

FLANDERS CORP  
Form 10-Q  
July 30, 2009  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 2009

Commission File Number 000-27958

**FLANDERS CORPORATION**

(Exact name of registrant as specified in its charter)

North Carolina  
(State or other jurisdiction of

13-3368271  
(IRS Employer

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incorporation or organization)

ID Number)

**531 Flanders Filters Road, Washington, NC**  
(Address of principal executive offices)

**27889**  
(Zip Code)

**Registrant's telephone number, including area code: (252) 946-8081**

Indicate by check mark whether the issuer (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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

The number of shares outstanding of the registrant's common stock, as of June 30, 2009 was 25,524,074.

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**FLANDERS CORPORATION**

**FORM 10-Q**

**FOR QUARTER ENDED June 30, 2009**

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**Table of Contents****PART I - FINANCIAL INFORMATION****Item 1. Financial Statements  
FLANDERS CORPORATION AND SUBSIDIARIES****CONSOLIDATED CONDENSED BALANCE SHEETS**

(In thousands)

|  | June 30,<br>2009<br>(unaudited) | December 31,<br>2008 |
|--|---------------------------------|----------------------|
| <b>ASSETS</b>  |                                 |                      |
| <b>Current assets</b>  |                                 |                      |
| Cash and cash equivalents  | \$ 690                          | \$ 404               |
| Receivables:   |                                 |                      |
| Trade, less allowance:   |                                 |                      |
| 6/30/2009 \$3,297; 12/31/2008 \$3,683  | 45,642                          | 37,682               |
| Other  | 897                             | 280                  |
| Inventories  | 35,615                          | 31,549               |
| Deferred taxes   | 3,716                           | 4,285                |
| Income Taxes   | 7,447                           | 10,048               |
| Other current assets   | 4,150                           | 4,714                |
| <b>Total current assets</b>  | <b>98,157</b>                   | <b>88,962</b>        |
| <b>Property and equipment</b> , less accumulated depreciation: 6/30/2009<br>\$56,345; 12/31/2008 \$55,520  | 65,052                          | 57,156               |
| <b>Intangible assets</b> , less accumulated amortization: 6/30/2009<br>\$1,479; 12/31/2008 \$1,449   | 304                             | 295                  |
| <b>Notes Receivable and Other Assets</b>   | 14,730                          | 14,604               |
|  | \$ 178,243                      | \$ 161,017           |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                                 |                      |
| <b>Current liabilities</b>   |                                 |                      |
| Current maturities of long-term debt and capital lease obligations   | \$ 1,098                        | \$ 1,307             |
| Accounts payable   | 24,659                          | 22,795               |
| Accrued expenses   | 17,063                          | 13,517               |
| Other current liabilities  | 6,179                           | 6,179                |
| <b>Total current liabilities</b>   | <b>48,999</b>                   | <b>43,798</b>        |
| <b>Long-term capital lease obligations, less current maturities</b>  | 190                             | 554                  |
| <b>Long-term debt, less current maturities</b>   | 37,918                          | 29,611               |
| <b>Long-term liabilities, other</b>  | 3,821                           | 4,286                |
| <b>Deferred taxes</b>  |                                 |                      |
| <b>Commitments and contingencies</b>   |                                 |                      |
| <b>Stockholders equity</b>   |                                 |                      |
| Preferred stock, \$.001 par value, 10,000 shares authorized; none issued   |                                 |                      |
| Common stock, \$.001 par value; 50,000 shares authorized; issued and outstanding: 25,524 and 25,524 shares<br>at June 30, 2009 and December 31, 2008, respectively | 26                              | 26                   |

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|                                      |            |            |
|--------------------------------------|------------|------------|
| Additional paid-in capital           | 87,298     | 87,253     |
| Accumulated other comprehensive loss | (966)      | (1,231)    |
| Retained earnings (deficit)          | 957        | (3,280)    |
|                                      | 87,315     | 82,768     |
|                                      | \$ 178,243 | \$ 161,017 |

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**Table of Contents****FLANDERS CORPORATION AND SUBSIDIARIES****CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS****(In thousands, except per share data)****(unaudited)**

|   | <b>Three Months Ended</b> |                 | <b>Six Months Ended</b> |                 |
|---|---------------------------|-----------------|-------------------------|-----------------|
|   | <b>June 30,</b>           |                 | <b>June 30,</b>         |                 |
|   | <b>2009</b>               | <b>2008</b>     | <b>2009</b>             | <b>2008</b>     |
| Net sales   | \$ 58,727                 | \$ 57,269       | \$ 106,747              | \$ 106,463      |
| Cost of goods sold  | 46,129                    | 48,773          | 84,244                  | 89,243          |
| <b>Gross profit</b>   | <b>12,598</b>             | <b>8,496</b>    | <b>22,503</b>           | <b>17,220</b>   |
| Operating expenses  | 8,559                     | 9,313           | 16,094                  | 18,589          |
| <b>Operating income (loss)</b>                              | <b>4,039</b>              | <b>(817)</b>    | <b>6,409</b>            | <b>(1,369)</b>  |
| Nonoperating income (expense):                              |                           |                 |                         |                 |
| Other income, net   | 148                       | 1,442           | 902                     | 4,045           |
| Interest expense  | (318)                     | (492)           | (585)                   | (1,125)         |
|   | (170)                     | 950             | 317                     | 2,920           |
| <b>Earnings before income taxes and extraordinary item</b>  | <b>3,869</b>              | <b>133</b>      | <b>6,726</b>            | <b>1,551</b>    |
| Provision for income taxes                                  | 1,432                     | 53              | 2,489                   | 620             |
| Income before extraordinary item                            | 2,437                     | 80              | 4,237                   | 931             |
| Extraordinary gain on Fire (net of taxes)                   |                           | 6,802           |                         | 8,335           |
| <b>Net earnings</b>   | <b>\$ 2,437</b>           | <b>\$ 6,882</b> | <b>\$ 4,237</b>         | <b>\$ 9,266</b> |
| Income before extraordinary item Basic earnings per share   | \$ 0.10                   | \$ 0.00         | \$ 0.17                 | \$ 0.04         |
| Extraordinary item  | \$                        | \$ 0.27         | \$                      | \$ 0.32         |
| <b>Net earnings per share</b>                               | <b>\$ 0.10</b>            | <b>\$ 0.27</b>  | <b>\$ 0.17</b>          | <b>\$ 0.36</b>  |
| Income before extraordinary item Diluted earnings per share | \$ 0.09                   | \$ 0.00         | \$ 0.16                 | \$ 0.03         |
| Extraordinary item  | \$                        | \$ 0.26         | \$                      | \$ 0.32         |
| <b>Net earnings per share</b>                               | <b>\$ 0.09</b>            | <b>\$ 0.26</b>  | <b>\$ 0.16</b>          | <b>\$ 0.35</b>  |
| Weighted average common shares outstanding                  |                           |                 |                         |                 |
| Basic   | 25,524                    | 25,725          | 25,524                  | 25,724          |
| Diluted   | 25,887                    | 26,203          | 25,845                  | 26,185          |



**Table of Contents****FLANDERS CORPORATION AND SUBSIDIARIES****CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY****(In thousands)**

|   | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-In<br/>Capital</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Loss</b> | <b>Retained<br/>Earnings</b> | <b>Total</b> |
|---|-------------------------|---|---|------------------------------|--------------|
| <b>Balance, January 1, 2008</b>                                 | \$ 26                   | \$ 87,305                                 | \$ (782)  | \$ 853                       | \$ 87,402    |
| Stock option award compensation                                 |                         | 1,426                                     |   |                              | 1,426        |
| Purchase and retirement of 306 shares of common stock           | (1)                     | (1,904)                                   |   |                              | (1,905)      |
| Issuance of 138 shares of common stock upon exercise of options | 1                       | 426                                       |   |                              | 427          |
| <b>Comprehensive loss</b>                                       |                         |   |   |                              |              |
| Net loss  |                         |   |   | (4,133)                      | (4,133)      |
| Loss on cash flow hedges  |                         |   | (449)   |                              | (449)        |
| Total Comprehensive loss, net of tax                            |                         |   |   |                              | (4,582)      |
| <b>Balance, December 31, 2008</b>                               | \$ 26                   | \$ 87,253                                 | \$ (1,231)  | \$ (3,280)                   | \$ 82,768    |
| Stock option award compensation                                 |                         | 45  |   |                              | 45           |
| <b>Comprehensive earnings</b>                                   |                         |   |   |                              |              |
| Net earnings  |                         |   |   | 4,237                        | 4,237        |
| Gain on cash flow hedges  |                         |   | 265   |                              | 265          |
| Total Comprehensive earnings, net of tax                        |                         |   |   |                              | 4,502        |
| <b>Balance, June 30, 2009 (unaudited)</b>                       | \$ 26                   | \$ 87,298                                 | \$ (966)  | \$ 957                       | \$ 87,315    |



**Table of Contents****FLANDERS CORPORATION AND SUBSIDIARIES****CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS (In thousands)****(Unaudited)**

|  | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|--|--|-------------|--------------------------------------|-------------|
|  | <b>2009</b>                            | <b>2008</b> | <b>2009</b>                          | <b>2008</b> |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                |  |             |                                      |             |
| Net cash provided by operating activities                                  | \$ 860                                 | \$ 1,818    | \$ 2,665                             | \$ 5,468    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                |  |             |                                      |             |
| Disposal, net of cash acquired   |  |             |                                      | (11)        |
| Purchase of property and equipment   | (6,060)                                | (3,192)     | (9,910)                              | (5,237)     |
| Proceeds from sale of property and equipment                               | 205                                    | 7           | 254                                  | 10          |
| Proceeds from insurance claim on building and equipment                    | 466                                    |             | 466                                  |             |
| Decrease in other assets   | 478                                    | 479         | 647                                  | 678         |
| Net cash used in investing activities                                      | (4,911)                                | (2,706)     | (8,543)                              | (4,560)     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                |  |             |                                      |             |
| Principal payments on long-term borrowings                                 | (943)                                  | (228)       | (1,133)                              | (373)       |
| Net proceeds from (payments on) revolving credit agreement                 | 5,233                                  | 596         | 7,387                                | (406)       |
| Payment of Debt Issuance Costs   |  |             | (90)                                 |             |
| Purchase and Retirement of Common Stock                                    |  | (53)        |                                      | (334)       |
| Proceeds from Sales of Common Stock  |  |             |                                      | 56          |
| Net cash provided by (used in) financing activities                        | 4,290                                  | 315         | 6,164                                | (1,057)     |
| Net increase (decrease) in cash and cash equivalents                       | 239                                    | (573)       | 286                                  | (149)       |
| <b>CASH AND CASH EQUIVALENTS</b>   |  |             |                                      |             |
| Beginning of period  | 451                                    | 922         | 404                                  | 498         |
| End of period  | \$ 690                                 | \$ 349      | \$ 690                               | \$ 349      |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>                   |  |             |                                      |             |
| Cash paid during the period for:   |  |             |                                      |             |
| Income taxes   | \$ 179                                 | \$ 743      | \$ 241                               | \$ 793      |
| Interest   | \$ 411                                 | \$ 558      | \$ 612                               | \$ 1,122    |
| <b>SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES</b> |  |             |                                      |             |
| Sale of equipment for note receivable                                      | \$ 249                                 | \$ 332      | \$ 415                               | \$ 415      |
| Purchase of building with debt   | \$ 1,480                               | \$          | \$ 1,480                             | \$          |
| Sale of building for note receivable                                       | \$ 200                                 | \$          | \$ 200                               | \$          |
| Cashless exercise of common stock (Net)                                    | \$                                     | \$ (100)    | \$                                   | \$ (370)    |

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|   |          |          |          |           |
|---|----------|----------|----------|-----------|
| Offset of accrued expenses against trade accounts receivable                | \$ 2,412 | \$ 1,614 | \$ 5,839 | \$ 8,825  |
| Note Receivable in lieu of account receivable trade                         | \$       | \$ 677   | \$       | \$ 677    |
| Offset of accrued expenses against other receivables                        | \$       | \$ 900   | \$       | \$ 900    |
| <b>DISPOSAL OF COMPANIES</b>  |          |          |          |           |
| Working Capital surplus disposed, net of cash and cash equivalents disposed |          | 959      |          | 1,425     |
| Fair value of other assets disposed, principally property and equipment     |          | 8,518    |          | 8,637     |
| Goodwill disposed   |          |          |          | 589       |
| Minority interest   |          |          |          | 141       |
|   | \$       | \$ 9,477 | \$       | \$ 10,792 |

**Table of Contents****Note A. Nature of Business and Interim Financial Statements****Nature of business:**

The Company designs, manufactures and sells air filters and related products. It is focused on providing complete environmental filtration systems for uses ranging from controlling contaminants in residences and commercial office buildings through specialized manufacturing environments for semiconductors and pharmaceuticals. The Company also designs and manufactures much of its own production equipment to automate processes to decrease labor costs associated with its standard products. The vast majority of the Company's current revenues come from the sale of after-market replacement filters, since air filters are typically placed in equipment designed to last much longer than the filters.

The Company sells some products for end users outside of the United States through domestic specialty clean room contractors. These sales are accounted for as domestic sales. The Company also sells products through foreign distributors, primarily in Europe, and through a wholly-owned subsidiary, which sells to customers in the Pacific Rim. Sales through foreign distributors and its wholly owned foreign subsidiary total less than 5% of net sales. Assets held outside the United States are negligible.

The Company has one reportable segment which is air filtration systems.

**Interim financial statements:**

The interim consolidated condensed financial statements presented herein are unaudited and have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. These statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2008. In the opinion of management the interim statements include all adjustments (consisting only of normal recurring adjustments) necessary to summarize fairly our financial position, results of operations, and cash flows. The results of operations and cash flows for the six months ended June 30, 2009 may not be indicative of the results that may be expected for the year ending December 31, 2009. Further, in connection with preparation of the consolidated condensed financial statements and in accordance with the recently issued Statement of Financial Accounting Standards No. 165 Subsequent Events (SFAS 165), the Company evaluated subsequent events after the balance sheet date of June 30, 2009 through July 30, 2009.

**Other comprehensive loss:**

Other comprehensive loss is defined as the change in equity during a period, from transactions and other events not included in net earnings, excluding changes resulting from investments by owners (e.g., supplemental stock offerings) and distributions to owners (e.g., dividends).

As of June 30, 2009, accumulated comprehensive loss consisted of the following:

|  |                 |
|--|-----------------|
| Balance at December 31, 2008                             | \$ (1,231)      |
| Net change during the period related to cash flow hedges | 265             |
| <b>Balance at June 30, 2009</b>                          | <b>\$ (966)</b> |

**Accounts receivable:**

The majority of the Company's accounts receivables are due from large retail, wholesale, construction and other companies. Credit is extended based on evaluation of the customers' financial condition. Accounts receivable terms are within normal time frames for the respective industries. The Company maintains allowances for doubtful accounts for estimated losses, which are reviewed regularly by management. The estimated losses are based on the aging of accounts receivable balances and historical write-off experience, net of recoveries. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

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### **Principles of consolidation:**

The consolidated financial statements include the accounts and operations of the Company and its subsidiaries, all of which are wholly owned. All intercompany transactions and balances are eliminated in consolidation.

Prior to February 1, 2008, Air Filter Sales and Service, Inc. was 39% owned by Flanders Corporation and 61% was owned by other shareholders unrelated to the Company or any of its officers and directors. As of February 1, 2008, Air Filter Sales and Service, Inc. ceased to be consolidated, due to the Stock Purchase Agreement dated February 1, 2008. The accompanying financial statements present the consolidated result including Air Filter Sales and Service, Inc. up until February 1, 2008 with all intercompany transactions eliminated. After that date the financial statements do not include the financial results of Air Filter Sales and Service, Inc. The revenues and expense of Air Filter Sales and Service, Inc. through February 1, 2008 were \$254 and \$216, respectively.

### **Derivative financial instruments:**

The Company has only limited involvement with derivative financial instruments. The Company has three interest-rate swap agreements to hedge against the potential impact on earnings from increases in market interest rates of two variable rate bonds and one variable rate note. Under the interest rate swap agreements for the bonds, we receive or make payments on a monthly basis, based on the differential between 5.49% and a tax exempt interest rate as determined by a remarketing agent. Under the interest rate swap agreement for the note, we receive or make payments on a monthly basis, based on the differential between 5.86% and LIBOR plus 1.75%. These interest rate swaps are accounted for as a cash flow hedge in accordance with SFAS 133 and SFAS 138. Gains or losses related to inefficiencies of the cash flow hedge were included in net income during the period related to hedge ineffectiveness. The tax affected fair market value of the interest rate swaps of \$966 is included in Accumulated other comprehensive loss on the balance sheet. This fair value was determined using level 2 inputs as defined in SFAS No. 157. The interest rate swap contracts on the bonds expire in 2013 and 2015 and the interest rate swap on the note expires in 2013.

### **Revenue recognition:**

The Company's products are sold with terms and conditions, which vary depending on particular business environments in which the Company operates. The standard policy of the Company is to recognize revenue in accordance with accounting principles generally accepted in the United States of America; specifically SAB Topic 13A.

Generally, sales are recognized when shipments are made to customers. Rebates, allowances for damaged goods and other advertising and marketing program rebates, are accrued pursuant to contractual provisions and included in accrued expenses. An insignificant amount of our revenues fall under the percentage-of-completion method of accounting used for long-term contracts. Under this method, sales and gross profit are recognized as work is performed based on the relationship between actual costs incurred and total estimated costs at completion. Sales and gross profit are adjusted prospectively for revisions in estimated total contract costs and contract values. Estimated losses are recorded when identified.

### **Advertising costs:**

Advertising costs are charged to operations when incurred and are included in operating expenses. Advertising costs for the quarters ended June 30, 2009 and June 30, 2008 were \$1,006 and \$1,371, respectively. Advertising costs for the six months ended June 30, 2009 and June 30, 2008 were \$2,000 and \$2,651, respectively.

### **Impact of Recently Issued Accounting Pronouncements**

In March 2008, the FASB issued SFAS No. 161, Disclosures About Derivative Instruments and Hedging Activities (SFAS 161). SFAS 161 is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. The new standard is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of SFAS 161 did not have a material impact on the Company's financial statements.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS 162). The new standard is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles (GAAP) for nongovernmental entities. The new standard is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of SFAS 162 did not have a material impact on the Company's financial statements or condition.



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In May 2009, the FASB issued SFAS 165, *Subsequent Events* the objective of this Statement is to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In particular, this Statement sets forth: 1. the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, 2. the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and 3. the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. In accordance with this Statement, an entity should apply the requirements to interim or annual financial periods ending after June 15, 2009. The adoption of SFAS 165 did not have a material impact on the Company's financial statements or condition.

In June 2009, the FASB issued SFAS 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* a replacement of FASB Statement No. 162 (SFAS 168). SFAS 168 provides for the FASB Accounting Standards Codification (the Codification) to become the single official source of authoritative, nongovernmental U.S. generally accepted accounting principles (GAAP). The Codification did not change GAAP but reorganizes the literature. SFAS 168 is effective for interim and annual periods ending after September 15, 2009.

Other recent accounting pronouncements issued by the FASB, the AICPA, and the SEC did not or are not believed by management to have a material impact on the Company's present or future financial statements.

**Stock Options and Warrants:**

The following table summarizes the activity related to all Company stock options and warrants for the six months ended June 30, 2009 and the year ended December 31, 2008:

|                                  | Warrants | Stock<br>Options | Exercise Price<br>per Share |              | Weighted<br>Average<br>Exercise Price<br>per Share |         |
|----------------------------------|----------|------------------|-----------------------------|--------------|--|---------|
|                                  |          |                  | Warrants                    | Options      | Warrants   | Options |
| Outstanding at January 1, 2008   |          | 3,267            | \$ 1.74 - 11.72             |              | \$ 5.53  |         |
| Granted                          | 15       | 55               | 4.69 - 4.69                 | 4.69 - 5.71  | 4.69   | 4.78    |
| Exercised                        |          | (138)            |                             | 1.74 - 5.21  |  | 3.09    |
| Canceled or expired              |          | (279)            |                             | 3.93 - 11.72 |  | 8.93    |
| Outstanding at December 31, 2008 | 15       | 2,905            | 4.69 - 4.69                 | 1.74 - 11.72 | 4.69   | 5.29    |
| Granted                          |          | 15               |                             | 4.60 - 4.60  |  | 4.60    |
| Exercised                        |          |                  |                             |              |  |         |
| Canceled or expired              |          | (20)             |                             | 5.21 - 5.21  |  | 5.21    |
| Outstanding at June 30, 2009     | 15       | 2,900            |                             | 2.50 - 11.72 |  | \$ 5.29 |

The options expire at various dates ranging from August 2009 through January 2019.

**Share-Based Compensation**

As of June 30, 2009, there was no unrecognized stock-based compensation expense related to non-vested stock options.

The aggregate intrinsic value of options outstanding at June 30, 2009, based on the Company's closing stock price of \$6.11 as of the last business day of the period ended June 30, 2009, which would have been received by the optionees had all options been exercised on that date was \$4,409. The aggregate intrinsic value of options exercisable at June 30, 2009, based on the Company's closing stock price of \$6.11 as of the last business day of the period ended June 30, 2009, which would have been received by the optionees had all options exercisable been exercised on that date was \$4,409. The aggregate intrinsic value of options exercised during the six months ended June 30, 2009 was \$0. Intrinsic value is the amount by which the fair value of the underlying stock exceeds the exercise price of the options.

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Options on 1,285 shares of common stock were not included in computing diluted EPS for the quarter period ended June 30, 2009, because their effects were anti-dilutive.

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**Table of Contents****Note B. Inventories**

Inventories consist of the following at June 30, 2009 and December 31, 2008:

|                  | 6/30/2009 | 12/31/2008 |
|------------------|-----------|------------|
| Finished goods   | \$ 15,918 | \$ 14,579  |
| Work in progress | 3,066     | 1,924      |
| Raw materials    | 17,405    | 15,820     |
|                  | 36,389    | 32,323     |
| Less allowances  | 774       | 774        |
|                  | \$ 35,615 | \$ 31,549  |

**Note C. Notes Receivable and Other Assets**

Other assets consist of the following at June 30, 2009 and December 31, 2008:

|                  | June 30, 2009 | December 31,<br>2008 |
|------------------|---------------|----------------------|
| Other Assets     | \$ 1,267      | \$ 1,111             |
| Notes Receivable | 13,463        | 13,493               |
|                  | \$ 14,730     | \$ 14,604            |

**Note D. Pledged Assets and Debt**

As of June 30, 2009 the Company's total obligations to Bank of America were approximately \$22,135. During July 2009, the Company entered into an amendment to the credit facility with its bank. The current revolving credit agreement with the bank provides a maximum line of credit of \$36 million (subject to availability) and bears interest at (i) LIBOR plus 3.75%; or (ii) the bank's base rate plus 2.75%. The revolving credit agreement is part of a combined facility with a bank that also includes a \$12 million facility to guarantee letters of credit. The line of credit is due in 2011. The combined facility is collateralized by substantially all of the Company's assets and restricts capital expenditures, payment of dividends and share repurchases. The company also has debt to a regional development authority with certain restrictive covenants. As of June 30, 2009 the Company is in compliance with its financial covenants.

**Note E. Extraordinary Gain and Loss on Fire**

In June of 2006 a manufacturing facility in Pennsylvania was damaged by flood. In July 2007 another manufacturing facility in Florida was destroyed by fire. The extraordinary gain as of June 30, 2008 of \$8,335 was calculated as the gain on the costs that were attributable to these natural disasters (\$1,587) that were less than the insurance proceeds (\$15,479), net of taxes of \$5,557.

In September 2008, the warehouse in Auburn, Pennsylvania was partially destroyed by fire. All anticipated losses resulting from this fire are expected to be covered by insurance.

**Note F. Acquisitions**



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In May of 2009 the Company acquired furnace filter equipment and inventory of Wildwood Industries, Inc. for \$3.6 million. Flanders then immediately sold unrelated assets to R.P.S Products, Inc. for \$2.2 million.

### **Note G. Income Taxes**

The IRS is currently examining the Company's federal income tax returns of 2002, 2003, 2004, 2005, and 2006. To date the IRS has proposed certain changes for the 2002, 2003, 2004, 2005, and 2006 examinations, resulting in additional liabilities due. The Company has submitted a petition to the IRS for a redetermination of the changes with the U.S. Tax Court. These liabilities have been included in the Company's FIN 48 liability which is included in other current liabilities.

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### **Note H. Litigation**

From time to time, the Company is a party to various legal proceedings incidental to our business. None of these proceedings are material to our business, operations or financial condition.

In the opinion of management, although the outcome of any legal proceeding cannot be predicted with certainty, the ultimate liability of the Company in connection with its legal proceedings will not have a material adverse effect on the Company's financial position, but could be material to the results of operations in any one future accounting period.

### **Note I. Sale Leaseback of Property and Related Party Transactions**

In August 2008, the Company sold its Bartow property to Wal-Pat II, LLC, a related party. The property was sold for \$3.7 million and part of the proceeds were used to pay down the existing debt on this property in the amount of approximately \$1.8 million. The Company has leased this property back in March 2009. The Company has recorded a deferred gain of \$1.4 million on the sale which will be amortized to rent expense over the lease term of 10 years.

During the second quarter 2009 the Company purchased a building in Folcroft, Pennsylvania from Wal-Pat II, LLC by assuming a note payable for \$1.5 million.

The above terms and amounts are not necessarily indicative of the terms and amounts that would have been incurred had comparable transactions been entered into with independent parties.

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

The following discussions should be read in conjunction with our Consolidated Condensed Financial Statements and the notes thereto presented in Item 1 Financial Statements and our audited financial statements and the related Management's Discussion and Analysis of Financial Condition and Results of Operations included in our report on Form 10-K for the year ended December 31, 2008. The information set forth in this Management's Discussion and Analysis of Financial Condition and Results of Operations includes forward-looking statements that involve risks and uncertainties. Many factors, including those discussed below under Factors That May Affect Future Results and Outlook could cause actual results to differ materially from those contained in the forward-looking statements below.

#### **Overview**

Flanders is a full-range air filtration product company engaged in designing, manufacturing and marketing high performance, mid-range and standard-grade air filtration products and related products and services. Our focus has evolved from expansion through acquisition to increasing the quality and efficiency of our high-volume replacement filtration products, and using these benefits to compete more effectively in the marketplace. We also design and manufacture much of our own production equipment.

#### **Critical Accounting Policies**

The following discussion and analysis is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of our financial statements requires management to make estimates and assumptions that affect the reported amounts of revenues and expenses, and assets and liabilities during the periods reported. Estimates are used when accounting for certain items such as revenues, allowances for returns, early payment discounts, customer discounts, doubtful accounts, employee compensation programs, depreciation and amortization periods, taxes, inventory values, insurance programs, and valuations of investments, other intangible assets and long-lived assets. We base our estimates on historical experience where applicable and other assumptions that we believe are reasonable under the circumstances. Actual results may differ from our estimates under different assumptions or conditions. In the ordinary course of accounting for items such as allowance for doubtful accounts, inventory valuation, and other items mentioned above, we make changes in estimates as appropriate in the circumstances. Such changes and refinements in estimation methodologies are reflected in report results of operations and, if material, the approximate effects of changes in estimates are disclosed in the Notes to our Consolidated Financial Statements. We believe that the following critical accounting policies reflect our more significant judgments and estimates used in preparation of our consolidated financial statements.



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We maintain allowances for estimated losses resulting from the inability of our customers to make required payments. We base our estimates on the aging of our accounts receivable balances and our historical write-off experience, net of recoveries. Actual results could differ materially from this estimate, making it reasonably possible that a change in this estimate could occur in the near term.

We value our inventories at the lower of cost or market. We write down inventory balances for estimated obsolescence or unmarketable inventory equal to the difference between the cost of the inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

Estimates of our insurance costs are developed by management's evaluation of the likelihood and probable amount of potential claims based on historical experience and evaluation of each claim. Changes in the key assumptions may occur in the future, which would result in changes to related insurance costs.

Poor operating performance of the business activities related to intangible assets or long-lived assets could result in future cash flows of these assets declining below carrying values, which could require a write-down of the carrying value of these assets, which would adversely affect operating results.

Generally, sales are recognized when shipments are made to customers. Rebates, allowances for damaged goods and other advertising and marketing program rebates are accrued pursuant to contractual provisions and included in accrued expenses. An insignificant amount of our revenues fall under the percentage-of-completion method of accounting used for long-term contracts. Under this method, sales and gross profit are recognized as work is performed based on the relationship between actual costs incurred and total estimated costs at completion. Sales and gross profit are adjusted prospectively for revisions in estimated total contract costs and contract values. Estimated losses are recorded when identified.

**Results of Operations for Three Months Ended June 30, 2009 Compared to June 30, 2008**

The following table summarizes our results of operations as a percentage of net sales for the three months ended June 30, 2009 and 2008.

|   | <b>Three Months Ended</b> |             |             |             |
|---|---------------------------|-------------|-------------|-------------|
|   | <b>2009</b>               |             | <b>2008</b> |             |
|   | <b>June 30,</b>           |             |             |             |
|   | <b>2009</b>               | <b>2008</b> | <b>2009</b> | <b>2008</b> |
| Net sales   | \$ 58,727                 | 100.0%      | \$ 57,269   | 100.0%      |
| Gross profit  | 12,598                    | 21.5        | 8,496       | 14.8        |
| Operating expenses                                  | 8,559                     | 14.6        | 9,313       | 16.3        |
| Operating income (loss)                             | 4,039                     | 6.9         | (817)       | (1.4)       |
| Nonoperating income (expense)                       | (170)                     | (0.3)       | 950         | 1.7         |
| Provision for income taxes                          | 1,432                     | 2.4         | 53          | 0.1         |
| Extraordinary gain on Fire and Flood (net of taxes) |                           |             | 6,802       | 11.9        |
| Net earnings  | 2,437                     | 4.1         | 6,882       | 12.0        |

*Net sales:* Net sales for the second quarter of 2009 increased by \$1,458, or 2.5%, to \$58,727 from \$57,269 for the second quarter of 2008. Sales increased during the second quarter of 2009 compared to the second quarter of 2008 due to an increase in our retail business partially offset by a decrease in most areas of our commercial and industrial business lines.

*Gross Profit:* Gross profit for the second quarter of 2009 increased by \$4,102, or 48.3%, to \$12,598, which represented 21.5% of net sales, from \$8,496, which represented 14.8% of net sales for the second quarter of 2008. The gross profit was higher during the second quarter of 2009 due to 2008 increases in in-bound shipping costs, due to increased fuel costs and raw material costs, especially in the cost of metal. Also, in 2008, our media producing facility was producing for part of the period which contributed to lower margins.

*Operating expenses:* Operating expenses for the second quarter of 2009 decreased by \$754 or 8.1%, to \$8,559, representing 14.6% of net sales, from \$9,313, representing 16.3% of net sales, for the second quarter of 2008. The decrease in operating expenses is primarily due to the sale of certain direct sales offices, decreases in freight costs of \$620, decreases in commissions of \$363, and a decrease in advertising costs of \$366 offset by an increase in our bad debt expense of \$488.



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*Nonoperating income (expense):* Net nonoperating income for the second quarter of 2009 decreased by \$1,120, to expense of \$170 representing (0.3%) of net sales, from income of \$950 representing 1.7% of net sales, for the second quarter of 2008 due to the sale of a direct office and its media producing facility during the second quarter 2008.

*Provision for income taxes:* The IRS is currently examining the Company's federal income tax returns of 2002, 2003, 2004, 2005, and 2006. To date the IRS has proposed certain changes for the 2002, 2003, 2004, 2005, and 2006 examinations, resulting in additional liabilities due. The Company has submitted a petition to the IRS for a redetermination of the changes with the U.S. Tax Court. These liabilities have been included in the Company's FIN 48 liability which is included in other current liabilities. Our provision for the three months of 2009 and 2008 were a blended state and federal rate of approximately 37% and 40% of pretax earnings, respectively.

*Extraordinary gain on Fire and Flood (net of taxes):* In June of 2006 a manufacturing facility in Pennsylvania was damaged by flood. In July 2007 another manufacturing facility in Florida was destroyed by fire. The extraordinary gain for the quarter ended June 30, 2008 of \$6,802 was calculated as the gain on the costs that were attributable to these natural disasters (\$613) that were less than the insurance proceeds (\$11,950), net of taxes of \$4,535.

**Results of Operations for Six Months Ended June 30, 2009 Compared to June 30, 2008**

The following table summarizes our results of operations as a percentage of net sales for the six months ended June 30, 2009 and 2008.

|   | Six Months Ended June 30, |        |            |        |
|---|---------------------------|--------|------------|--------|
|   | 2009                      |        | 2008       |        |
| Net sales   | \$ 106,747                | 100.0% | \$ 106,463 | 100.0% |
| Gross profit  | 22,503                    | 21.1   | 17,220     | 16.2   |
| Operating expenses                                  | 16,094                    | 15.1   | 18,589     | 17.5   |
| Operating income (loss)                             | 6,409                     | 6.0    | (1,369)    | (1.3)  |
| Nonoperating income                                 | 317                       | 0.3    | 2,920      | 2.7    |
| Provision for income taxes                          | 2,489                     | 2.3    | 620        | 0.6    |
| Extraordinary gain on Fire and Flood (net of taxes) |                           |        | 8,335      | 7.8    |
| Net earnings  | 4,237                     | 4.0    | 9,266      | 8.7    |

*Net sales:* Net sales for the first half 2009 increased by \$284, or (0.3%), to \$106,747 from \$106,463 for the first half of 2008. Sales increased during the second quarter of 2009 compared to the second quarter of 2008 due to an increase in our retail business partially offset by a decrease in most areas of our commercial and industrial business lines.

*Gross Profit:* Gross profit for the first half of 2009 increased by \$5,283, or 30.7%, to \$22,503, which represented 21.1% of net sales, from \$17,220, which represented 16.2% of net sales for the first half of 2008. The gross profit was higher during the first half of 2009 due to 2008 increases in in-bound shipping costs, due to increased fuel costs and raw material costs, especially in the cost of metal. Also, in 2008, our media producing facility was producing for part of the period which contributed to lower margins.

*Operating expenses:* Operating expenses for the first half of 2009 decreased by \$2,495 or 13.4%, to \$16,094, representing 15.1% of net sales, from \$18,589, representing 17.5% of net sales, for the first half of 2008. The decrease in operating expenses is primarily due to the sale of certain direct sales offices, decreases in freight costs of \$1.4 million, decreases in commissions of \$1.6 million, and a decrease in advertising costs of \$647 offset by an increase in our bad debt expense of \$425 and insurance expenses of \$270.

*Nonoperating income (expense):* Net nonoperating income for the first half of 2009 decreased by \$2,603, to \$317 representing 0.3% of net sales, from \$2,920 representing 2.7% of net sales, for the first half of 2008 due to the sale of certain direct sales offices and its media producing facility during the first half 2008 as well as the settling of trade accounts payable with Superior Diecutting, Inc. (previously a related party of the Company) for less than what was owed during the first half of 2008.

*Provision for income taxes:* The IRS is currently examining the Company's federal income tax returns of 2002, 2003, 2004, 2005, and 2006. To date the IRS has proposed certain changes for the 2002, 2003, 2004, 2005, and 2006 examinations, resulting in additional liabilities due. The Company has submitted a petition to the IRS for a redetermination of the changes with the U.S. Tax Court. These liabilities have been included in the Company's FIN 48 liability which is included in other current liabilities. Our provision for the six months of 2009 and 2008 were a blended state and federal rate of approximately 37% and 40% of pretax earnings, respectively.



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*Extraordinary gain on Fire and Flood (net of taxes):* In June of 2006 a manufacturing facility in Pennsylvania was damaged by flood. In July 2007 another manufacturing facility in Florida was destroyed by fire. The extraordinary gain as of June 30, 2008 of \$8,335 was calculated as the gain on the costs that were attributable to these natural disasters (\$1,587) that were less than the insurance proceeds (\$15,479), net of taxes of \$5,557.

### **Liquidity and Capital Resources**

Our working capital was approximately \$49,158 at June 30, 2009, compared to approximately \$45,164 at December 31, 2008. This includes cash and cash equivalents of \$690, at June 30, 2009 and \$404 at December 31, 2008.

Our trade receivables increased \$7,960, or 21.1% to \$45,642 at June 30, 2009, from \$37,682 at December 31, 2008 due to the timing of sales during the second quarter of 2009. Trade receivables are typically higher during the second and third quarters due to higher sales volume due to increased demand during the warmer months of the year.

Inventories increased \$4,066, or 12.9%, to \$35,615 at June 30, 2009 from \$31,549 at December 31, 2008. The increase in inventory was primarily due to the increase in demand for the Company's retail products as well as the seasonal increase in inventory as the Company prepares for the peak demand during the warmer months.

Our continuing operations generated \$860 and \$1,818 of cash during the second quarter of 2009 and 2008, respectively. The decrease in cash flows from operating activities was primarily due to the decrease in cash received from the extraordinary items along with the increase in inventory, offset by decreases in accounts receivable and deferred taxes and by increases in accounts payable.

Our financing activities generated \$4,290 of cash during the second quarter of 2009, primarily consisting of proceeds on the line of credit, net of payments on other long term borrowings. Our investing activities used \$4,911 of cash during the second quarter of 2009, primarily due to purchase of property and equipment.

During July 2009, the Company entered into an amendment to the credit facility with its bank. The current revolving credit agreement with the bank provides a maximum line of credit of \$36 million (subject to availability) and bears interest at (i) LIBOR plus 3.75%; or (ii) the bank's base rate plus 2.75%. The revolving credit agreement is part of a combined facility with a bank that also includes a \$12 million facility to guarantee letters of credit. The line of credit is due in 2011. The combined facility is collateralized by substantially all of the Company's assets and restricts capital expenditures, payment of dividends and share repurchases.

In connection with the working capital credit facility and notes payable to a regional development authority and bank, the Company and its majority owned subsidiaries have agreed to certain restrictive covenants which include, among other things, not paying dividends or repurchasing its stock without prior written consent, and maintenance of certain financial ratios at all times including: a minimum current ratio; a minimum tangible net worth; a maximum ratio of total liabilities to tangible net worth; a minimum fixed charge coverage ratio; and a minimum earnings before interest, taxes, depreciation and amortization amount. As of June 30, 2009 the financial covenants of the Company are in compliance with the credit facility.

We believe that our cash on hand, cash generated by operations, and cash available from our existing credit facilities is sufficient to meet the capital demands of our current operations during the 2009 fiscal year. Any major increases in sales, particularly in new products, may require substantial capital investment for the manufacture of filtration products. Failure to obtain sufficient capital could materially adversely impact our growth potential.

### **Outlook**

During the past three years, we have captured additional market share among big box retailers like The Home Depot, Lowe's and Wal-Mart, capitalizing on our ability to service national accounts from regional distribution centers. We anticipate additional market gains among these types of retailers during the next two years and are introducing new products focused on their marketing and end-user requirements. Sales to these retail outlets, while seasonal, also tend to follow progress in the overall economy. Additional gains in market share in this market may not have a significant impact on revenues without some recovery in the overall U.S. economy. Additionally, significant revenue enhancement to these customers is largely dependent upon the success of the new products we are introducing to this marketplace.



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We have adapted our biocontainment products for use as part of a system for hardening government buildings, commercial office complexes and public venues against airborne bioweapons such as anthrax and smallpox. There is currently an increase of interest in these products over the past quarter. Any interest towards hardening these types of facilities against airborne bioweapons could have a significant impact on our business.

Sales of air filtration products for semiconductor facilities, historically a major market, are expected to be slow again during 2009, with most analysts pushing recovery for this sector out until 2010.

We have collected data that indicates that residential filter users replace their filters, on average, approximately one and a half times per year. Manufacturers of residential furnace and air conditioning systems recommend that these filters be changed every month. A minor trend toward increased maintenance of these residential heating and cooling systems could have a positive impact on our business.

Our most common products, in terms of unit and dollar volume, are residential throw-away spun-glass filters, which usually sell for prices under \$1.00. Any increase in consumer concern regarding air pollution, airborne pollens, allergens, and other residential airborne contaminants could result in replacement of some of these products with higher value products. Our higher value products include our NaturalAire® higher-efficiency filters for residential use with associated sales prices typically over \$5.00 each. Any such trend would have a beneficial effect on our business.

We believe there is currently a gradually increasing public awareness of the issues surrounding indoor air quality and that this trend will continue for the next several years. We also believe there is an increase in public concern regarding the effects of indoor air quality on employee productivity, as well as an increase in interest by standards-making bodies in creating specifications and techniques for detecting, defining and solving indoor air quality problems. We further believe there will be an increase in interest in our Absolute Isolation Barriers in the future because these products may be used in both semiconductor and pharmaceutical manufacturing plants to prevent cross-contamination between different lots and different processes being performed at the same facility. These products also increase production yields in many applications.

Currently, the largest domestic market for air filtration products is for mid-range ASHRAE-rated products and HVAC systems, typically used in commercial and industrial buildings. To date, our penetration of this market has been relatively small. We believe our ability to offer a one stop supply of air filtration products to HVAC distributors and wholesalers may increase our share of this market. We also believe that our recently developed modular air handlers and environmental tobacco smoke systems will enable us to expand sales to these customers. We intend our new products to serve as high profile entrants with distributors and manufacturers representatives, who can then be motivated to carry our complete product line.

We have continually looked for cost reductions in our products. During the past five years, we have continued to complete the development and redesigning of numerous systems and products which were only partially completed when we acquired the companies which originally claimed to have fully developed them. These products include the automated machinery necessary for high-speed production of our pleated filters, acquired with Precisionaire, and the mass-production processes for bonded carbon high-mass zero-density products. During 2006, we built our first fully automated production lines which reduced our labor related costs.

This Outlook section, and other portions of this document, include certain forward-looking statements within the meaning of that term in Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934, including, among others, those statements preceded by, following or including the words believe, expect, intend, anticipate or similar expressions. These forward-looking statements are based largely on the current expectations of management and are subject to a number of assumptions, risks and uncertainties. Our actual results could differ materially from these forward-looking statements. Important factors to consider in evaluating such forward-looking statements include those discussed in Item 1A. Risk Factors as well as:

the shortage of reliable market data regarding the air filtration market,

changes in external competitive market factors or in our internal budgeting process which might impact trends in our results of operations,

anticipated working capital or other cash requirements,

changes in our business strategy or an inability to execute our strategy due to unanticipated changes in the market,

product obsolescence due to the development of new technologies, and

various competitive factors that may prevent us from competing successfully in the marketplace.

In light of these risks and uncertainties, there can be no assurance that the events contemplated by the forward-looking statements contained in this Form 10-Q will in fact occur.

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### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to various market risks, primarily changes in interest rates. Market risk is the potential loss arising from adverse change in market rates and prices, such as foreign currency exchange and interest rates. For Flanders, these exposures are primarily related to changes in interest rates. We do not hold any derivatives or other financial instruments for trading or speculative purposes.

The fair value of the Company's total long-term debt, including capital leases and current maturities of long-term debt, at June 30, 2009 was \$39,206. Market risk was estimated as the potential decrease (increase) in future earnings and cash flows resulting from a hypothetical 10% increase (decrease) in the Company's estimated weighted average borrowing rate at June 30, 2009. Although most of the interest on the Company's debt is indexed to a market rate, there would be no material effect on the future earnings or cash flows related to the Company's total debt for such a hypothetical change.

We have only a limited involvement with derivative financial instruments. We have three interest-rate swap agreements to hedge against the potential impact on earnings from increases in market interest rates of two variable rate bonds and one variable rate note. Under the interest rate swap agreements for the bonds, we receive or make payments on a monthly basis, based on the differential between 5.49% and a tax exempt interest rate as determined by a remarketing agent. Under the interest rate swap agreement for the note, we receive or make payments on a monthly basis, based on the differential between 5.86% and LIBOR plus 1.75%. These interest rate swaps are accounted for as a cash flow hedge in accordance with SFAS 133 and SFAS 138. Gains or losses related to inefficiencies of the cash flow hedge were included in net income during the period related to hedge ineffectiveness. The tax affected fair market value of the interest rate swaps of \$966 is included in

Accumulated other comprehensive loss on the balance sheet. The interest rate swap contracts on the bonds expire in 2013 and 2015 and the interest rate swap on the note expires in 2013.

The Company's financial position is not materially affected by fluctuations in currencies against the U.S. dollar, since assets held outside the United States are negligible. Risks due to changes in foreign currency exchange rates are negligible, as the preponderance of our foreign sales occur over short periods of time or are demarcated in U.S. dollars.

### **Item 4. Controls and Procedures**

#### *Evaluation of Disclosure Controls and Procedures*

Under the supervision and with the participation of the Company's management, including the Company's principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of the design and operations of its disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), as of the end of the period covered by this report. Based on their evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective such that the material information required to be included in our Securities and Exchange Commission (SEC) reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and (ii) is accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

#### *Changes in Internal Control Over Financial Reporting*

There were no changes in the Company's internal control over financial reporting during the second quarter of 2009, which were identified in connection with management's evaluation required by paragraph (d) of rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

From time to time, we are a party to various legal proceedings incidental to our business. None of the current proceedings in which we are involved are material to our business, operations or financial condition.

**Item 1A. Risk Factors**

Our business, financial condition, operating results and cash flows can be impacted by a number of factors, including, but not limited to those set forth below, any one of which could cause our actual results to vary materially from recent results or from our anticipated future

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results. For a discussion identifying additional risk factors and important factors that could cause actual results to differ materially from those anticipated, see the discussion in *Factors That May Affect Future Results* in our Form 10-K for 2008 and in *Management's Discussion and Analysis of Financial Condition and Results of Operations* and *Notes to Consolidated Financial Statements* in our 2008 Annual Report and in this Form 10-Q.

*Failure to Manage Future Growth Could Adversely Impact Our Business Due to the Strain on Our Management, Financial and Other Resources*

If our business expands in the future, the additional growth will place burdens on management to manage such growth while maintaining profitability. Our ability to compete effectively and manage future growth depends on our ability to:

recruit, train and manage our work force, particularly in the areas of corporate management, accounting, research and development and operations,

manage production and inventory levels to meet product demand,

manage and improve production quality,

expand both the range of customers and the geographic scope of our customer base, and

improve financial and management controls, reporting systems and procedures.

Any failure to manage growth effectively could have a material adverse effect on our business, financial condition and results of operations.

*Failure to Adequately Ramp-Up Production Capacity to Meet Demand Could Adversely Impact Our Business Due to Strain on Financial Resources.*

Any delays in an untried supply chain, new production chains, and other delays common to the launch of a new product line could also adversely impact the success of the products, as well as current relationships with major accounts.

*Our Business May Suffer If Our Competitive Strategy is Not Successful*

Our continued success depends on our ability to compete in an industry that is highly competitive. This competition may increase as new competitors enter the market. Several of our competitors may have longer operating histories and greater financial, marketing and other resources than we do. Additionally, our competitors may introduce new products or enhancements to products that could cause a decline in sales or loss of market acceptance of our existing products. Under our current competitive strategy, we endeavor to remain competitive by:

increasing our market share,

expanding our market through the introduction of new products which require periodic replacement, and

improving operating efficiencies.

Although our executive management team continues to review and monitor our strategic plans, we have no assurance that we will be able to follow our current strategy or that this strategy will be successful.

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### *Our Business May Suffer if Our Strategy to Increase the Size and Customer Base of the Air Filtration Market is Unsuccessful*

We are developing new products as part of our strategy to increase the size and customer base of the air filtration market. We have no assurance that this strategy will be successful. We have no guarantee that any new products we develop will gain acceptance in the marketplace, or that these products will be successful. Additionally, we have no assurance we will be able to recoup the expenditures associated with the development of these products. To succeed in this area we must:

increase public awareness of the issues surrounding indoor air quality,

adequately address the unknown requirements of the potential customer base,

develop new products that are competitive in terms of price, performance and quality, and

avoid significant increases in current expenditure levels in development, marketing and consumer education.

### *We May Experience Critical Equipment Failure Which Could Have a Material Adverse Effect on Our Business*

If we experience extended periods of downtime due to the malfunction or failure of our automated production equipment, our business, financial condition and operations may suffer. We design and manufacture much of the automated production equipment used in our facilities. We also use other technologically advanced equipment for which manufacturers may have limited production capability or service experience. If we are unable to quickly repair our equipment or quickly obtain new equipment or parts from outside manufacturers, we could experience extended periods of downtime in the event of malfunction or equipment failure.

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*Our Plan to Centralize Overhead Functions May Not Produce the Anticipated Benefits to Our Operating Results*

We are currently completing the implementation of plans to centralize overhead functions and eliminate duplication of efforts between our subsidiaries in the following areas:

purchasing,

production planning,

shipping coordination,

marketing,

accounting,

personnel management,

risk management, and

benefit plan administration.

We have no assurance that cutting overhead in this fashion will have the anticipated benefits to our operating results. Additionally, we have no assurance that these reorganizations will not significantly disrupt the operations of the affected subsidiaries.

*Our Success Depends on Our Ability to Retain and Attract Key Personnel*

Our success and future operating results depend in part upon our ability to retain our executives and key personnel, many of whom would be difficult to replace. Our success also depends on our ability to attract highly qualified engineering, manufacturing, and technical sales and support personnel for our operations. Competition for such personnel, particularly qualified engineers, is intense, and there can be no assurance that we will be successful in attracting or retaining such personnel. Our failure to attract or retain such persons could have a material adverse effect on our business, financial condition and results of operations.

*Our Current Distribution Channels May be Unavailable if Our Manufacturers' Representatives Decide to Work Primarily With One of Our Competitors*

We provide our manufacturers' representatives with the ability to offer a full product line of air filtration products to existing and new customers. Some of our competitors offer similar arrangements. We do not have exclusive relationships with all of our representatives. Consequently, if our representatives decide to work primarily with one of our competitors, our current distribution channels, and hence, our sales, could be significantly reduced.

*We may have additional tax liability.*

We are subject to complex income tax and other taxing regulations. Significant judgment is required in the determination of a provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly under audit by taxing authorities. Although we believe our tax estimates are reasonable, the final outcome of tax

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audits in any related litigation could be materially different than that which is reflected in historical income tax provisions and accruals. Based on the status of a given tax audit or related litigation, a material effect on our income tax provision or net income may result in a period or periods from initial recognition in our reported financial results to the final closure that tax auditor settlement of related litigation when the ultimate tax and related cash flow is known with certainty.

### *Management Controls a Significant Percentage of Our Stock*

As of June 30, 2009, our directors and executive officers beneficially held approximately 35.2% of our outstanding common stock. As a result, such shareholders effectively control or significantly influence all matters requiring shareholder approval. These matters include the election of directors and approval of significant corporate transactions. Such concentration of ownership may also have the effect of delaying or preventing a change in control that may otherwise be advantageous to the non-affiliated shareholders.

### *We May be Required to Issue Stock in the Future That Will Dilute the Value of Our Existing Stock*

We have granted options to purchase a total of 2,900,000 shares of common stock to various parties with exercise prices ranging from \$2.50 to \$11.72 per share. These options are all currently exercisable. Additionally, if the option holders exercise their options, the interests of current shareholders may be diluted.



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*Even though our common stock is currently traded on the NASDAQ Stock Market's Global Select Market, it has less liquidity than many other stocks quoted on a national securities exchange.*

The trading volume in our common stock on the NASDAQ Global Select Market has been relatively low when compared with larger companies listed on the NASDAQ Global Select Market or other stock exchanges. Although we have experienced increased liquidity in our stock, we cannot say with any certainty that a more active and liquid trading market for our common stock will continue to develop. Because of this, it may be more difficult for shareholders to sell a substantial number of shares for the same price at which shareholders could sell a smaller number of shares.

We cannot predict the effect, if any, that future sales of our common stock in the market, or the availability of shares of common stock for sale in the market, will have on the market price of our common stock. We can give no assurance that sales of substantial amounts of common stock in the market, or the potential for large amounts of sales in the market, would not cause the price of our common stock to decline or impair our future ability to raise capital through sales of our common stock.

The market price of our common stock has fluctuated significantly, and may fluctuate in the future. These fluctuations may be unrelated to our performance. General market or industry price declines or overall market volatility in the future could adversely affect the price of our common stock, and the current market price may not be indicative of future market prices.

*Our internal control over financial reporting may have weaknesses or inadequacies that may be material.*

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to perform an evaluation of our internal control over financial reporting and our auditor to attest to such evaluation on an annual basis. Management concluded that our internal control over financial reporting was effective at June 30, 2009. Ongoing compliance with these requirements is expected to be expensive and time-consuming and may negatively impact our results of operations. While our management did not identify any material weaknesses in our internal control over financial reporting at June 30, 2009 and concluded that our internal control over financial reporting was effective, we cannot make any assurances that material weaknesses in our internal control over financial reporting will not be identified in the future. If any material weaknesses are identified in the future, we may be required to make material changes in our internal control over financial reporting, which could negatively impact our results of operations. In addition, upon such occurrence, our management may not be able to conclude that our internal control over financial reporting is effective or our independent registered public accounting firm may not be able to attest that our internal control over financial reporting was effective. If we cannot conclude that our internal control over financial reporting is effective or if our independent registered public accounting firm is not able to attest that our internal control over financial reporting is effective, we may be subject to regulatory scrutiny, and a loss of public confidence in our internal control over financial reporting, which may cause the value of our common stock to decrease.

*Our Shareholders May Not Realize Certain Opportunities Because of North Carolina Law*

We are subject to the Control Shares Acquisition Act of the State of North Carolina. This act provides that any person who acquires control shares of a publicly held North Carolina corporation will not have voting rights with respect to the acquired shares in certain circumstances. The North Carolina Shareholder Protection Act requires the affirmative vote of 95% of our voting shares to approve a business combination with any entity that beneficially owns 20% of the outstanding voting shares of the corporation unless the fair price provisions of the Act are satisfied. These provisions could deprive shareholders of opportunities to realize takeover premiums for their shares or other advantages that large accumulations of stock would typically provide.

*Our Business Can be Significantly Affected by Environmental Laws*

The constantly changing body of environmental laws and regulations may significantly influence our business and products. These laws and regulations require that various environmental standards be met and impose liability for the failure to comply with such standards. While we endeavor at each of our facilities to assure compliance with environmental laws and regulations, and are currently not aware of any ongoing issues of this nature, we cannot be certain that our operations or activities, or historical operations by others at our locations, will not result in civil or criminal enforcement actions or private actions that could have a materially adverse effect on our business. We have, in the past, and may, in the future, purchase or lease properties with unresolved potential violations of federal or state environmental regulations. In these transactions, we have been successful in obtaining sufficient indemnification and mitigating the impact of the issues without recognizing significant expenses associated with litigation and cleanup. However, purchasing or leasing these properties requires us to weigh the cost of resolving these issues and the likelihood of litigation against the potential economic and business benefits of the transaction. If we fail to correctly identify, resolve and obtain indemnification against these risks, they could have a material adverse impact on our financial position.



**Table of Contents***Fire disruptions may adversely affect our business*

Our raw materials and manufacturing process involve a risk of fire loss or disruption. We have recently experienced three fires. In April 2006, a manufacturing facility in Texas was destroyed by fire. In July 2007, a manufacturing facility in Bartow, Florida was destroyed by fire. In 2008 a manufacturing facility in Auburn, Pennsylvania was damaged by fire. To date we have been able to mitigate the effects of fires and floods by transferring manufacturing, warehousing and shipping to other facilities. Our management has advised us that to date we have been insured against the losses caused by such fires. Although we intend to increase security and increase fire protection equipment at our facilities, another major fire could occur and materially affect our operations. Furthermore, there is no assurance that we will be able to maintain business interruption, loss of income and physical damage insurance in sufficient amounts to fully recoup losses caused by fire or other natural disasters. It is an event of default under our credit facility with Bank of America if we are not fully insured for any loss, theft, damage or destruction to our assets, subject to agreeable insurance deductibles, that exceeds \$200.

*Covenants in our credit facilities could restrict our ability to borrow additional funds, which could impair the improvement and expansion of our operations*

Certain covenants in our credit facility with Bank of America restrict the types and amounts of additional indebtedness that we may incur. In addition, the credit facility contains specific financial covenants. These restrictions could inhibit our ability to improve and expand our operations. Our credit facility with Bank of America matures in October 2011. There is no assurance that we will be able to maintain covenant compliance, negotiate extensions to this credit facility or find a replacement credit facility on comparable terms. We pledged substantially all of our assets as security for the Bank of America credit facility.

*A significant amount of our leased physical facilities are owned by an affiliate of Mr. Amerson and a substantial number of our shares are pledged to a financial institution.*

We are currently the lessee under a series of five (5) real estate operating leases for approximately 836,000 square feet of warehousing, shipping and manufacturing facilities, expiring between 2019 and 2028 with Wal-Pat II, LLC ( Wal-Pat ), an entity owned by Robert R. Amerson. Mr. Amerson was our CEO and Chairman of our Board of Directors but recently retired. He beneficially owns approximately 29.0% of our outstanding common shares as of June 30, 2009. Mr. Amerson acquired Mr. Clark's interest in Wal-Pat as part of the Settlement and Mutual Release with Mr. Clark, as described below.

Our aggregate monthly base lease payment obligation to Wal-Pat is approximately \$267,000. Our total remaining aggregate obligation under the Wal-Pat operating leases is approximately \$44,586,000. These amounts exclude any obligations for payment of real estate taxes and repairs and maintenance, which are our responsibility as the lessee.

In September 2007, we entered into a Master Lease Modification Agreement with Wal-Pat, which requires Wal-Pat to notify us at least thirty (30) days in advance of any future proposed sale of any of the premises or a proposed sale of a majority of the equity interests in Wal-Pat. In such event, we have the right to accept, renegotiate or terminate the leases. We were granted a future right of first refusal in connection with a sale of any of the leased Wal-Pat facilities. In the event of a future sale of Flanders, which includes a merger, sale of substantially all of our assets or acquisition of greater than 50% of our shares, by a party other than Mr. Amerson, then Flanders is granted the right to terminate or renegotiate the terms of the Wal-Pat leases. We also have a fair market value purchase option for the facilities we lease from Wal-Pat.

A default by us under the terms of any of these leases or a default by Wal-Pat, or Mr. Amerson, as guarantor on their obligations to BB&T, the financial institution which holds mortgages and deeds of trust on these properties, could adversely affect our leasehold interests in these properties. Mr. Amerson has pledged 5,128,103 of our common shares as security to BB&T in order to facilitate the financings to Wal-Pat, other personal loans, and the acquisition of Mr. Clark's shares.

In October 2007, we entered into a Settlement Agreement and Mutual Release, effective as of September 30, 2007 ( Settlement Agreement ), by and between Mr. Clark, our former CFO, Mr. Amerson, Mr. Smith and Wal-Pat. A copy of the Settlement Agreement was filed as an exhibit to our Form 8-K, dated October 5, 2007, to which reference is hereby made. In connection with the Settlement Agreement, Mr. Smith and Mr. Amerson each acquired 755,183 of our common shares from Mr. Clark at a purchase price of \$4.60 per share. Mr. Smith and Mr. Amerson pledged these shares to BB&T, who provided financing for the acquisition of these shares.

A default by either Mr. Amerson or Mr. Smith under their loan obligations to BB&T could result in BB&T foreclosing upon our shares, which could adversely affect the market price of our common stock and substantially reduce our key management's equity ownership interest. We filed a Form S-3 registering 5,118,103 shares of our common stock pledged to BB&T by Mr. Amerson. We are not currently aware of any events of default under the financial documents between Wal-Pat, Mr. Amerson, Mr. Smith, and BB&T.



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Because of the foregoing factors, as well as other variables affecting our operating results, past financial performance should not be considered a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

The preceding discussion should be read in conjunction with our annual report on Form 10-K, which also includes additional Factors That May Affect Future Results which are still applicable during the current period.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**  
**ISSUER PURCHASES OF EQUITY SECURITIES**

| Period             | (a) Total<br>Number of<br>Shares (or<br>Units)<br>Purchased | (b) Average Price Paid per<br>Share (or Unit) | (c) Total Number of<br>Shares (or Units)<br>Purchased as Part of<br>Publicly Announced<br>Plans or Programs * | (d) Maximum Number (or<br>Approximate Dollar Value) of<br>Shares (or Units) that May Yet<br>Be Purchased Under the Plans<br>or Programs |
|--------------------|---|---|---|---|
| Apr 1 Apr 30, 2009 |   |   |   | 1,147,465   |
| May 1 May 31, 2009 |   |   |   | 1,147,465   |
| Jun 1 Jun 30, 2009 |   |   |   | 1,147,465   |
| Total              |   |   |   | 1,147,465   |

\* The Plan announced September 22, 2000 authorized the repurchase of up to 2 million shares of common stock.

**Item 3. Defaults Upon Senior Securities - None.**

**Item 4. Submission of Matters to a Vote of Security Holders - None.**

**Item 5. Other Information Purchase of Assets**

Flanders Corporation acquired furnace filter equipment and inventory of Wildwood Industries, Inc. for \$3.6 million. Flanders then immediately sold unrelated assets to R.P.S Products, Inc. for \$2.2 million.

**Item 6. Exhibits**

| Exhibit No. | Description   |
|-------------|---|
| 31.1        | Certification of Chief Executive Officer pursuant to Rule 13a-14(a).  |
| 31.2        | Certification of Chief Financial Officer pursuant to Rule 13a-14(a).  |
| 32          | Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002.  |
| 99.1        | Twentieth Amendment to Loan and Security Agreement, dated July 29, 2009, by and among Flanders Corporation, Flanders/Precisionaire Corp., Flanders Filters, Inc., Flanders/CSC Corporation, Precisionaire, Inc., Precisionaire of Utah, Inc., Eco-Air Products, Inc., Air Seal Filter Housings, Inc., Flanders Realty Corp. and Bank of America (filed herewith). |



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**SIGNATURES**

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

Dated this 30th day of July, 2009.

**FLANDERS CORPORATION**

By: /s/ Harry Smith  
Harry Smith  
Chairman of the Board of Directors and Chief  
Executive Officer  
(Principal Executive Officer)

By: /s/ John Oakley  
John Oakley  
Chief Financial Officer (Principal Financial Officer)