H E R C PRODUCTS INC
Form 10QSB
August 14, 2002

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-QSB

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934:

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2002

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from ____________ to ____________.

Commission File Number 1-13012

H.E.R.C. PRODUCTS INCORPORATED
(Name of small business issuer as specified in its charter)

Delaware	86-0570800
State of Incorporation	IRS Employer Identification Number

2215 W Melinda Lane, Suite A
Phoenix, Arizona 85027
(Address of principal executive offices)

(623) 492-0336
(Issuer's telephone number)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 [ ]

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date.

Class	Outstanding at August 12, 2002
Common Stock, $.01 par value	12,004,872

Transitional Small Business Disclosure Format: YES [ ] NO [X]

H.E.R.C. PRODUCTS INCORPORATED AND SUBSIDIARIES

Index To Consolidated Financial Statements

ITEM 1. FINANCIAL STATEMENTS

H.E.R.C. PRODUCTS INCORPORATED AND SUBSIDIARIES

Consolidated Balance Sheets

ASSETS	June 30, 2002 (Unaudited)	December 31, 2001
CURRENT ASSETS		
Cash	$ 147,189	$ 75,759
Trade accounts receivable, net of allowance for doubtful accounts of $28,908 and $35,269, respectively	781,830	602,468
Inventories	54,698	27,061
Costs of uncompleted contracts	36,409	150,530
Costs and estimated earnings in excess of billings on uncompleted contracts	12,010	74,289
Other receivables, includes unbilled amounts of $111,554 and $53,437, respectively	117,489	66,112
Prepaid expenses	350,618	51,008
Total Current Assets	1,500,243	1,047,227
PROPERTY AND EQUIPMENT		
Property and equipment	1,436,683	1,374,993
Less: accumulated depreciation	(1,040,366)	(938,755)
Net Property and Equipment	396,317	436,238
OTHER ASSETS		
Patents, net of accumulated amortization of $110,711 and $100,397, respectively	113,424	107,366

Patents pending	111,704	117,954
Refundable deposits and other assets	8,963	9,940
Total Other Assets	234,091	235,260
	$ 2,130,651	$ 1,718,725

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES		
Accounts payable	$ 298,052	$ 287,259
Accrued wages	112,189	117,350
Current portion of notes payable	195,956	19,944
Other accrued expenses	314,039	225,267
Total Current Liabilities	920,236	649,820
LONG-TERM LIABILITIES		
Notes payable, net of current portion	--	2,570
Total Liabilities	920,236	652,390
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Preferred stock, $0.01 par value; authorized 1,000,000 shares; issued and outstanding zero shares	--	--
Common stock, $0.01 par value; authorized 40,000,000 shares; issued and outstanding 11,944,872 and 11,864,872 shares, respectively	119,449	118,649
Additional paid-in capital	14,019,664	14,012,464
Accumulated deficit	(12,928,698)	(13,064,778)
Total Stockholders' Equity	1,210,415	1,066,335
	$ 2,130,651	$ 1,718,725

The accompanying notes are an integral part of this consolidated balance sheet.

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H.E.R.C. PRODUCTS INCORPORATED AND SUBSIDIARIES

Consolidated Statements of Operations
(Unaudited)

	Three Months Ended June 30,		Six Mon
	2002	2001	2002
SALES	$ 1,496,335	$ 1,337,130	$ 3,172,
COST OF SALES	885,491	684,564	1,786,
GROSS PROFIT	610,844	652,566	1,386,
SELLING EXPENSES	122,038	67,247	255,
GENERAL AND ADMINISTRATIVE EXPENSES	630,915	610,378	1,180,

OPERATING LOSS	(142,109)	(25,059)	(49,
OTHER INCOME (EXPENSE)			
Gain on sale of asset	--	52,378	
Interest expense	(16,870)	(18,893)	(40,
Miscellaneous	225,290	1,689	225,
Total Other Income	208,420	35,174	185,
NET INCOME (LOSS) BEFORE INCOME TAXES	66,311	10,115	136,
Income tax provision	--	--	
NET INCOME (LOSS)	$ 66,311	$ 10,115	$ 136,
NET INCOME (LOSS) PER COMMON SHARE - BASIC AND DILUTED	$ 0.01	$ --	$ 0
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:			
BASIC	11,944,872	11,769,634	11,924,
DILUTED	12,021,788	11,771,420	11,995,

The accompanying notes are an integral part of this consolidated balance sheet.

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H.E.R.C. PRODUCTS INCORPORATED AND SUBSIDIARIES

Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30,	
	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ 136,080	$(277,737)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities		
Depreciation and amortization	112,398	127,222
Gain on sale of Chlor-Rid(R)rights	(225,000)	--
Gain on sale of asset	--	(52,378)
Common stock issued for services	8,000	12,000
(Increase) decrease in assets		
Trade accounts receivable	(179,362)	(244,812)
Inventories	(27,637)	2,388
Costs of uncompleted contracts	114,121	32,419
Costs and estimated earnings in excess of billings on uncompleted contracts	62,279	--
Other receivables	(51,377)	(1,555)
Prepaid expenses	69,504	51,134
Refundable deposits and other assets	977	2,226
Increase (decrease) in liabilities		
Accounts payable	10,793	252,635
Accrued wages and other accrued expenses	83,611	21,014

Customer deposits	--	(777)
Net cash provided by (used in) operating activities	114,387	(76,221)
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(61,690)	(38,610)
Cash received from sale of Chlor-Rid(R)rights	225,000	--
Cash received from sale of asset	--	135,000
Expenditures related to patents and patents pending	(10,594)	(36,691)
Net cash provided by (used in) investing activities	152,716	59,699
CASH FLOWS FROM FINANCING ACTIVITIES		
Principal payments under notes payable	(195,673)	(241,228)
Net cash used in financing activities	(195,673)	(241,228)
NET INCREASE (DECREASE) IN CASH	71,430	(257,750)
CASH AT BEGINNING OF PERIOD	75,759	302,392
CASH AT END OF PERIOD	$ 147,189	$ 44,642
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for interest	$ 40,062	$ 27,356
Cash paid during the period for income taxes	$ --	$ --
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Prepaid insurance financed with notes payable	$ 369,114	$ 198,262

The accompanying notes are an integral part of this consolidated balance sheet.

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H.E.R.C. PRODUCTS INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 - BASIS OF PRESENTATION

The unaudited consolidated financial statements are presented in accordance with the requirements of Form 10-QSB and consequently do not include all of the disclosures normally made in an annual Form 10-KSB filing. Accordingly, the consolidated financial statements of H.E.R.C. Products Incorporated included herein should be reviewed in conjunction with the consolidated financial statements and the accompanying footnotes included within the Company's Form 10-KSB for the year ended December 31, 2001.

The consolidated financial statements have been prepared in accordance with the Company's customary accounting practices and have not been audited. In the opinion of management, the consolidated financial statements reflect all adjustments necessary to fairly report the Company's financial position and results of operations for the interim period. All such adjustments are normal and recurring in nature. The interim consolidated results of operations are not necessarily indicative of results to be expected for the year ending December

31, 2002.

NOTE 2 - REVENUE RECOGNITION

For chemical product sales, the Company recognizes revenue at the time products are shipped to customers. For most service projects, the Company recognizes revenue and costs when the services are completed. For fixed price contracts in excess of three month duration, revenue is recognized on the percentage of completion method, measured by the percentage of cost incurred to date to estimated total cost for each contract. This method is used because management considers total cost to be the best available measure of progress on these contracts.

Contract costs include all direct material, labor, subcontract labor and other costs related to contract performance, such as indirect labor, supplies, tools and repairs. Selling, general and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability, including those arising from contract penalty provisions and final contract settlements may result in revisions to estimates of contract costs and profits and are recognized in the period in which the revisions are determined.

The current asset, "costs and estimated earnings in excess of billings on uncompleted contracts" represents revenue recognized in excess of amounts billed. The current liability, "billings in excess of costs on uncompleted contracts," represents billings in excess of revenue recognized.

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NOTE 3 - AGREEMENT WITH FACTOR

During the second quarter of 2002, the Company signed an amendment to its existing factoring arrangement. The terms of the amended agreement are as follows:

The factor purchases eligible receivables and advances 85% of the purchased amount to the Company. Purchased receivables may not exceed $1,000,000 at any time. Either party may cancel the arrangement with 30 days notice. At June 30, 2002, there was $449,382 of factored receivables of which the Company has received $371,056 from the factor. This $371,056 and $3,916 in interest expense are not included in accounts receivable as of June 30, 2002. This arrangement is accounted for as a sale of receivables on which the factor has recourse to the 15% residual of aggregate receivables purchased and outstanding. Interest payable by the Company to the factor is calculated as a fixed discount fee equal to .75% of the amount of the receivable factored plus a variable (1.5% above the institutions base rate, with a minimum of 7%) discount fee computed on the amount advanced to the Company and accruing on the basis of actual days elapsed from the date of the 85% advance until five days after collection of such account receivable by the factor at a per annum rate equal to an internal rate set by the factor. The rate at June 30, 2002 was 7%. In connection with this agreement, the Company is required to maintain certain financial covenants. In the event of a breach of representation, warranty or agreement, the factor has a security interest in the Company's assets.

NOTE 4 - SEGMENT INFORMATION

Information by segment for the three months ended and as of June 30, 2002:

	Pipe	Tank

	Cleaning	Cleaning	Chemicals	Corporate
Sales to unaffiliated customers	$ 720,568	$ 727,265	$ 48,502	$ --
Income (loss) from continuing operations	126,960	165,137	192,053	(417,839
Total assets	690,640	633,527	35,651	770,833
Depreciation and amortization	42,104	8,809	1,746	9,138
Capital expenditures	43,878	1,788	--	--

Information by segment for the three months ended and as of June 30, 2001:

	Pipe Cleaning	Tank Cleaning	Chemicals	Corporate
Sales to unaffiliated customers	$1,088,783	$ 198,397	$ 49,950	$ --
Income (loss) from continuing operations	307,656	39,560	31,293	(368,394
Total assets	1,115,807	135,097	71,154	337,745
Depreciation and amortization	42,015	7,210	1,535	9,875
Capital expenditures	2,779	4,482	--	--

Information by segment for the six months ended and as of June 30, 2002:

	Pipe Cleaning	Tank Cleaning	Chemicals	Corporate
Sales to unaffiliated customers	$1,822,107	$1,268,647	$ 81,632	$ --
Income (loss) from continuing operations	417,155	333,374	167,761	(782,210
Total assets	690,640	633,527	35,651	770,833
Depreciation and amortization	78,156	12,675	3,285	18,282
Capital expenditures	50,278	7,255	--	4,157

Information by segment for the six months ended and as of June 30, 2001:

	Pipe Cleaning	Tank Cleaning	Chemicals	Corpo
Sales to unaffiliated customers	$ 2,201,332	$ 259,577	$ 110,099	$
Income (loss) from continuing operations	401,479	(52,134)	65,932	(69
Total assets	1,115,807	135,097	71,154	33
Depreciation and amortization	90,769	10,869	3,154	2
Capital expenditures	20,162	17,237	--	

NOTE 5 - EARNINGS PER SHARE

A reconciliation of the numerators and denominators (weighted average number of shares outstanding) of the basic and diluted earnings per share (EPS) computation for the three and six months ended June 30, 2002 and 2001 is as follows:

	Three Months Ended June 30, 2002		
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS	$ 66,311	11,944,872	$ 0.01
Effect of stock options and warrants	--	76,916	
Diluted EPS	$ 66,311	12,021,788	$ 0.01

	Three Months Ended June 30, 2001		
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS	$ 10,115	11,769,634	$ --
Effect of stock options and warrants	--	1,786	
Diluted EPS	$ 10,115	11,771,420	$ --

	Six Months Ended June 30, 2002		
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS	$ 136,080	11,924,982	$ 0.01
Effect of stock options and warrants	--	70,206	
Diluted EPS	$ 136,080	11,995,188	$ 0.01

	Six Months Ended June 30, 2001		
	Net Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS	$ (277,737)	11,753,722	$ (0.02)
Effect of stock options and warrants	--	--	
Diluted EPS	$ (277,737)	11,753,722	$ (0.02)

NOTE 6 - RECENTLY ISSUED ACCOUNTING STANDARDS

SFAS No. 143, Accounting for Asset Retirement Obligations, requires recognition of the fair value of obligations associated with the retirement of long-lived assets when there is a legal obligation to incur such costs. This amount is accounted for as an additional element of the corresponding asset's cost, and is depreciated over that asset's useful life. SFAS No. 143 will become effective for the Company on January 1, 2003. The Company does not believe that this will have a material impact on its liquidity or results of operations.

NOTE 7 - NOTES PAYABLE

During the month of January 2002, the Company financed $321,914 of insurance premiums payable in nine monthly installments at an annual percentage rate of 3.68%. During the month of May 2002, the Company financed $47,200 of insurance premiums payable in nine monthly installments at an annual percentage rate of 3.68%

NOTE 8 - COMMITMENTS AND CONTINGENCIES

LITIGATION
A civil claim under federal civil rights statutes has been filed seeking $35,000 in alleged lost earnings, $200,000 in compensation for loss of future pensions and benefits, damages for non-pecuniary losses of $250,000, punitive damages of

$500,000, and attorneys fees, expert fees and costs. The Company, acting through outside legal counsel, has denied all liability and intends to vigorously defend against this claim. Outside legal counsel estimates the range of potential loss to be less than $50,000.

NOTE 9 - INCOME TAXES

The Company's net operating loss carryforwards fully offset all taxable income for the six months ended June 30, 2002 and therefore there is no current federal income tax expense. Deferred tax assets as of June 30, 2002 arising primarily from loss carry forward benefits have not been recorded because of the historical operating losses and the uncertainty of realizing such benefits.

NOTE 10 - RELEASE AND ASSIGNMENT AGREEMENT

On June 14, 2002, the Company executed a release and assignment agreement which assigned all of the Company's right, title and interest in any patents, royalties, manufacturing rights or any other rights in the product Chlor*Rid(R). In return, the Company received a cash payment of $225,000 from Chlor*Rid(R) International. This $225,000 is accounted for as other income.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

PORTIONS OF THIS REPORT DESCRIBE HISTORICAL INFORMATION, SUCH AS THE 2001 AND 2002 OPERATING RESULTS, AND WE BELIEVE THE DESCRIPTIONS TO BE ACCURATE. IN CONTRAST TO DESCRIBING THE PAST, SOME STATEMENTS IN THIS REPORT INDICATE THAT WE BELIEVE THAT EVENTS OR FINANCIAL RESULTS ARE LIKELY TO OCCUR IN THE FUTURE. THESE STATEMENTS TYPICALLY USE WORDS OR PHRASES LIKE "BELIEVE," "EXPECTS," "ANTICIPATES," "ESTIMATES," "WILL CONTINUE" AND SIMILAR EXPRESSIONS. STATEMENTS USING THOSE WORDS OR SIMILAR EXPRESSIONS ARE INTENDED TO IDENTIFY "FORWARD-LOOKING STATEMENTS" AS THAT TERM IS USED IN SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. FORWARD-LOOKING STATEMENTS INCLUDE PROJECTIONS OF OPERATING RESULTS FOR 2002 AND BEYOND, EITHER CONCERNING A SPECIFIC SEGMENT OF OUR BUSINESS, OR CONCERNING OUR COMPANY AS A WHOLE.

ACTUAL RESULTS, HOWEVER, MAY BE MATERIALLY DIFFERENT FROM THE RESULTS PROJECTED IN THE FORWARD-LOOKING STATEMENTS, DUE TO A VARIETY OF RISKS AND UNCERTAINTIES. THESE RISKS AND UNCERTAINTIES INCLUDE THOSE SET FORTH IN "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS."

THE FORWARD-LOOKING STATEMENTS IN THIS REPORT ARE CURRENT ONLY AS OF THE DATE THIS REPORT IS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION. AFTER THE FILING OF THIS REPORT, OUR EXPECTATIONS AND BELIEFS MAY CHANGE, AND WE MAY COME TO BELIEVE THAT CERTAIN FORWARD-LOOKING STATEMENTS IN THIS REPORT ARE NO LONGER ACCURATE. WE DO NOT HAVE AN OBLIGATION TO CORRECT OR REVISE ANY FORWARD-LOOKING STATEMENTS IN THIS REPORT, EVEN IF WE BELIEVE THE FORWARD LOOKING STATEMENTS ARE NO LONGER TRUE.

OVERVIEW

We derive the majority of our revenue from two sources, cleaning piping systems on U.S. Navy and U.S. Coast Guard vessels and cleaning bilge, fuel, oil and CHT tanks on ships. A significant portion of the pipe cleaning is performed pursuant to a five-year contract with the U.S. Navy (Portsmouth CHT contract). This subjects our Company to certain business risks that can cause volatility in our revenue stream and our gross margins. We are also subject to the deployment and servicing schedules of the U.S. Navy as well as the available maintenance funds in the Navy budget. These factors can cause revenue to change dramatically from one quarter to the next. Additionally, we are required by our Portsmouth CHT contract to perform work on different classes of ships. Performing work on different classes of ships can cause our gross margins to vary widely from one quarter to the next because we realize higher gross margins on certain classes of ships than on others. Moreover, we are often asked to perform work on ships outside of the state of Virginia. When we perform work under the Portsmouth CHT contract outside of the state of Virginia, we incur certain reimbursable travel costs that are included in both revenue and cost of goods sold. These reimbursable travel costs cause gross margins to be lower than the margins that would have otherwise been recognized had the work been performed in Virginia.

The final option year of our five-year CHT system chemical cleaning contract with the U.S. Navy will expire during September 2002. This contract accounted for approximately 46% of our revenue during the six months ended June 30, 2002, and approximately 45% of our revenue during fiscal year 2001. In addition, this contract has been responsible for the majority of our consolidated revenue for several years. We intend to submit an offer to the U.S. Navy for additional services under a request for proposal for a new five-year agreement to replace the expiring contract, and must submit a bid for negotiation to the U.S. Navy by August 13, 2002. Prior to awarding the new contract to any provider, the U.S. Navy will evaluate the various bids for the best value based on the non-cost technical factors of management and organization, manpower resources and chemical solution, the non-cost factor of past performance and, to a lesser extent, price. We expect that several providers will submit bids to the U.S. Navy in an effort to secure this contract. Based on this competition and the uncertainty of this process, the U.S. Navy may choose a sole provider or alternate providers for the services that we currently provide. In the event the U.S. Navy does not select a provider prior to the expiration of our agreement, we expect that our agreement will be extended during the bid negotiation process. Our failure to secure all or part of the new CHT system chemical cleaning agreement with the U.S. Navy would have a material adverse effect on our business.

CRITICAL ACCOUNTING JUDGMENTS AND ESTIMATES

We consider the following accounting policies to be critical to an understanding of our financial statements because their application places the most significant demands on our judgment, with financial reporting results relying on estimates about the effect of matters that are inherently uncertain. Specific risks for these critical accounting policies are described in the following paragraphs. For all of these policies, we caution that future events rarely develop exactly as forecast, and the best estimates routinely require adjustment.

REVENUE RECOGNITION

For chemical product sales, we recognize revenue at the time products are shipped to customers. For most service projects, we recognize revenue when the services are completed. For fixed price contracts that are in excess of three months, we recognize revenue on the percentage of completion method, measured by the percentage of cost incurred to date to estimated total cost for each contract. We use this method because we consider total cost to be the best available measure of progress on these contracts.

Contract costs include all direct material, subcontract labor, and other costs related to contract performance, such as indirect labor, supplies, tools, and repairs. Selling, general, and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability, including those arising from contract penalty provisions and final contract settlements may result in revisions to estimates of contract costs and profits and are recognized in the period in which the revisions are determined.

The current asset, "costs and estimated earnings in excess of billings on uncompleted contracts" represents revenue recognized in excess of amounts billed. The current liability, "billings in excess of costs on uncompleted contracts," represents billings in excess of revenue recognized.

ALLOWANCE FOR DOUBTFUL ACCOUNTS AND DEFERRED TAX ASSETS

We analyze accounts receivable to determine the ultimate collectibility of those accounts. If information is available to us to make a determination that there exists a reasonable probability that an account will not be collectible, we create a reserve for that account at the time of the determination and recognize a related expense. If the account is later collected, the reserve and expense are reversed in the current accounting period. Since we must use our best judgment as to which accounts will be collected, there exists the risk that some accounts might not be collected and thus could have a negative impact on our liquidity and results of operations.

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when it is determined to be more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

IMPAIRMENT OF LONG-LIVED ASSETS

We periodically evaluate the carrying value of long-lived assets and intangibles. We review long-lived assets and certain identifiable intangible assets to be held and used in operations for potential impairment whenever events or circumstances indicate that the carrying amount of an asset may not be fully recoverable. An impairment loss is recognized if the sum of the expected long-term undiscounted cash flows is less than the carrying amount of the long-lived assets being evaluated. Future losses may be recorded if cash flows are less than expected.

ACCRUALS

Loss contingencies are recorded as liabilities when it is probable that a liability has been incurred and the amount of the loss is reasonably estimable. Disclosure is required when there is a reasonable possibility that the ultimate loss will exceed the recorded provision. Contingent liabilities are often resolved over long time periods. Estimating probable losses requires analysis of multiple forecasts that often depend on judgments about potential actions by third parties such as regulators.

Other significant accounting policies, not involving the same level of measurement uncertainties as those discussed above, are nevertheless important to a complete understanding of the financial statements.

RESULTS OF OPERATIONS

THREE MONTHS ENDED JUNE 30, 2002 COMPARED WITH THREE MONTHS ENDED JUNE 30, 2001

Sales for the three months ended June 30, 2002 were $1,496,335 compared with $1,337,130 during the same period in 2001. Pipe cleaning services accounted for $720,568 during the three months ended June 30, 2002, of which $478,630 was billed under the Portsmouth CHT contract with the United States Navy. For the three months ended June 30, 2001, pipe cleaning services accounted for $1,088,783 of which $593,028 was billed under the Portsmouth CHT contract. Tank cleaning services totaled $727,265 during the three months ended June 30, 2002 compared with $198,397 during the same period in 2001. Industrial chemical sales were $48,502 during the three months ended June 30, 2002 compared with $49,950 during the same period in 2001.

We began offering tank cleaning services in the first quarter of 2001. Our entrance into the tank cleaning services market has helped to reduce the percentage of consolidated sales generated from pipe system cleaning pursuant to the Portsmouth CHT contract with the U.S. Navy from 44% during the three months ended June 30, 2001 to 32% during the three months ended June 30, 2002. We currently focus specific sales and marketing efforts in the areas of marine, industrial and municipal pipe cleaning as well as in the areas of marine and land based tank cleaning. In the future, we will continue our efforts to diversify our revenue sources and thereby further reduce our reliance on a single customer for a significant portion of our revenue.

Sales of pipe cleaning services decreased 34% during the three months ended June 30, 2002 compared to the same period in 2001. The decrease in pipe cleaning revenue represents a slowdown in orders for cleaning piping systems on board U.S. Navy and U.S. Coast Guard vessels. Sales of tank cleaning services increased 267% during the three months ended June 30, 2002 compared to the same period in 2001. The increase in tank cleaning revenue reflects our successful penetration into the tank cleaning market, strong general demand for tank cleaning services and additional demand for our services in particular due to our focus on customer satisfaction. Sales of industrial chemicals were relatively flat with a decrease of 3% during the three months ended June 30, 2002 compared to the same period in 2001.

Consolidated gross margin was 41% during the three months ended June 30, 2002 compared with 49% during the same period in 2001. The decrease in consolidated gross margin was the result of the increase in tank cleaning revenue performed at a lower gross margin combined with the decrease in pipe cleaning revenue performed at a higher gross margin.

Performing pipe cleaning services on different classes of ships can cause our gross margins to vary widely from one quarter to the next because we make higher gross margins on certain classes of ships than we do on others. Additionally, when we perform work under the Portsmouth CHT contract outside of the state of Virginia, we incur certain reimbursable travel costs that are included in both revenue and cost of goods sold. These reimbursable travel costs cause gross margins to be lower than the margins that would have otherwise been recognized had the work been performed in Virginia.

We anticipate that future gross margins from pipe cleaning and tank cleaning will fluctuate with changes in revenue mix and other operational factors such as our ability to bid work at profitable levels as well as our ability to control costs on projects.

Gross profit decreased to $610,844 during the three months ended June 30, 2002 from $652,566 during the same period in 2001. The decrease in gross profit was the result of lower consolidated gross margins offset slightly by higher consolidated revenue.

Selling expenses increased to $122,038 during the three months ended June 30, 2002 from $67,247 during the same period in 2001 while general and administrative expenses increased to $630,915 for the three months ended June 30, 2002 from $610,378 during the same period in 2001. The increase in selling expenses was primarily the result of additional sales personnel. General and administrative expenses remained relatively flat from one period to the next.

On June 14, 2002, the Company executed a release and assignment agreement which assigned all of the Company's right, title and interest in any patents, royalties, manufacturing rights or any other rights in the product Chlor*Rid(R). In return, the Company received a cash payment of $225,000 from Chlor*Rid(R) International. This $225,000 is accounted for as other income. During the three months ended June 30, 2001, the Company sold an asset and realized a gain of $52,378, which is included in other income.

For the three months ended June 30, 2002, we generated net income of $66,311 compared to net income of $10,115 for the same period in 2001.

SIX MONTHS ENDED JUNE 30, 2002 COMPARED WITH SIX MONTHS ENDED JUNE 30, 2001,

Sales for the six months ended June 30, 2002 were $3,172,386 compared with $2,571,008 during the same period in 2001. Pipe cleaning services accounted for $1,822,107 during the six months ended June 30, 2002, of which $1,465,286 was billed under the Portsmouth CHT contract with the United States Navy. For the six months ended June 30, 2001, pipe cleaning services accounted for $2,201,332 of which $1,412,010 was billed under the Portsmouth CHT contract. Tank cleaning services totaled $1,268,647 during the six months ended June 30, 2002 compared with $259,577 during the same period in 2001. Industrial chemical sales were $81,632 during the six months ended June 30, 2002 compared with $110,099 during the same period in 2001.

The continuing growth of our tank cleaning service revenue has helped to reduce the percentage of consolidated sales generated from pipe system cleaning pursuant to the Portsmouth CHT contract with the U.S. Navy from 55% during the six months ended June 30, 2001 to 46% during the six months ended June 30, 2002. We currently focus specific sales and marketing efforts in the areas of marine, industrial and municipal pipe cleaning as well as in the areas of marine and land based tank cleaning. In the future, we will continue our efforts to diversify our revenue sources and thereby further reduce our reliance on a single customer for a significant portion of our revenue.

Sales of pipe cleaning services decreased 17% during the six months ended June 30, 2002 compared to the same period in 2001. The decrease in pipe cleaning revenue represents a slowdown in orders for cleaning piping systems on board U.S. Navy and U.S. Coast Guard vessels. Sales of tank cleaning services increased 389% during the six months ended June 30, 2002 compared to the same period in 2001. The increase in tank cleaning revenue reflects our successful penetration into the tank cleaning market, strong general demand for tank cleaning services and additional demand for our services in particular due to our focus on customer satisfaction. Sales of industrial chemicals decreased 26% during the six months ended June 30, 2002 compared to the same period in 2001. The reduction in chemical sales represents the lack of any Chlor*Rid(R) chemical sales during the period.

Consolidated gross margin was 44% during the six months ended June 30, 2002 compared with 39% during the same period in 2001. The increase in consolidated gross margin was the result higher gross margins in both pipe and tank cleaning as compared to the same period in 2001.

Performing pipe cleaning services on different classes of ships can cause our gross margins to vary widely from one quarter to the next because we make higher gross margins on certain classes of ships than we do on others. Additionally, when we perform work under the Portsmouth CHT contract outside of the state of Virginia, we incur certain reimbursable travel costs that are included in both revenue and cost of goods sold. These reimbursable travel costs cause gross margins to be lower than the margins that would have otherwise been recognized had the work been performed in Virginia.

We anticipate that future gross margins from pipe cleaning and tank cleaning will fluctuate with changes in revenue mix and other operational factors such as our ability to bid work at profitable levels as well as our ability to control costs on projects.

Gross profit increased to $1,386,054 during the six months ended June 30, 2002 from $1,011,187 during the same period in 2001. The increase in gross profit was the result of higher consolidated revenue offset slightly by lower consolidated gross margins.

Selling expenses increased to $255,339 during the six months ended June 30, 2002 from $139,334 during the same period in 2001 while general and administrative expenses increased to $1,180,264 during the six months ended June 30, 2002 from $1,178,547 during the same period in 2001. The increase in selling expenses was primarily the result of additional sales personnel. General and administrative expenses remained relatively flat from one period to the next.

On June 14, 2002, the Company executed a release and assignment agreement which assigned all of the Company's right, title and interest in any patents, royalties, manufacturing rights or any other rights in the product Chlor*Rid(R). In return, the Company received a cash payment of $225,000 from Chlor*Rid(R) International. This $225,000 is accounted for as other income. During the six months ended June 30, 2001, the Company sold an asset and realized a gain of $52,378, which is included in other income.

For the six months ended June 30, 2002, we generated net income of $136,080 compared to a net loss of $277,737 for the same period in 2001.

LIQUIDITY AND CAPITAL RESOURCES

Cash was $147,189 at June 30, 2002 and $75,759 at December 31, 2001 while working capital was $580,007 and $397,407 at those respective dates. The increase in cash and working capital is primarily the result of our net income.

During the second quarter of 2002, the Company signed an amendment to its existing factoring arrangement. The terms of the amended agreement are as follows:

The factor purchases eligible receivables and advances 85% of the purchased amount to our Company. Purchased receivables may not exceed $1,000,000 at any one time. Either party may cancel the arrangement with 30 days notice. At June 30, 2002, there was $449,382 of factored receivables of which we have received $371,056 from the factor. This $371,056 and $3,916 in interest expense are not shown as receivables. This arrangement is accounted for as a sale of receivables on which the factor has recourse to the 15% residual of aggregate receivables purchased and outstanding. Interest payable by us to the factor is calculated as a fixed discount fee equal to 0.75% of the amount of the receivable factored plus a variable (1.5% above the institutions base rate, with a minimum of 7%) discount fee computed on the amount advanced to us and accruing on the basis of actual days elapsed from the date of the 85% advance until 5 days after collection of such account receivable by the factor at a per annum rate equal to an internal rate set by the factor. The rate at June 30, 2002 was 7%. In connection with this agreement, we are required to maintain certain financial covenants. In the event of a breach of representation, warranty or agreement, the institution has a security interest in our assets.

Our five-year Portsmouth CHT contract with the U.S. Navy is due to expire in September 2002. This contract has been responsible for the majority of our consolidated revenue for several years. Management is currently working on the re-solicitation by the U.S. Navy for these services. If the new contract is not awarded to us, it could have a material impact on our revenue and results of operations.

We rely primarily on our internally generated operating cash flow and our factoring arrangement to fund our operations and our business. We currently contract with a few major customers responsible for a large percentage of our revenue and we expect the high concentration levels to continue through 2002. Thus, any material delay, cancellation or reduction of orders from these customers could have a material adverse effect on our liquidity and operations.

The table below describes our contractual obligations as of June 30, 2002 to make future payments under contracts such as debt and lease agreements:

Contractual Obligations	Payments Due by Fiscal Year 2002	2003	2004
Long-Term Debt and Other Financing Arrangements	$178,199	$ 11,940	$ --
Capital Lease Obligations	4,585	1,232	--
Operating Leases	31,414	50,757	3,700

While we believe that we will not need to raise additional capital because our current cash and cash flows expected to be generated from operations are anticipated to be sufficient for the foreseeable future, we may, in the future, sell additional securities to raise capital. Any such sale, if necessary, could substantially dilute the interest of our existing stockholders. We cannot provide any assurance that we will be able to sell additional securities at terms acceptable to us. We may, in the future, make acquisitions by utilizing debt financing if available. Any such acquisition and debt financing could have a material adverse impact on our liquidity and results of operations.

PART II: OTHER INFORMATION

ITEM 2. CHANGES IN SECURITIES

RECENT SALES OF UNREGISTERED SECURITIES

During the second quarter of 2002 the Company issued 40,000 shares of common stock as compensation to its outside Board of Directors. These shares were issued under an exemption from registration pursuant to Section 4(2) of the Securities Act of 1933.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

Reports on Form 8-K: None

Exhibits:

10.17 Amendment to Account Transfer and Purchase Agreement by and between the Registrant, H.E.R.C. Consumer Products, Inc., and KBK Financial Incorporated dated September 22, 1997.

99.1 Certification of the Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

99.2 Certification of the Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Signatures

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

H.E.R.C. PRODUCTS INCORPORATED
(Registrant)

Date: August 14, 2002

By: /s/ S. Steven Carl
S. Steven Carl
Chief Executive Officer

By: /s/ Michael H. Harader
Michael H. Harader
Chief Financial Officer
(Principal Financial and
Accounting Officer)