufficient to recover the asset's carrying amount, an impairment loss is charged to expense in the period identified. Factors that may cause an impairment include negative industry or economic trends or significant underperformance relative to historical or projected future operating results.

### *Income Taxes*

The Company and its includable subsidiaries file a consolidated U.S. federal income tax return in accordance with the provisions of the Internal Revenue Code of 1986, as amended.

The Company's accounting for income taxes represents management's best estimate of various events and transactions.

Deferred tax assets and liabilities resulting from temporary differences between the financial reporting and tax bases of assets and liabilities are measured at the balance sheet date using enacted tax rates expected to apply to taxable income in the years the temporary differences are expected to reverse.

The realization of deferred tax assets depends upon the existence of sufficient taxable income within the carryback or carryforward periods under the tax law in the applicable tax jurisdiction. Valuation allowances are established when management determines, based on available information, that it is more likely than not that deferred income tax assets will not be realized. Significant judgment is required in determining whether valuation allowances should be established as well as the amount of such allowances. When making such determination, consideration is given to, among other things, the following:

future taxable income exclusive of reversing temporary differences and carryforwards;

future reversals of existing taxable temporary differences;

taxable income in prior carryback years; and

tax planning strategies.

The Company classifies tax related interest and tax related penalties as a component of income taxes.

### *Revenue Recognition*

The Company generally recognizes revenue from sales of its products when the following have occurred: evidence of a sale arrangement exists; delivery or shipment has occurred or services have been rendered; the price to the buyer is fixed or determinable; and collectibility is reasonably

assured.

The Company follows the percentage-of-completion method of accounting for one long-term engineering service contract. Under this method, contract revenue is computed as that percentage of estimated total revenue that costs incurred to date bear to total estimated costs, after giving effect to the most recent estimates of costs to complete. From time to time, the Company will record costs and estimated profits in excess of billings for certain of these contracts. Revisions in costs and revenue estimates are reflected in the period in which the revisions are determined. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined without regard to the percentage-of-completion.

## **Table of Contents**

Occasionally the Company enters into research and development contracts with customers. The Company accounts for such contracts on the basis of the lesser of non-refundable cash versus percentage of completion.

As a general matter, the terms specified in customer purchase orders determine whether the Company or the customer bears the obligation for payment of freight charges. While customers pay for freight in most transactions, the Company does occasionally pay freight charges on behalf of customers and bill all or a portion to customers.

### *Research and Development*

Research and development costs are expensed as incurred and are included in selling, general and administrative expenses.

### *Environmental Expenditures*

The Company assesses its property held for sale, along with any property that is being taken out of its initially intended use, for the presence of hazardous or toxic substances that would result in an environmental liability. In addition, management assesses its current property in use for any environmental issues.

Liabilities for environmental remediation costs not related to retirements of tangible long-lived assets, and arising from claims, assessments, litigation, fines, and penalties and other sources, are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

Legal costs incurred in connection with environmental remediation are expensed as incurred. Recoveries of environmental remediation costs from third parties, which are probable of realization, are separately recorded as assets, and are not offset against the related environmental liability, in accordance with Financial Accounting Standards Board ( **FASB** ) Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.

### *Share-Based Compensation*

Effective February 1, 2006, the Company adopted, using the modified prospective transition method, SFAS No. 123 (revised 2004), *Share-Based Payment* ( **SFAS 123(R)** ), which replaces SFAS 123 and supersedes APB 25 and recognized share-based employee compensation cost as a charge to net income. Under this transition method, compensation expense associated with stock options recognized in the first quarter of fiscal year 2007 and subsequent quarters, includes expense related to the remaining unvested portion of all stock option awards granted prior February 1, 2006 based on the grant date fair value estimated in accordance with the original provisions of SFAS 123. The adoption of SFAS 123(R) did not have a significant impact on the Company's financial position or results of operations. SFAS 123(R) requires that the cost of all share-based transactions be measured at fair value and recognized over the period during which a grantee is required to provide goods or services in exchange for the award. Although the terms of the Company's share-based plans do not accelerate vesting upon retirement, or the attainment of retirement eligibility, the requisite service period subsequent to attaining such eligibility is considered nonsubstantive. Accordingly, the Company recognizes compensation expense related to share-based awards over the shorter of the requisite service period or the period to attainment of retirement eligibility. SFAS 123(R) also requires an estimation of future forfeitures of share-based awards to be incorporated into the determination of compensation expense when recognizing expense over the requisite service period.

### **Off-Balance Sheet Arrangements**

The Company does not maintain off-balance sheet arrangements except as disclosed in our Annual Report on Form 10-K for the year ended January 31, 2008 nor does it participate in non-exchange traded contracts requiring fair value accounting treatment.

### **Contractual Obligations**

There have been no material changes to our commitments and contingencies from that disclosed in our Annual Report on Form 10-K for the year ended January 31, 2008.

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## Table of Contents

### **Recent Accounting Pronouncements**

In February 2007, the FASB issued Statement SFAS No. 159, *The Fair Value Option for Financial Assets and Liabilities* ( **SFAS 159** ). SFAS 159 permits companies to make an election to carry certain eligible financial assets and liabilities at fair value, even if fair value measurement has not historically been required for such assets and liabilities under U.S. GAAP. Effective February 1, 2008, the Company did not elect the fair value option for any instruments.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( **SFAS 157** ). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP, and expands disclosures about fair value measurements. The Company was required to adopt the provisions of SFAS 157 in the first quarter of the fiscal year beginning February 1, 2008. The adoption of SFAS 157 had no effect on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations - A Replacement of FASB Statement No. 141* ( **SFAS 141(R)** ). SFAS 141(R) retains the fundamental requirements in SFAS No. 141, *Business Combinations* ( **SFAS 141** ), that the acquisition method of accounting (which SFAS 141 called the *purchase method*) be used for all business combinations and that an acquirer be identified for each business combination. It also retains the guidance in SFAS 141 for identifying and recognizing intangible assets separately from goodwill. However, SFAS 141(R) will change the accounting treatment for certain specific items, including:

All business combinations (whether full, partial, or step acquisitions) will result in all assets and liabilities of an acquired business being recorded at fair value, with limited exceptions;

Acquisition costs will be generally expensed as incurred;

The fair value of the purchase price, including the issuance of equity securities, will be determined on the acquisition date;

Purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. Upon a loss of control, the interest sold, as well as any interest retained, will be measured at fair value, with any gain or loss recognized in earnings;

Non-controlling interests (formerly known as minority interests ) will be valued at fair value at the acquisition date;

Certain acquired contingent liabilities will be recorded at fair value at the acquisition date and subsequently measured at either the higher of such amount or the amount determined under existing guidance for non-acquired contingencies;

Restructuring costs associated with a business combination will be generally expensed subsequent to the acquisition date; and

Changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally will affect income tax expense.

SFAS 141(R) also includes a substantial number of new disclosure requirements. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. SFAS 141(R) will have an effect on the Company's future acquisitions.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We do not issue or invest in financial instruments or their derivatives for trading or speculative purposes. Our market risk is limited to fluctuations in interest rates pertaining to our borrowings under our existing credit facilities which require the payment of interest at a variable rate equal to one-month LIBOR plus 300 basis points. We therefore are exposed to market risk from changes in interest rates on funded debt. Any increase in these rates could adversely affect our interest expense. The extent of market rate risk associated with fluctuations in interest rates is not quantifiable or predictable because of the volatility of future interest rates and business financing requirements. We use no derivative products to hedge or mitigate interest rate risk.

Based on the outstanding balance on our credit facilities as of August 1, 2008, a 1% increase in interest rates would cost us approximately \$73,000 annually.

**Table of Contents**

**ITEM 4. CONTROLS AND PROCEDURES**

We evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act, as of August 1, 2008. Our principal executive and financial officers supervised and participated in the evaluation. Based on the evaluation, and in light of the previously identified material weakness in internal control over financial reporting, as of January 31, 2008, described within the 2008 Annual Report on Form 10-K, our principal executive and financial officers each concluded that, as of August 1, 2008, our disclosure controls and procedures were not effective in providing reasonable assurance that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's form and rules.

*Changes in Internal Control Over Financial Reporting*

Since January 31, 2008, including the period covered by this Quarterly Report, we have made certain changes to our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) which are likely to have a material effect on such controls. For a discussion of these changes, please refer to Item 9A. CONTROLS AND PROCEDURES in our Annual Report on Form 10-K for the year ended January 31, 2008.

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

From time to time, the Company is involved in certain claims and legal actions arising in the ordinary course of business. In the opinion of management, at this time, there are no claims or legal actions that will have a material adverse effect on the Company's consolidated financial position, results of operations, or liquidity.

**ITEM 1A. RISK FACTORS**

The risk factors included in our Annual Report on Form 10-K for the year ended January 31, 2008 have not materially changed.

**ITEM 2. UNREGISTERED SALE OF EQUITY SECURITIES AND USE OF PROCEEDS**

None

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None

**ITEM 5. OTHER INFORMATION**

On September 22, 2008, Charles L. Pope, our former Chief Financial Officer, entered into a consulting agreement with the Company pursuant to which he has agreed during a limited transition period to provide financial advisory and consulting services to the Company. The consulting agreement shall remain in effect for a ninety day period with 30 day automatic extensions, subject to termination at any time by either party. Pursuant to the terms of the consulting agreement, the Company shall pay Mr. Pope an hourly rate for his services plus reimbursement for travel and other expenses or disbursements. Mr. Pope shall not be required to devote more than 120 hours per month in performing services to the Company.

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On September 11, 2008, Jeffrey Hummel resigned as the Company's Controller, effective as of October 3, 2008. Since Mr. Pope's resignation as Chief Financial Officer, Mr. Hummel has not acted as interim Chief Financial Officer. Douglas Hillman, the Company's President and CEO has and will continue to act as interim Chief Financial Officer until a permanent successor is hired for that position.

**Table of Contents**

**ITEM 6. EXHIBITS**

<b>Exhibit No.</b>	<b>Description of Exhibit</b>
31.1	Section 302 Certification
31.2	Section 302 Certification
32.1	Section 906 Certification
32.2	Section 906 Certification



**Table of Contents**

**SIGNATURES**

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

Date: September 26, 2008

**AEROSONIC CORPORATION**

/s/ Douglas J. Hillman  
Douglas J. Hillman  
President and Chief Executive Officer  
Date: September 26, 2008

**AEROSONIC CORPORATION**

/s/ Douglas J. Hillman  
Douglas J. Hillman  
  
Acting Chief Financial Officer