

MOTORCAR PARTS AMERICA INC

Form 10-Q

November 09, 2007



**MOTORCAR PARTS OF AMERICA, INC.  
TABLE OF CONTENTS**

|   | <b>Page</b> |
|---|-------------|
| <u>Glossary</u>   | 2           |
| <b><u>PART I FINANCIAL INFORMATION</u></b>  |             |
| <u>Item 1. Financial Statements</u>   | 3           |
| <u>Consolidated Balance Sheets as of September 30, 2007 (unaudited) and March 31, 2007</u>                              | 3           |
| <u>Consolidated Statements of Operations (unaudited) for the six and three months ended September 30, 2007 and 2006</u> | 4           |
| <u>Consolidated Statements of Cash Flows (unaudited) for the six months ended September 30, 2007 and 2006</u>           | 5           |
| <u>Condensed Notes to Consolidated Financial Statements (unaudited)</u>   | 6           |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                    | 23          |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>   | 41          |
| <u>Item 4. Controls and Procedures</u>  | 42          |
| <b><u>PART II OTHER INFORMATION</u></b>   |             |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>  | 44          |
| <u>Item 6. Exhibits</u>   | 44          |
| <b><u>SIGNATURES</u></b>  | 45          |
| <u>EXHIBIT 31.1</u>   |             |
| <u>EXHIBIT 31.2</u>   |             |
| <u>EXHIBIT 32.1</u>   |             |

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**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC.**

**GLOSSARY**

The following terms are frequently used in the text of this report. These have the meanings indicated below.

**Used Core** An alternator or starter which has been used in the operation of a vehicle. The Used Core is an original equipment ( OE ) alternator or starter installed by the vehicle manufacturer and subsequently removed for replacement. Used Cores contain salvageable parts which are an important raw material in the remanufacturing process. We obtain most Used Cores by providing credits to our customers for Used Cores sent back to us using our core exchange program. Our customers receive these Used Cores from consumers who deliver a Used Core to obtain credit from our customers upon the purchase of a newly remanufactured alternator or starter. If sufficient Used Cores cannot be obtained from our customers, we will purchase Used Cores from core brokers, who are in the business of buying and selling Used Cores. The Used Cores purchased or sent to us by our customers using the core exchange program, and which have been physically received by us, are part of our on-hand raw material or work-in-process inventory included in long-term core inventory.

**Remanufactured Core** The Used Core underlying an alternator or starter that has gone through the remanufacturing process and through that process has become part of a newly remanufactured alternator or starter. The remanufacturing process takes a Used Core, breaks it down into its component parts, replaces those components that cannot be reused and reassembles the salvageable components of the Used Core and additional new components into a remanufactured alternator or starter. Remanufactured Cores are included in our on-hand finished goods inventory and in the remanufactured finished good product held for sale at the customers' locations. Used Cores that have been returned by end-users to customers but have not yet been sent back to us continue to be classified as Remanufactured Cores until they are physically received by us. All Remanufactured Cores are included in our long-term core inventory or in our long-term core inventory deposit.

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements.**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**  
**Consolidated Balance Sheets**  
**(Unaudited)**

|   | <b>September 30,<br/>2007</b> | <b>March 31,<br/>2007</b> |
|---|-------------------------------|---------------------------|
| <b>ASSETS</b>                                       |                               |                           |
| Current assets:                                     |                               |                           |
| Cash  | \$ 1,345,000                  | \$ 349,000                |
| Short term investments                              | 994,000                       | 859,000                   |
| Accounts receivable net                             | 8,385,000                     | 2,259,000                 |
| Non-core inventory net                              | 25,974,000                    | 32,260,000                |
| Inventory unreturned                                | 3,280,000                     | 3,886,000                 |
| Income tax receivable                               |                               | 1,670,000                 |
| Deferred income tax asset                           | 7,101,000                     | 6,768,000                 |
| Prepaid expenses and other current assets           | 1,912,000                     | 1,873,000                 |
| <br>  |                               |                           |
| Total current assets                                | 48,991,000                    | 49,924,000                |
| Plant and equipment net                             | 16,074,000                    | 16,051,000                |
| Long-term core inventory                            | 43,826,000                    | 42,076,000                |
| Long-term core inventory deposit                    | 22,008,000                    | 21,617,000                |
| Deferred income tax asset                           | 1,817,000                     | 1,817,000                 |
| Other assets  | 507,000                       | 501,000                   |
| <br>  |                               |                           |
| <b>TOTAL ASSETS</b>                                 | <b>\$ 133,223,000</b>         | <b>\$ 131,986,000</b>     |
| <br>  |                               |                           |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>          |                               |                           |
| Current liabilities:                                |                               |                           |
| Accounts payable                                    | \$ 23,821,000                 | \$ 42,756,000             |
| Accrued liabilities                                 | 1,705,000                     | 1,292,000                 |
| Accrued salaries and wages                          | 1,824,000                     | 2,780,000                 |
| Accrued workers compensation claims                 | 3,043,000                     | 3,972,000                 |
| Income tax payable                                  | 295,000                       | 285,000                   |
| Line of credit                                      | 3,900,000                     | 22,800,000                |
| Deferred compensation                               | 994,000                       | 859,000                   |
| Deferred income                                     | 133,000                       | 133,000                   |
| Other current liabilities                           | 325,000                       | 225,000                   |
| Current portion of capital lease obligations        | 1,697,000                     | 1,568,000                 |
| <br>  |                               |                           |
| Total current liabilities                           | 37,737,000                    | 76,670,000                |
| Deferred income, less current portion               | 188,000                       | 255,000                   |
| Deferred core revenue                               | 2,387,000                     | 1,575,000                 |
| Deferred gain on sale-leaseback                     | 1,599,000                     | 1,859,000                 |
| Other liabilities                                   | 212,000                       | 170,000                   |
| Capitalized lease obligations, less current portion | 3,219,000                     | 3,629,000                 |
| <br>  |                               |                           |
| Total liabilities                                   | 45,342,000                    | 84,158,000                |

Commitments and Contingencies

Shareholders' equity:

Preferred stock; par value \$.01 per share, 5,000,000 shares authorized; none issued

Series A junior participating preferred stock; par value \$.01 per share, 20,000 shares authorized; none issued

Common stock; par value \$.01 per share, 20,000,000 shares authorized; 12,052,280 and 8,373,122 shares issued and outstanding at September 30, 2007 and March 31, 2007, respectively

Additional paid-in capital-common stock

Additional paid-in capital-warrant

Shareholder note receivable

Accumulated other comprehensive income

Accumulated deficit

Total shareholders' equity

TOTAL LIABILITIES & SHAREHOLDERS' EQUITY

|                |                |
|----------------|----------------|
| 121,000        | 84,000         |
| 92,194,000     | 56,241,000     |
| 1,883,000      |                |
| (682,000)      | (682,000)      |
| 162,000        | 40,000         |
| (5,797,000)    | (7,855,000)    |
| 87,881,000     | 47,828,000     |
| \$ 133,223,000 | \$ 131,986,000 |

The accompanying condensed notes to consolidated financial statements are an integral part hereof.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Operations**  
**(Unaudited)**

|  | <b>Six Months Ended</b> |               | <b>Three Months Ended</b> |                |
|--|-------------------------|---------------|---------------------------|----------------|
|  | <b>September 30,</b>    |               | <b>September 30,</b>      |                |
|  | <b>2007</b>             | <b>2006</b>   | <b>2007</b>               | <b>2006</b>    |
| Net sales                                      | \$ 69,260,000           | \$ 71,589,000 | \$ 33,819,000             | \$ 44,165,000  |
| Cost of goods sold                             | 50,815,000              | 59,476,000    | 25,574,000                | 39,218,000     |
| Gross profit                                   | 18,445,000              | 12,113,000    | 8,245,000                 | 4,947,000      |
| Operating expenses:                            |                         |               |                           |                |
| General and administrative                     | 9,513,000               | 7,202,000     | 4,725,000                 | 4,812,000      |
| Sales and marketing                            | 1,726,000               | 2,325,000     | 797,000                   | 1,420,000      |
| Research and development                       | 550,000                 | 757,000       | 275,000                   | 341,000        |
| Total operating expenses                       | 11,789,000              | 10,284,000    | 5,797,000                 | 6,573,000      |
| Operating income (loss)                        | 6,656,000               | 1,829,000     | 2,448,000                 | (1,626,000)    |
| Interest expense net of interest income        | 3,186,000               | 2,137,000     | 1,543,000                 | 1,315,000      |
| Income (loss) before income tax expense        | 3,470,000               | (308,000)     | 905,000                   | (2,941,000)    |
| Income tax expense (benefit)                   | 1,412,000               | (124,000)     | 439,000                   | (1,179,000)    |
| Net income (loss)                              | \$ 2,058,000            | \$ (184,000)  | \$ 466,000                | \$ (1,762,000) |
| Basic net income (loss) per share              | \$ 0.19                 | \$ (0.02)     | \$ 0.04                   | \$ (0.21)      |
| Diluted net income (loss) per share            | \$ 0.18                 | \$ (0.02)     | \$ 0.04                   | \$ (0.21)      |
| Weighted average number of shares outstanding: |                         |               |                           |                |
| basic  | 10,979,426              | 8,328,386     | 12,043,198                | 8,333,792      |
| diluted  | 11,351,048              | 8,328,386     | 12,402,249                | 8,333,792      |

The accompanying condensed notes to consolidated financial statements are an integral part hereof.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**

|   | <b>Six Months Ended</b> |              |
|---|-------------------------|--------------|
|   | <b>September 30,</b>    |              |
|   | <b>2007</b>             | <b>2006</b>  |
| Cash flows from operating activities:   |                         |              |
| Net income (loss)   | \$ 2,058,000            | \$ (184,000) |
| Adjustments to reconcile net income to net cash used in operating activities: |                         |              |
| Depreciation and amortization   | 1,434,000               | 1,167,000    |
| Amortization of deferred gain on sale-leaseback                               | (259,000)               | (259,000)    |
| Provision for (recovery of) inventory reserves                                | 575,000                 | 369,000      |
| Provision for (recovery of) doubtful accounts                                 | 152,000                 | (7,000)      |
| Provision for (recovery of) customer payment discrepancies                    | 163,000                 | (963,000)    |
| Deferred income taxes   | (332,000)               | (448,000)    |
| Share-based compensation expense  | 590,000                 | 975,000      |
| Impact of tax benefit on APIC pool  | (110,000)               |              |
| Shareholder note receivable   |                         | (682,000)    |
| Changes in assets and liabilities:  |                         |              |
| Accounts receivable   | (6,440,000)             | (4,268,000)  |
| Non-core inventory  | 5,712,000               | 5,579,000    |
| Inventory unreturned  | 606,000                 | (2,756,000)  |
| Income tax receivable   | 1,885,000               | (1,098,000)  |
| Prepaid expenses and other current assets                                     | (32,000)                | (1,303,000)  |
| Other assets  | (6,000)                 | (20,000)     |
| Accounts payable and accrued liabilities                                      | (20,418,000)            | 12,446,000   |
| Income tax payable  | (209,000)               | (855,000)    |
| Deferred compensation   | 135,000                 | 62,000       |
| Deferred income   | (67,000)                | (67,000)     |
| Credit due customer   |                         | (1,793,000)  |
| Deferred core revenue   | 812,000                 |              |
| Long-term core inventory  | (1,750,000)             |              |
| Long-term core inventory deposit  | (391,000)               | (19,775,000) |
| Other current liabilities   | 132,000                 | (638,000)    |
| Net cash used in operating activities   | (15,760,000)            | (14,518,000) |
| Cash flows from investing activities:   |                         |              |
| Purchase of property, plant and equipment                                     | (891,000)               | (2,208,000)  |
| Change in short term investments  | (100,000)               | (66,000)     |
| Net cash used in investing activities   | (991,000)               | (2,274,000)  |
| Cash flows from financing activities:   |                         |              |
| Borrowings under line of credit   | 30,200,000              | 23,536,000   |
| Repayments under line of credit   | (49,100,000)            | (6,436,000)  |
| Net payments on capital lease obligations                                     | (790,000)               | (744,000)    |
| Exercise of stock options   | 187,000                 | 208,000      |
| Excess tax benefit from employee stock options exercised                      | 115,000                 | 166,000      |
| Proceeds from issuance of common stock and warrants                           | 40,061,000              |              |



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|  |              |              |
|--|--------------|--------------|
| Stock issuance costs                               | (3,079,000)  |              |
| Impact of tax benefit on APIC pool                 | 110,000      |              |
| Net cash provided by financing activities          | 17,704,000   | 16,730,000   |
| Effect of exchange rate changes on cash            | 43,000       | 7,000        |
| Net increase (decrease) in cash                    | 996,000      | (55,000)     |
| Cash Beginning of period                           | 349,000      | 400,000      |
| Cash End of period                                 | \$ 1,345,000 | \$ 345,000   |
| Supplemental disclosures of cash flow information: |              |              |
| Cash paid during the period for:                   |              |              |
| Interest   | \$ 3,220,000 | \$ 2,090,000 |
| Income taxes, net of refunds                       | (389,000)    | 1,979,000    |
| Non-cash investing and financing activities:       |              |              |
| Property acquired under capital lease              | \$ 509,000   | \$ 307,000   |
| Shareholder note receivable                        | \$           | \$ 682,000   |

The accompanying condensed notes to consolidated financial statements are an integral part hereof.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**  
**Condensed Notes to Consolidated Financial Statements**  
**September 30, 2007 and 2006**  
**(Unaudited)**

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six and three months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending March 31, 2008. This report should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended March 31, 2007, which are included in the Company's Annual Report on Form 10-K/A Amendment No. 2 filed with the Securities and Exchange Commission (SEC) on October 19, 2007.

**NOTE A Company Background and Organization**

Motorcar Parts of America, Inc. and its subsidiaries (the Company or MPA) remanufacture and distribute alternators and starters for import and domestic cars and light trucks. These replacement parts are sold for use on vehicles after initial vehicle purchase. These automotive parts are sold to automotive retail chain stores and warehouse distributors throughout the United States and Canada and to a major automobile manufacturer.

The Company obtains used alternators and starters, commonly known as Used Cores, primarily from its customers as trade-ins. It also purchases Used Cores from vendors (core brokers). The customers grant credit to consumers when a Used Core is returned to them, and the Company in turn provides a credit to the customer upon return of the Used Core to the Company. These Used Cores contain salvageable parts which are an essential material needed for the remanufacturing operations. The Company has remanufacturing, warehousing and shipping/receiving operations for alternators and starters in Mexico, California, Singapore and Malaysia. In addition, the Company utilizes third party warehouse distribution centers in Fairfield, New Jersey and Springfield, Oregon.

The Company's warehouse distribution facility in Nashville, Tennessee was closed in the second quarter of fiscal 2008. The Company is sub-leasing this facility for the remainder of its lease term and has a signed non-binding letter of intent with a prospective sub-lessee. The Company does not expect to incur material expenses in connection with the closure and sub-lease of this facility.

In September 2007, the Company exercised its right to cancel the lease of its Torrance facility with respect to approximately 80,000 square feet currently utilized for core receipt, storage and packing by March 31, 2008. The Company continues to transition the remaining functions to its facilities in Mexico.

The Company operates in one business segment pursuant to Statement of Financial Accounting Standards (SFAS) No. 131, Disclosures about Segments of Enterprise and Related Information.

**NOTE B Summary of Significant Accounting Policies**

*1. Principles of consolidation*

The accompanying consolidated financial statements include the accounts of Motorcar Parts of America, Inc. and its wholly-owned subsidiaries, MVR Products Pte. Ltd., Unijoh Sdn. Bhd. and Motorcar Parts de Mexico, S.A. de C.V. All significant inter-company accounts and transactions have been eliminated.

*2. Cash*

The Company maintains cash balances in local currencies in Singapore and Malaysia and in local and U.S. dollar currencies in Mexico for use by the facilities operating in those foreign countries. The balances in these foreign accounts if translated into U.S. dollars at September 30, 2007 and March 31, 2007 were \$232,000 and \$347,000, respectively.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

3. *Accounts Receivable*

The allowance for doubtful accounts is developed based upon several factors including customers' credit quality, historical write-off experience and any known specific issues or disputes which exist as of the balance sheet date. Accounts receivable are written off only when all collection attempts have failed. The Company does not require collateral for accounts receivable.

The Company has two separate agreements executed with two customers and their respective banks. Under these agreements, the Company may sell those customers' receivables to those banks at a discount to be agreed upon at the time the receivables are factored. Once the customer chooses which outstanding invoices are going to be made available for factoring, the Company can accept or decline the bundle of invoices provided. The factoring agreements are non-recourse, and funds cannot be reclaimed by the customer or its bank after the related invoices have been factored.

4. *Inventory*

*Non-core Inventory*

Non-core inventory is comprised of non-core raw materials, the non-core value of work-in-process and the non-core value of finished goods. Used Cores, the Used Core value of work-in-process and the Remanufactured Core portion of finished goods are classified as long-term core inventory as described below.

Non-core inventory is stated at the lower of cost or market. The cost of non-core inventory approximates average historical purchase prices paid, and is based upon the direct costs of material and an allocation of labor and variable and fixed overhead costs. The cost of non-core inventory is evaluated at least quarterly during the fiscal year and adjusted to reflect current lower of cost or market levels. These adjustments are determined for individual items of inventory within each of the three classifications of non-core inventory as follows:

Non-core raw materials are recorded at average cost, which is based on the actual purchase price of raw materials on hand. The average cost is updated quarterly. This average cost is used in the inventory costing process and is the basis for allocation of materials to finished goods during the production process.

Non-core work in process is in various stages of production, is on average 50% complete and is valued at 50% of the cost of a finished good. Non-core work in process inventory historically comprises less than 3% of the total non-core inventory balance.

Finished goods cost includes the average cost of non-core raw materials and allocations of labor and variable and fixed overhead. The allocations of labor and variable and fixed overhead costs are determined based on the average actual use of the production facilities over the prior twelve months which approximates normal capacity. This method prevents the distortion in costs that would occur during short periods of abnormally low or high production. In addition, we exclude certain unallocated overhead such as severance costs, duplicative facility overhead costs, and spoilage from the calculation and expense them as period costs as required in Financial Accounting Standards Board (FASB) Statement No. 151, Inventory Costs, an amendment of Accounting Research Bulletin ( ARB ) No. 43, Chapter 4 ( FAS 151 ). For the six months ended September 30, 2007, costs of approximately \$1,057,000 were considered abnormal and thus excluded from the cost calculation.

The Company provides an allowance for potentially excess and obsolete inventory based upon recent sales history, the quantity of inventory remaining on-hand, and a forecast of potential use of the inventory. The Company reviews inventory on a monthly basis to identify excess quantities and part numbers that are experiencing a reduction in demand. In general, part numbers with quantities representing a one to three-year supply are partially reserved for at rates based upon management's judgment and consistent with historical rates. Any part numbers with quantities representing more than a three-year supply are reserved for at a rate that

considers possible scrap and liquidation values and may be as high as 100% if no liquidation market exists for the part.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

The quantity thresholds and reserve rates are subjective and are based on management's judgment and knowledge of current and projected industry demand. The reserve estimates may, therefore, be revised if there are changes in the overall market for the Company's products or market changes that, in management's judgment, impact the Company's ability to sell or liquidate potentially excess or obsolete inventory.

The Company applies the guidance provided by the Emerging Issues Task Force (EITF) Issue No. 02-16, Accounting by a Customer (Including a Reseller) for Cash Consideration Received from a Vendor (EITF 02-16), by recording vendor discounts as a reduction of inventories that are recognized as a reduction to cost of sales as the inventories are sold.

*Inventory Unreturned*

Inventory Unreturned represents the Company's estimate, based on historical data and prospective information provided directly by the customer, of finished goods shipped to customers that the Company expects to be returned after the balance sheet date. The inventory unreturned balance includes only the added unit value of finished goods (as previously mentioned, all cores are classified separately as long term assets). The return rate is calculated based on expected returns within a normal operating cycle, which is one year. Hence, the related amounts are classified in current assets.

Inventory unreturned is valued in the same manner as the Company's finished goods inventory.

*Long-term Core Inventory*

Long-term core inventory consists of:

Used Cores purchased from core brokers and held in inventory at the Company's facilities,

Used Cores returned by the Company's customers and held in inventory at the Company's facilities,

Used Cores expected to be returned by the Company's customers and held at customer locations. Used Cores that have been returned by end-users to customers but have not yet been returned to the Company are classified as Remanufactured Cores until they are physically received by the Company.

Remanufactured Cores held in finished goods inventory at the Company's facilities; and

Remanufactured Cores held at customer locations as a part of finished goods sold to the customer. For these Remanufactured Cores, the Company expects the finished good containing the Remanufactured Core to be returned under the Company's general right of return policy or a similar Used Core to be returned to the Company by the customer, in each case, for credit.

Long-term core inventory is recorded at average historical purchase prices determined based on actual purchases of inventory on hand. The cost and market value of Used Cores for which sufficient recent purchases have occurred are deemed the same as the purchases are made in arms length transactions.

Long-term core inventory recorded at average purchase price is primarily made up of Used Cores for newer products related to more recent automobile models or products for which there is a less liquid market. The Company must purchase these Used Cores from core brokers because its customers do not have a sufficient supply of these newer Used Cores available for the core exchange program.

Approximately 15% to 25% of Used Cores are obtained in core broker transactions and are valued based on average purchase price. The average purchase price of Used Cores for more recent automobile models is retained as the cost for these Used Cores in subsequent periods even as the source of these Used Cores shifts to the core exchange program.

Long-term core inventory is recorded at the lower of cost or market value. In the absence of sufficient recent purchases, the Company uses core broker price lists to assess whether Used Core cost exceeds Used Core market value on an item by item basis. The primary reason for the insufficient recent purchases is that the Company obtains most of its Used Core inventory from the customer core exchange program.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

In the fourth quarter of fiscal 2007, the Company reclassified all of its core inventories to a long-term asset account. The determination of the long-term classification was based on its view that the value of the cores is not consumed or realized in cash during the Company's normal operating cycle, which is one year for most of the cores recorded in inventory. According to ARB No. 43, current assets are defined as assets or other resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. The Company does not believe that core inventories, which the Company classifies as long-term, are consumed because the credits issued upon the return of Used Cores offset the amounts invoiced when the Remanufactured Cores included in finished goods were sold. The Company does not expect the core inventories to be consumed, and thus the Company does not expect to realize cash, until its relationship with a customer ends, a possibility that the Company considers remote based on existing long-term customer agreements and historical experience.

However, historically for approximately 4.5% of finished goods sold, the Company's customer will not send the Company a Used Core to obtain the credit the Company offers under its core exchange program. Therefore, based on the Company's historical estimate, the Company derecognizes the core value for these finished goods upon sale, as the Company believes they have been consumed and the Company has realized cash.

The Company realizes cash for only the core exchange program shortfall of approximately 4.5%. This shortfall represents the historical difference between the number of finished goods shipped to customers and the number of Used Cores returned to the Company by customers. The Company does not realize cash for the remaining portion of the cores because the credits issued upon the return of Used Cores offset the amounts invoiced when the Remanufactured Cores included in finished goods were sold. The Company does not expect to realize cash for the remaining portion of these Remanufactured Cores until its relationship with a customer ends, a possibility that the Company considers remote based on existing long-term customer agreements and historical experience.

For these reasons, the Company concluded that it is more appropriate to classify core inventory as a long-term asset.

*Long-term Core Inventory Deposit*

The long-term core inventory deposit account represents the value of Remanufactured Cores the Company purchased from customers, which are held by the customers and remain on the customers' premises. The purchase is made through the issuance of credits against that customer's receivables either on a one time basis or over an agreed-upon period. The credits against the customer's receivable are based upon the Remanufactured Core purchase price previously established with the customer. At the same time, the Company records the long-term core inventory deposit for the Remanufactured Cores purchased at its cost, determined as noted under Long-term Core Inventory. The long-term core inventory deposit is stated at the lower of cost or market. The cost is established at the time of the transaction based on the then current cost, determined as noted under Long-term Core Inventory. The difference between the credit granted and the cost of the long-term core inventory deposit is treated as a sales allowance reducing revenue as required under EITF 01-9. When the purchases are made over an agreed-upon period, the long-term core inventory deposit is recorded at the same time the credit is issued to the customer for the purchase of the Remanufactured Cores.

At least annually, and as often as quarterly, reconciliations and confirmations are performed to determine that the number of Remanufactured Cores purchased, but retained at the customer location remains sufficient to support the amounts recorded in the long-term core inventory deposit account. At the same time, the mix of Remanufactured Cores is reviewed to determine that the aggregate value of Remanufactured Cores in the account has not changed during the reporting period. The Company evaluates the cost of cores supporting the aggregate

long-term core inventory deposit account each quarter. If the Company identifies any permanent reduction in either the number or the aggregate value of the Remanufactured Core inventory mix held at the customer location, the Company will record a reduction in the long-term core inventory deposit account during that period.



**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

5. *Income Taxes*

The Company accounts for income taxes in accordance with guidance issued by the FASB in SFAS No. 109, Accounting for Income Taxes, which requires the use of the liability method of accounting for income taxes.

The liability method measures deferred income taxes by applying enacted statutory rates in effect at the balance sheet date to the differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. The resulting asset or liability is adjusted to reflect changes in the tax laws as they occur. A valuation allowance is provided to reduce deferred tax assets when it is more likely than not that a portion of the deferred tax asset will not be realized.

As required, the liability method is also used in determining the impact of the adoption of FASB SFAS No. 123 (revised 2004), Share-Based Payment, ( FAS 123R ) on the Company's deferred tax assets and liabilities.

The primary components of the Company's income tax provision (benefit) are (i) the current liability or refund due for federal, state and foreign income taxes and (ii) the change in the amount of the net deferred income tax asset, including the effect of any change in the valuation allowance.

Realization of deferred tax assets is dependent upon the Company's ability to generate sufficient future taxable income. In evaluating this ability, management considered the Company's long-term agreements with each of its major customers which expire at various dates ranging from December 2007 through December 2012 and the Company's Remanufactured Core purchase obligations with certain customers that expire at various dates through March 2010. Management believes that it is more likely than not that future taxable income will be sufficient to realize the recorded deferred tax assets. Future taxable income is based on management's forecast of the Company's future operating results. Management periodically reviews such forecasts in comparison with actual results, and there can be no assurance that such results will be achieved.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting and disclosure for uncertainty in tax positions, as defined, and seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. The Company is subject to the provisions of FIN 48 as of April 1, 2007 and has analyzed filing positions in all of the federal, state and foreign jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. For analysis under FIN 48, the Company is deemed to primarily conduct business in the United States, specifically in the state of California. The Company's US federal income tax returns for the periods ended March 31, 2004 through 2006 may still be reviewed at the discretion of the Internal Revenue Service. The Company's California income tax returns for the tax periods ended March 31, 2003 through 2006 may still be reviewed at the discretion of the California Franchise Tax Board. The Company is not aware of any audits pending or planned by the Internal Revenue Service or the California Franchise Tax Board for these periods.

The Company believes that its income tax filing positions and deductions will be sustained on audit and does not anticipate any adjustments that will result in a material change to its financial position. Therefore, no reserves for uncertain income tax positions have been recorded pursuant to FIN 48. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

The Company's policy for recording interest and penalties associated with audits is to record such items as a component of income taxes.

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For the six months ended September 30, 2007 and 2006, the Company recognized income tax expense of \$1,412,000 and an income tax benefit of \$124,000, respectively. For the three months ended September 30, 2007 and 2006, the Company recognized income tax expense of \$439,000 and an income tax benefit of \$1,179,000, respectively. As a result of the Company's fiscal 2007 loss, the Company has a net operating loss carryforward of approximately \$1,921,000 that can be used to reduce future tax payments.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

6. *Revenue Recognition*

The Company recognizes revenue when performance by the Company is complete. Revenue is recognized when all of the following criteria established by the Staff of the SEC in Staff Accounting Bulletin No. 104, *Revenue Recognition* ( SAB 104 ), have been met:

Persuasive evidence of an arrangement exists,

Delivery has occurred or services have been rendered,

The seller's price to the buyer is fixed or determinable, and

Collectibility is reasonably assured.

For products shipped free-on-board ( FOB ) shipping point, revenue is recognized on the date of shipment. For products shipped FOB destination, revenues are recognized two days after the date of shipment based on the Company's experience regarding the length of transit duration. The Company includes shipping and handling charges in its gross invoice price to customers and classifies the total amount as revenue in accordance with EITF Issue No. 00-10, *Accounting for Shipping and Handling Fees and Costs* ( EITF 00-10 ). Shipping and handling costs are recorded as cost of sales.

Unit value revenue is recorded based on the Company's price list, net of applicable discounts and allowances. The Company allows customers to return slow moving and other inventory. The Company provides for such returns of inventory in accordance with SFAS 48, *Revenue Recognition When Right of Return Exists* ( SFAS 48 ). The Company reduces revenue and cost of sales for the unit value of goods sold that are expected to be returned based on a historical return analysis and information obtained from customers about current stock levels.

The Company accounts for revenues and cost of sales on a net-of-core-value basis. Management has determined that the Company's business practices and contractual arrangements result in more than 90% of the remanufactured alternators and starters sold being replaced by similar Used Cores sent back for credit by customers under the Company's core exchange program. Accordingly, the Company excludes the value of Remanufactured Cores from revenue by applying SFAS 48 by analogy.

When the Company ships a product, it recognizes an obligation to accept a similar Used Core sent back under the core exchange program by recording a contra receivable account based upon the Remanufactured Core price agreed upon by the Company and its customer. Upon receipt of a Used Core, the Company grants the customer a credit based on the Remanufactured Core price billed and restores the Used Core to on-hand inventory.

When the Company ships a product, it invoices certain customers for the Remanufactured Core portion of the product at full Remanufactured Core sales price. For these Remanufactured Cores, the Company recognizes core revenue based upon an estimate of the rate at which the Company's customers will pay cash for Remanufactured Cores in lieu of sending back similar Used Cores for credits under the Company's core exchange program.

In addition, the Company recognizes revenue related to Remanufactured Cores originally sold at a nominal price and not expected to be replaced by a similar Used Core under the core exchange program. Unlike the full price Remanufactured Cores, the Company only recognizes revenue from

nominally priced Remanufactured Cores not expected to be replaced by a similar Used Core sent back under the core exchange program when the Company believes it has met all of the following criteria:

The Company has a signed agreement with the customer covering the nominally priced Remanufactured Cores not expected to be replaced by a similar Used Core sent back under the core exchange program. This agreement must specify the number of Remanufactured Cores its customer will pay cash for in lieu of sending back a similar Used Core and the basis on which the nominally priced Remanufactured Cores are to be valued (normally the average price per Remanufactured Core stipulated in the agreement).

**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

The contractual date for reconciling the Company's records and customer's records of the number of nominally priced Remanufactured Cores not expected to be replaced by a similar Used Core sent back under the core exchange program must be in the current or a prior period.

The reconciliation of the nominally priced Remanufactured Cores must be completed and agreed to by the customer.

The amount must be billed to the customer.

The Company has agreed in the past and may in the future agree to buy back Remanufactured Cores. The difference between the credit granted and the cost of the Remanufactured Cores bought back is treated as a sales allowance reducing revenue as required under EITF 01-9. As a result of the increasing level of Remanufactured Core buybacks, the Company now defers core revenue from these customers until there is no expectation that the sales allowances associated with Remanufactured Core buybacks from these customers will offset Remanufactured Core revenues that would otherwise be recognized once the criteria noted above have been met. At September 30, 2007 and March 31, 2007 Remanufactured Core revenue of \$2,387,000 and \$1,575,000, respectively, was deferred.

In May 2004, the Company began to offer products on pay-on-scan ( POS ) arrangement with its largest customer. For POS inventory, revenue was recognized when the customer notified the Company that it had sold a specifically identified product to an end user. POS inventory represented inventory held on consignment at customer locations. This arrangement was discontinued in August 2006.

**7. Net Income Per Share**

Basic income per share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted income per share includes the effect, if any, from the potential exercise or conversion of securities, such as stock options and warrants, which would result in the issuance of incremental shares of common stock.

The following presents a reconciliation of basic and diluted net income per share.

|   | <b>Six Months Ended</b> |              | <b>Three Months Ended</b> |                |
|---|-------------------------|--------------|---------------------------|----------------|
|   | <b>September 30,</b>    |              | <b>September 30,</b>      |                |
|   | <b>2007</b>             | <b>2006</b>  | <b>2007</b>               | <b>2006</b>    |
| Net income (loss)                             | \$ 2,058,000            | \$ (184,000) | \$ 466,000                | \$ (1,762,000) |
| Basic shares                                  | 10,979,426              | 8,328,386    | 12,043,198                | 8,333,792      |
| Effect of dilutive stock options and warrants | 371,622                 |              | 359,051                   |                |
| Diluted shares                                | 11,351,048              | 8,328,386    | 12,402,249                | 8,333,792      |
| Basic net income (loss) per share             | \$ 0.19                 | \$ (0.02)    | \$ 0.04                   | \$ (0.21)      |
| Diluted net income (loss) per share           | \$ 0.18                 | \$ (0.02)    | \$ 0.04                   | \$ (0.21)      |

The effect of dilutive options and warrants excludes 165,875 options and 546,283 warrants with exercise prices ranging from \$12.00 to \$19.13 per share for the six and three months ended September 30, 2007 and 1,133,420

options with exercise prices ranging from \$1.10 to \$19.13 per share for the six and three months ended September 30, 2006 all of which were anti-dilutive.

8. *Use of Estimates*

The preparation of unaudited consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ( GAAP ) requires management to make estimates and assumptions that affect the reported amounts in the unaudited consolidated financial statements and accompanying notes. Actual results could differ from those estimates. On an on-going basis, the Company

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

evaluates its estimates, including those related to the carrying amount of property, plant and equipment; valuation and return allowances for receivables, inventories, and deferred income taxes; accrued liabilities; and litigation and disputes.

The Company uses significant estimates in the calculation of sales returns. These estimates are based on the Company's historical return rates and an evaluation of estimated sales returns from specific customers.

The Company uses significant estimates in the calculation of the lower of cost or market value of long term core inventory.

The Company's calculation of inventory reserves involves significant estimates. The basis for the inventory reserve is a comparison of inventory on hand to historical production usage or sales volumes.

The Company records its liability for self-insured workers' compensation by including an estimate of the total claims incurred and reported as well as an estimate of incurred, but not reported, claims by applying the Company's historical claims development factor to its estimate of incurred and reported claims.

The Company uses significant estimates in the calculation of its income tax provision or benefit by using forecasts to estimate whether it will have sufficient future taxable income to realize its deferred tax assets. There can be no assurances that the Company's taxable income will be sufficient to realize such deferred tax assets.

A change in the assumptions used in the estimates for sales returns, inventory reserves and income taxes could result in a difference in the related amounts recorded in the Company's consolidated financial statements.

*9. Reclassifications*

Certain prior year amounts have been reclassified from those reported in the Company's amended filing to conform with the fiscal 2008 presentation. Changes in classification were made to certain inventory, accounts receivable and deferred tax amounts within the operating cash flows section of the cash flow statement. These changes did not result in changes to total cash flows used in or provided by operating activities, investing activities, or financing activities.

*10. New Accounting Pronouncements*

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (FAS No. 159). FAS No. 159 permits companies to choose to measure at fair value certain financial instruments and other items that are not currently required to be measured at fair value. FAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company expects to adopt FAS No. 159 in the first quarter of fiscal 2009. The Company is currently evaluating the impact of FAS No. 159 on its consolidated financial position and results of operations.

In September 2006, the FASB issued FAS No. 157, "Fair Value Measurements" (FAS No. 157). FAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It also established a framework for measuring fair value under GAAP and expands disclosures about fair value measurement. FAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements. FAS No. 157 is effective for fiscal years ending after November 15, 2007 and interim periods within those fiscal years. The Company expects to adopt FAS No. 157 in the first quarter of fiscal 2009. The Company is currently evaluating the impact of FAS

No. 157 on its consolidated financial position and results of operations.



**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES****NOTE C Accounts Receivable**

Included in Accounts receivable net are significant offset accounts related to customer allowances earned, customer payment discrepancies, in-transit and estimated future unit returns, estimated future credits to be provided for Used Cores returned by the customers and potential bad debts. Due to the forward-looking nature and the different aging periods of certain estimated offset accounts, they may not, at any point in time, directly relate to the balances in the open trade accounts receivable.

Accounts receivable net is comprised of the following:

|   | <b>September 30,<br/>2007</b> | <b>March 31,<br/>2007</b> |
|---|-------------------------------|---------------------------|
| Accounts receivable - trade                     | \$ 30,583,000                 | \$ 27,299,000             |
| Allowance for bad debts                         | (170,000)                     | (18,000)                  |
| Customer allowances earned                      | (2,467,000)                   | (5,003,000)               |
| Customer payment discrepancies                  | (838,000)                     | (823,000)                 |
| Customer finished goods returns accruals        | (5,957,000)                   | (9,776,000)               |
| Customer core returns accruals                  | (12,766,000)                  | (9,420,000)               |
| Less: total accounts receivable offset accounts | (22,198,000)                  | (25,040,000)              |
| Total accounts receivable - net                 | \$ 8,385,000                  | \$ 2,259,000              |

**NOTE D Inventory**

Non-core inventory, Inventory unreturned, Long-term core inventory and Long-term core inventory deposit are comprised of the following:

|  | <b>September<br/>30,<br/>2007</b> | <b>March 31,<br/>2007</b> |
|--|-----------------------------------|---------------------------|
| <b>Non-core inventory</b>                        |                                   |                           |
| Raw materials                                    | \$ 12,130,000                     | \$ 14,990,000             |
| Work-in-process                                  | 124,000                           | 185,000                   |
| Finished goods                                   | 15,481,000                        | 18,762,000                |
|  | 27,735,000                        | 33,937,000                |
| Less allowance for excess and obsolete inventory | (1,761,000)                       | (1,677,000)               |
| Total  | \$ 25,974,000                     | \$ 32,260,000             |
| <b>Inventory unreturned</b>                      | \$ 3,280,000                      | \$ 3,886,000              |
| <b>Long-term core inventory</b>                  |                                   |                           |
| Used Cores held at company's facilities          | \$ 14,399,000                     | \$ 13,797,000             |
| Used Cores expected to be returned by customers  | 3,937,000                         | 2,482,000                 |
| Remanufactured Cores held in finished goods      | 10,530,000                        | 11,921,000                |
| Remanufactured Cores held at customers locations | 15,695,000                        | 14,292,000                |

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|  |               |               |
|--|---------------|---------------|
|  | 44,561,000    | 42,492,000    |
| Less allowance for excess and obsolete inventory | (735,000)     | (416,000)     |
| Total  | \$ 43,826,000 | \$ 42,076,000 |
| <b>Long-term core inventory deposit</b>          | \$ 22,008,000 | \$ 21,617,000 |

**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES****NOTE G Long Term Customer Contracts; Marketing Allowances**

The Company has long-term agreements with substantially all of its major customers. Under these agreements, which typically have initial terms of at least four years, the Company is designated as the exclusive or primary supplier for specified categories of remanufactured alternators and starters. In consideration for its designation as a customer's exclusive or primary supplier, the Company typically provides the customer with a package of marketing incentives. These incentives differ from contract to contract and can include (i) the issuance of a specified amount of credits against receivables in accordance with a schedule set forth in the relevant contract, (ii) support for a particular customer's research or marketing efforts on a scheduled basis, (iii) discounts granted in connection with each individual shipment of product and (iv) other marketing, research, store expansion or product development support. These contracts typically require that the Company meet ongoing performance, quality and fulfillment requirements, and one contract grants the customer the right to terminate the agreement at any time for any reason. The Company's contracts with major customers expire at various dates ranging from December 2007 through December 2012. There are Remanufactured Core purchase obligations with certain customers that expire at various dates through March 2010.

The Company typically grants its customers marketing allowances in connection with these customers' purchase of goods. The Company records the cost of all marketing allowances provided to its customers in accordance with EITF 01-9. Such allowances include sales incentives and concessions and typically consist of: (i) allowances which may only be applied against future purchases and are recorded as a reduction to revenues in accordance with a schedule set forth in the long-term contract, (ii) allowances related to a single exchange of product that are recorded as a reduction of revenues at the time the related revenues are recorded or when such incentives are offered and (iii) allowances that are made in connection with the purchase of inventory from a customer.

The following table presents the breakout of marketing allowances recorded as a reduction to revenues in the six and three months ended September 30:

|   | <b>Six Months Ended</b> |               | <b>Three Months Ended</b> |              |
|---|-------------------------|---------------|---------------------------|--------------|
|   | <b>September 30,</b>    |               | <b>September 30,</b>      |              |
|   | <b>2007</b>             | <b>2006</b>   | <b>2007</b>               | <b>2006</b>  |
| Allowances incurred under long-term customer contracts        | \$ 4,926,000            | \$ 4,240,000  | \$ 3,046,000              | \$ 3,486,000 |
| Allowances related to a single exchange of product            | 5,501,000               | 6,435,000     | 2,468,000                 | 3,101,000    |
| Allowances related to core inventory purchase obligations     | 1,073,000               | 1,035,000     | 482,000                   | 582,000      |
| Total customer allowances recorded as a reduction of revenues | \$ 11,500,000           | \$ 11,710,000 | \$ 5,996,000              | \$ 7,169,000 |

The following table presents the commitments to incur marketing allowances which will be recognized as a charge against revenue in accordance with the terms of the relevant long-term customer contracts:

| <b>Year ending March 31,</b> |              |
|------------------------------|--------------|
| 2008 remaining six months    | \$ 5,238,000 |
| 2009                         | 7,567,000    |
| 2010                         | 2,599,000    |
| 2011                         | 1,866,000    |
| 2012                         | 1,239,000    |
| Thereafter                   | 1,050,000    |

Total

\$ 19,559,000

The Company has also entered into agreements to purchase certain customers' Remanufactured Core inventory and to issue credits to pay for that inventory according to an agreed upon schedule. Under the largest of these

15

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**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

agreements, the Company agreed to acquire Remanufactured Core inventory by issuing \$10,300,000 of credits over a five-year period that began in March 2005 (subject to adjustment if customer sales decrease in any quarter by more than an agreed upon percentage) on a straight-line basis. As the Company issues these credits, it establishes a long-term core inventory deposit account for the value of the Remanufactured Core inventory in customer hands and subject to customer purchase upon agreement termination and reduces revenue by recognizing the amount by which the credit exceeds the estimated Remanufactured Core inventory value as a marketing allowance. The amounts charged against revenues under this arrangement in the six months ended September 30, 2007 and 2006 were \$351,000 and \$676,000, respectively. As of September 30, 2007 and March 31, 2007, the long-term core inventory deposit related to this agreement was approximately \$2,379,000 and \$1,938,000, respectively. As of September 30, 2007 and March 31, 2007, approximately \$4,820,000 and \$5,613,000, respectively, of credits remains to be issued under this arrangement.

In the fourth quarter of fiscal 2005, the Company entered into a five-year agreement with one of the largest automobile manufacturers in the world to supply this manufacturer with a new line of remanufactured alternators and starters for the United States and Canadian markets. The Company expanded its operations and built-up its inventory to meet the requirements of this contract and incurred certain transition costs associated with this build-up. As part of the agreement, the Company also agreed to grant this customer \$6,000,000 of credits that are issued as sales to this customer are made. Of the total credits, \$3,600,000 was issued during fiscal 2006 and \$600,000 was issued in each of the second quarter of fiscal 2007 and 2008. The remaining \$1,200,000 is scheduled to be issued in two annual payments of \$600,000 in the second fiscal quarter of each of fiscal year 2009 and 2010. The agreement also contains other typical provisions, such as performance, quality and fulfillment requirements that the Company must meet, a requirement that the Company provide marketing support to this customer and a provision (standard in this manufacturer's vendor agreements) granting the customer the right to terminate the agreement at any time for any reason.

In July 2006, the Company entered into an agreement with a new customer to become their primary supplier of alternators and starters. As part of the significant terms of this agreement, the Company agreed to acquire a portion of the customer's import alternator and starter Remanufactured Core inventory by issuing approximately \$950,000 of credits over twenty quarters. On May 22, 2007, this agreement was amended to eliminate the Company's obligation to acquire this Remanufactured Core inventory, and the customer refunded approximately \$142,000 in accounts receivable credits previously issued. Certain promotional allowances were earned by the customer on an accelerated basis during the first year of the agreement.

In addition, during the six months ended September 30, 2007, the Company charged approximately \$376,000 against revenues under the significant terms of the agreements with certain traditional customers. As of September 30, 2007 and March 31, 2007, approximately \$1,337,000 and \$1,594,000 of credits remains to be issued under these agreements.

The following table presents the Company's obligation to purchase Remanufactured Cores from customers which will be recognized in accordance with the terms of the relevant long-term contracts:

| <b>Year ending March 31,</b> |                     |
|------------------------------|---------------------|
| 2008 remaining six months    | \$ 1,486,000        |
| 2009                         | 2,611,000           |
| 2010                         | 1,977,000           |
| 2011                         | 12,000              |
| 2012                         | 12,000              |
| Thereafter                   | 59,000              |
| <b>Total</b>                 | <b>\$ 6,157,000</b> |



**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES****NOTE H Major Customers**

The Company's five largest customers accounted for the following total percentage of net sales and accounts receivable:

| <b>Sales</b> | <b>Six Months Ended</b> |             | <b>Three Months Ended</b> |             |
|--------------|-------------------------|-------------|---------------------------|-------------|
|              | <b>September 30,</b>    |             | <b>September 30,</b>      |             |
|              | <b>2007</b>             | <b>2006</b> | <b>2007</b>               | <b>2006</b> |
| Customer A   | 54%                     | 72%         | 52%                       | 78%         |
| Customer B   | 11%                     | 7%          | 11%                       | 6%          |
| Customer C   | 13%                     | 8%          | 12%                       | 4%          |
| Customer D   | 8%                      | 3%          | 9%                        | 5%          |
| Customer E   | 8%                      | 6%          | 11%                       | 3%          |

  

| <b>Accounts Receivable</b> | <b>September 30,</b> | <b>March 31,</b> |
|----------------------------|----------------------|------------------|
|                            | <b>2007</b>          | <b>2007</b>      |
| Customer A                 | 23%                  | 31%              |
| Customer B                 | 7%                   | 5%               |
| Customer C                 | 10%                  | 9%               |
| Customer D                 | 33%                  | 28%              |
| Customer E                 | 18%                  | 17%              |

For the six months ended September 30, 2007, two suppliers provided approximately 21% and 12%, respectively, of the raw materials purchased. For the six months ended September 30, 2006, one supplier provided approximately 23% of the raw materials purchased. For the three months ended September 30, 2007 and 2006, one supplier provided approximately 23% of the raw materials purchased. No other supplier accounted for more than 10% of the Company's purchases for the six or three months ended September 30, 2007 or 2006.

**NOTE I Stock Options and Share-Based Payments**

Effective April 1, 2006, the Company adopted FAS 123R using the modified prospective application method of transition for all its stock-based compensation plans. FAS 123R requires the compensation costs associated with stock-based compensation plans be recognized and reflected in the Company's reported results.

The fair value of stock options used to compute share-based compensation reflected in reported results under FAS 123R is estimated using the Black-Scholes option pricing model, which was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. This model requires the input of subjective assumptions including the expected volatility of the underlying stock and the expected holding period of the option. These subjective assumptions are based on both historical and other information. Changes in the values assumed and used in the model can materially affect the estimate of fair value.

Options to purchase 49,000 and 402,500 shares of common stock were granted during the six months ended September 30, 2007 and 2006.

**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

The table below summarizes the Black-Scholes option pricing model assumptions used to derive the weighted average fair value of stock options granted during the six months ended September 30, 2007 and 2006.

|   | <b>Six Months Ended<br/>September 30,</b> |             |
|---|---|-------------|
|   | <b>2007</b>                               | <b>2006</b> |
| Risk free interest rate                       | 4.15%                                     | 4.64%       |
| Expected holding period (years)               | 3.03                                      | 5.91        |
| Expected volatility                           | 23.60%                                    | 40.54%      |
| Expected dividend yield                       |   |             |
| Weighted average fair value of options vested | \$ 2.53                                   | \$ 5.56     |

In January 1994, the Company adopted the 1994 Stock Option Plan (the "1994 Plan"), under which it was authorized to issue non-qualified stock options and incentive stock options to key employees, directors and consultants. After a number of shareholder-approved increases to this plan, at March 31, 2002 the Company was ultimately authorized to grant options to purchase up to 1,155,000 shares of the Company's common stock. The term and vesting period of options granted are determined by a committee of the Board of Directors. The term may not exceed ten years. As of September 30, 2007 and 2006, options to purchase 497,500 and 526,500 shares of common stock, respectively, were outstanding under the 1994 Plan and no options were available for grant.

At the Company's Annual Meeting of Shareholders held on December 17, 2003, the shareholders approved the Company's 2003 Long-Term Incentive Plan ("Incentive Plan") which had been adopted by the Company's Board of Directors on October 31, 2003. Under the Incentive Plan, a total of 1,200,000 shares of the Company's common stock were reserved for grants of Incentive Awards (as defined in the Incentive Plan), and all of the Company's employees are eligible to participate. The Incentive Plan will terminate on October 31, 2013, unless terminated earlier by the Company's Board of Directors. As of September 30, 2007 and 2006, options to purchase 1,125,484 and 1,127,450 shares of common stock, respectively, were outstanding under the Incentive Plan and options to purchase 36,100 and 72,550 shares of common stock, respectively, were available for grant.

In November 2004, the Company's shareholders approved the 2004 Non-Employee Director Stock Option Plan (the "2004 Plan") which provides for the granting of options to non-employee directors to purchase a total of 175,000 shares of the Company's common stock. As of September 30, 2007 and 2006, options to purchase 68,000 and 59,000 shares of common stock, respectively, were outstanding under the 2004 Plan and options to purchase 107,000 and 116,000 shares of common stock were available for grant.

A summary of stock option transactions for the six months ended September 30, 2007 follows:

|                                   | <b>Number of<br/>Shares</b> | <b>Weighted<br/>Average<br/>Exercise Price</b> |
|-----------------------------------|-----------------------------|--|
| Outstanding at March 31, 2007     | 1,688,067                   | \$ 8.29  |
| Granted                           | 49,000                      | 11.55  |
| Exercised                         | (37,249)                    | 5.01   |
| Cancelled or Forfeited            | (8,834)                     | 13.46  |
| Outstanding at September 30, 2007 | 1,690,984                   | \$ 8.43  |

The pre-tax intrinsic value of options exercised in the six months ended September 30, 2007 was \$260,000.



**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

The followings table summarizes information about the options outstanding at September 30, 2007:

| Range of<br>Exercise price | Shares    | Options Outstanding                      |  |                                 | Options Exercisable                      |                                 |              |
|----------------------------|-----------|--|--|---------------------------------|--|---------------------------------|--------------|
|                            |           | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Life<br>In Years | Aggregate<br>Intrinsic<br>Value | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value |              |
| \$1.100 to \$1.800         | 23,750    | \$ 1.23                                  | 3.74   | \$ 255,788                      | 23,750                                   | \$ 1.23                         | \$ 255,788   |
| \$2.160 to \$3.600         | 365,000   | 2.75                                     | 4.35   | 3,376,250                       | 365,000                                  | 2.75                            | 3,376,250    |
| \$6.345 to \$9.270         | 461,775   | 8.27                                     | 6.68   | 1,722,421                       | 461,775                                  | 8.27                            | 1,722,421    |
| \$9.650 to \$11.900        | 416,084   | 10.19                                    | 8.24   | 753,112                         | 251,992                                  | 10.14                           | 468,705      |
| \$12.000 to \$13.800       | 414,500   | 12.05                                    | 8.86   |                                 | 261,667                                  | 12.07                           |              |
| \$14.500 to \$19.125       | 9,875     | 16.02                                    | 5.80   |                                 | 5,875                                    | 17.06                           |              |
|                            | 1,690,984 |  |  | \$ 6,107,571                    | 1,370,059                                |                                 | \$ 5,823,164 |

The aggregate intrinsic values in the above table represent the pre-tax value of all in-the-money options if all such options had been exercised on September 30, 2007 based on the Company's closing stock price of \$12.00 as of that date.

At September 30, 2007, options to purchase 1,370,059 shares of common stock were exercisable at the weighted average exercise price of \$7.79.

A summary of changes in the status of nonvested stock options during the six months ended September 30, 2007 is presented below:

|                                  | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair<br>Value of<br>Options |
|----------------------------------|---------------------|--|
| Non-vested at March 31, 2007     | 417,418             | \$ 4.80  |
| Granted                          | 31,670              | 2.63   |
| Vested                           | (125,829)           | 5.56   |
| Forfeited                        | (2,334)             | 3.18   |
| Non-vested at September 30, 2007 | 320,925             | \$ 4.30  |

The Company recognized stock-based compensation expense of \$590,000 and \$975,000 for the six months ended September 30, 2007 and 2006, respectively. As of September 30, 2007, approximately \$951,000 of compensation cost related to the nonvested stock options was unrecognized. This cost is expected to be recognized over the remaining weighted average vesting period of 1.9 years.

**NOTE J Line of Credit; Factoring Agreements**

In April 2006, the Company entered into an amended credit agreement with its bank that increased the Company's credit availability from \$15,000,000 to \$25,000,000, extended the expiration date of the credit facility from October 2, 2006 to October 1, 2008 and changed the manner in which the margin over the benchmark interest rate was calculated. Starting June 30, 2006, the line of credit bears interest at a base rate per annum plus an applicable margin based on the Company's leverage ratio.

In connection with the April 2006 amendment to the credit agreement, the Company agreed to pay a quarterly fee of 0.375% per year if the leverage ratio as of the last day of the previous fiscal quarter was greater than or equal to 1.50 to 1.00 or 0.25% per year if the leverage ratio was less than 1.50 to 1.00 as of the last day of the previous fiscal quarter. A fee of \$125,000 is charged by the bank in order to complete the amendment. The amendment completion fee is payable in three installments of \$41,666. The first payment was made on the date of the amendment to the credit agreement, the second was made in the fourth quarter of fiscal 2007 and the third is to be paid on or before

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

February 1, 2008. The fee was deferred and is being amortized on a straight-line basis over the remaining term of the credit facility.

In August 2006, the bank credit agreement was amended to increase the credit availability from \$25,000,000 to \$35,000,000. On March 23, 2007, the credit agreement with its bank was further amended to provide the Company with a non-revolving loan of up to \$5,000,000. This non-revolving loan bore interest at the bank's prime rate and was due on June 15, 2007. On May 24, 2007, the Company repaid the \$5,000,000 loan from the proceeds of its private placement of common stock and warrants.

As a result of the August 2006 amendment, the bank increased the minimum fixed charge coverage ratio and the maximum leverage ratio and increased the amount of allowable capital expenditures. In addition, the unused facility fee is now applied against any difference between the \$35,000,000 commitment and the average daily outstanding amount of credit the Company actually uses during each quarter. The bank charged an amendment fee of \$30,000 which was paid and expensed on the effective date of the amendment to the credit agreement.

In November 2006, the bank credit agreement was further amended to eliminate the impact of a \$8,062,000 reduction in the carrying value of the long-term core deposit account that was made in connection with the termination of the Company's POS arrangement with its largest customer for purposes of determining the Company's compliance with the minimum cash flow covenant, and to decrease the minimum required current ratio. This amendment was effective as of September 30, 2006.

In addition, in conjunction with a March 2007 amendment to the credit agreement, the Company agreed to provide its bank with monthly financial statements, monthly aged reports of accounts receivable and accounts payable and monthly inventory reports. The Company also agreed to allow the bank, at its request, to inspect the Company's assets, properties and records and conduct on-site appraisals of the Company's inventory.

In conjunction with a waiver granted to the Company by its bank in June 2007, the credit agreement was amended to eliminate the impact of the \$8,062,000 reduction in the carrying value of the long-term core deposit account for purposes of determining the Company's compliance with the fixed charge coverage ratio and the leverage ratio. The effective date of the amendment for the fixed charge coverage ratio was March 31, 2007.

In August 2007, the bank credit agreement was further amended to reduce the minimum level of cash flow for each trailing twelve months during the term of the agreement and to reduce the fixed charge coverage ratio. These changes were effective June 30, 2007. As a result of this amendment the Company was in compliance with all its bank covenants.

On October 24, 2007, the Company entered into an amended and restated credit agreement (the "New Credit Agreement") with its bank. While many provisions of the prior bank credit agreement were retained in the New Credit Agreement, the New Credit Agreement eliminated two financial covenants and modified other covenants. Under the New Credit Agreement, the bank will continue to provide the Company with a revolving loan (the "Revolving Loan") of up to \$35,000,000, including obligations under outstanding letters of credit, which may not exceed \$7,000,000. The New Credit Agreement will expire on October 1, 2008. The New Credit Agreement was effective as of the last day of the fiscal quarter ended September 30, 2007.

The bank holds a security interest in substantially all of the Company's assets. At September 30, 2007, the Company had borrowed \$3,900,000 under the Revolving Loan and reserved \$4,126,000 of the Revolving Loan primarily for standby letters of credit for worker's compensation insurance.

The New Credit Agreement, among other things, continues to require the Company to maintain certain financial covenants, including cash flow, fixed charge coverage ratio and leverage ratio and a number of restrictive covenants, including limits on capital expenditures and operating leases, prohibitions against additional indebtedness, payment of dividends, pledge of assets and loans to officers and/or affiliates. In addition, it is an event of default under the loan agreement if Selwyn Joffe is no longer the Company's CEO.

The Company was in compliance with all financial covenants under the New Credit Agreement as of September 30, 2007.

**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

Borrowings under the Revolving Loan bear interest at a base rate per annum plus an applicable margin which fluctuates as noted below:

|   | <b>Leverage ratio as of the end of the fiscal quarter</b> |                     |
|---|---|---------------------|
|   | <b>Greater than or equal to 1.50</b>                      | <b>1.00 to 1.00</b> |
| <b>Base Interest Rate Selected by the Company</b> |   |                     |
| Bank's Reference Rate, plus                       | 0.0% per year   | -0.25% per year     |
| Bank's LIBOR Rate, plus                           | 2.0% per year   | 1.75% per year      |

Under two separate agreements executed on July 30, 2004 and August 21, 2003 with two customers and their respective banks, the Company may sell those customers' receivables to those banks at a discount to be agreed upon at the time the receivables are sold. These discount arrangements have allowed the Company to accelerate collection of the customers' receivables aggregating \$44,083,000 and \$36,938,000 for the six months ended September 30, 2007 and 2006, respectively, by an average of 264 days and 189 days, respectively. On an annualized basis, the weighted average discount rate on the receivables sold to the banks during the six months ended September 30, 2007 and 2006 was 6.6% and 6.7%, respectively. The amount of the discount on these receivables, \$2,475,000 and \$1,216,000 for the six months ended September 30, 2007 and 2006, respectively, was recorded as interest expense.

**NOTE K Comprehensive Income**

SFAS 130, Reporting Comprehensive Income, established standards for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Comprehensive income is defined as the change in equity during a period resulting from transactions and other events and circumstances from non-owner sources. The Company's total comprehensive income consists of net income, unrealized gain (loss) on short-term investments and foreign currency translation adjustments.

|  | <b>Six Months Ended</b> |              | <b>Three Months Ended</b> |                |
|--|-------------------------|--------------|---------------------------|----------------|
|  | <b>September 30,</b>    |              | <b>September 30,</b>      |                |
|  | <b>2007</b>             | <b>2006</b>  | <b>2007</b>               | <b>2006</b>    |
| Net income (loss)                                | \$ 2,058,000            | \$ (184,000) | \$ 466,000                | \$ (1,762,000) |
| Unrealized gain (loss) on short-term investments | 35,000                  | (1,000)      |                           | 5,000          |
| Foreign currency translation gain (loss)         | 87,000                  | 8,000        | (48,000)                  | 242,000        |
| Comprehensive net income (loss)                  | \$ 2,180,000            | \$ (177,000) | \$ 418,000                | \$ (1,515,000) |

**NOTE L Financial Risk Management and Derivatives**

Purchases and expenses denominated in currencies other than the U.S. dollar, which are primarily related to the Company's production facilities overseas, expose the Company to market risk from material movements in foreign exchange rates between the U.S. dollar and the foreign currency. The Company's primary risk exposure is from changes in the rate between the U.S. dollar and the Mexican peso related to the operation of the Company's facility in Mexico. In August 2005, the Company began to enter into forward foreign exchange contracts to exchange U.S. dollars for Mexican pesos. The extent to which forward foreign exchange contracts are used is modified periodically in response to management's estimate of market conditions and the terms and length of specific purchase requirements to fund those overseas facilities.

The Company enters into forward foreign exchange contracts in order to reduce the impact of foreign currency fluctuations and not to engage in currency speculation. The use of derivative financial instruments allows the Company to reduce its exposure to the risk that the eventual cash outflow resulting from funding the expenses of the foreign operations will be materially affected by changes in exchange rates. The Company does not hold or issue financial instruments for trading purposes. The forward foreign exchange contracts are designated for forecasted expenditure requirements to fund the overseas operations. These contracts expire in a year or less.



**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

The Company had forward foreign exchange contracts with a U.S. dollar equivalent notional value of \$4,425,000 and \$2,716,000 and materially the same nominal fair value at September 30, 2007 and 2006, respectively. The forward foreign exchange contracts entered into require the Company to exchange Mexican pesos for U.S. dollars at maturity ranging from one month to six months, at rates agreed at the inception of the contracts. The counterparty to this derivative transaction is a major financial institution with investment grade or better credit rating; however, the Company is exposed to credit risk with this institution. The credit risk is limited to the potential unrealized gains (which offset currency fluctuations adverse to the Company) in any such contract should this counterparty fail to perform as contracted. Any changes in the fair values of foreign exchange contracts are reflected in current period earnings and accounted for as an increase or offset to general and administrative expenses. For the six months ended September 30, 2007 and 2006, the Company recorded a decrease in general and administrative expenses of \$55,000 and an increase in general and administrative expenses of \$115,000, respectively, associated with these foreign exchange contracts.

**NOTE M Litigation**

In December 2003, the SEC and the United States Attorney's Office brought actions against Richard Marks, the Company's former President and Chief Operating Officer. (Mr. Marks is also the son of Mel Marks, the Company's founder, largest shareholder and member of its Board.) Mr. Marks agreed to plead guilty to the criminal charges, and on June 17, 2005 he was sentenced to nine months in prison, nine months of home detention, 18 months of probation and fined \$50,000. In settlement of the SEC's civil fraud action, Mr. Marks paid over \$1.2 million and was permanently barred from serving as an officer or director of a public company.

Based upon the terms of agreements it had previously entered into with Mr. Richard Marks, the Company paid the costs he incurred in connection with the SEC and United States Attorney's Office's investigation. Following the conclusion of these investigations, the Company sought reimbursement from Mr. Marks of certain of the legal fees and costs it had advanced. In June 2006, the Company entered into a Settlement Agreement and Mutual Release with Mr. Marks. Under this agreement, Mr. Marks is obligated to pay the Company \$682,000 on January 15, 2008 and to pay interest at the prime rate plus one percent on June 15, 2007 and January 15, 2008. Mr. Marks made the June interest payment on June 22, 2007. Mr. Marks has pledged 80,000 shares of the Company's common stock that he owns to secure this obligation. If at any time the market price of the stock pledged by Mr. Marks is less than 125% of Mr. Marks' obligation, he is required to pledge additional stock so as to maintain no less than the 125% coverage level. The settlement with Mr. Marks was unanimously approved by a Special Committee of the Board consisting of Messrs. Borneo, Gay and Siegel. In June 2006, the Company recorded a shareholder note receivable for the \$682,000 Mr. Marks owes the Company. The note is classified in shareholders' equity as it is collateralized by the Company's common stock.

The United States Attorney's Office has informed the Company that it does not intend to pursue criminal charges against the Company arising from the events involved in the SEC complaint.

The Company is subject to various other lawsuits and claims in the normal course of business. Management does not believe that the outcome of these matters will have a material adverse effect on its financial position or future results of operations.

**NOTE N Equity Transaction**

On May 23, 2007, the Company completed the sale of 3,641,909 shares of the Company's common stock at a price of \$11.00 per share, resulting in aggregate gross proceeds of \$40,061,000 and net proceeds of approximately \$37,000,000 after expenses, and warrants to purchase up to 546,283 shares of its common stock at an exercise price of \$15.00 per share. This sale was made through a private placement to accredited investors. The warrants are callable by the Company if, among other things, the volume weighted average trading price of the Company's common stock as quoted by Bloomberg L.P. is greater than \$22.50 for 10 consecutive trading days. As of September 30, 2007, the Company charged approximately \$3,079,000 for fees and costs related to this private placement to its additional paid-in-capital. The fair value of the warrants at the date of grant was estimated to be approximately \$4.44 per warrant using the Black-Scholes pricing model. The following assumptions were used to calculate the fair value of the warrants: dividend yield of 0%; expected volatility of 40.01%; risk-free interest rate of 4.5766%; and an expected life

of five years.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

On July 26, 2007, the Company filed a registration statement under the Securities Act of 1933 to register the shares of common stock sold and the shares to be issued upon the exercise of the warrants. This registration statement was declared effective by the SEC on October 19, 2007. The Company is obligated to use its commercially reasonable efforts to keep the registration statement continuously effective until the earlier of (i) five years after the registration statement is declared effective by the SEC, (ii) such time as all of the securities covered by the registration statement have been publicly sold by the holders, or (iii) such time as all of the securities covered by the registration statement may be sold pursuant to Rule 144(k) of the Securities Act. If the Company fails to satisfy this requirement, it is obligated to pay each purchaser of the common stock and warrants sold in the private placement partial liquidated damages equal to 1% of the aggregate amount invested by such purchaser, and an additional 1% for each subsequent month this requirement is not met, until the partial liquidated damages paid equals a maximum of 19% of such aggregate investment amount or approximately \$7,612,000. As required under FASB Staff Position EITF 00-19-2,

Accounting for Registration Payment Arrangements, the Company has determined that as of the date of this filing, the payment of such liquidated damages is not probable, as that term is defined in FASB Statement No. 5, Accounting for Contingencies. As a result, the Company has not recorded a liability for this contingent obligation as of September 30, 2007. Any subsequent accruals of a liability or payments made under this registration rights agreement will be charged to earnings as interest expense in the period they are recognized or paid.

**NOTE O Customs Duties**

The Company received a request for information dated April 16, 2007 from the U.S. Bureau of Customs and Border Protection ( CBP ) concerning the Company s importation of products remanufactured at the Company s Malaysian facilities. In response to the CBP s request, the Company began an internal review, with the assistance of customs counsel, of its custom duties procedures. During this review process, the Company identified a potential exposure related to the omission of certain cost elements in the appraised value of used alternators and starters, which were remanufactured in Malaysia and returned to the United States since June 2002.

The Company provided a prior disclosure letter dated June 5, 2007 to the customs authorities in order to provide more time to complete its internal review process. This prior disclosure letter also provides the Company the opportunity to self report any underpayment of customs duties in prior years which could reduce financial penalties, if any, imposed by the CBP.

The Company has until December 7, 2007 to respond to the CBP with the final results of its internal review. The Company has currently determined that it is probable that the CBP will make a claim for additional duties, fees, and interest on the value of remanufactured units shipped back to the Company during the period from June 5, 2002 to September 30, 2007. As a result, the Company has accrued \$1,450,000 as of September 30, 2007, representing the estimated value of the claim.

The ultimate outcome of the CBP review of the results of the Company s review process is not yet known. While the Company intends to vigorously defend its amended classification of these imported units, it is possible the CBP may assess a claim other than the amount accrued.



**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

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

The following discussion and analysis presents factors that we believe are relevant to an assessment and understanding of our consolidated financial position and results of operations. This financial and business analysis should be read in conjunction with our March 31, 2007 consolidated financial statements included in our Annual Report on Form 10-K/A Amendment No. 2 filed on October 19, 2007.

***Disclosure Regarding Private Securities Litigation Reform Act of 1995***

This report contains certain forward-looking statements with respect to our future performance that involve risks and uncertainties. Various factors could cause actual results to differ materially from those projected in such statements. These factors include, but are not limited to: concentration of sales to certain customers, changes in our relationship with any of our customers, including the increasing customer pressure for lower prices and more favorable payment and other terms, our ability to renew the contract with our largest customer that is scheduled to expire in August 2008 and the terms of any such renewal, the increasing demands on our working capital, including the significant strain on working capital associated with large Remanufactured Core inventory purchases from customers of the type we have increasingly made, our ability to obtain any additional financing we may seek or require, our ability to achieve positive cash flows from operations, potential future changes in our previously reported results as a result of the identification and correction of errors in our accounting policies or procedures or the material weaknesses in our internal controls over financial reporting, the outcome of the existing review of our custom duties payments and procedures, lower revenues than anticipated from new and existing contracts, our failure to meet the financial covenants or the other obligations set forth in our bank credit agreement and the bank's refusal to waive any such defaults, any meaningful difference between projected production needs and ultimate sales to our customers, increases in interest rates, changes in the financial condition of any of our major customers, the impact of high gasoline prices, the potential for changes in consumer spending, consumer preferences and general economic conditions, increased competition in the automotive parts industry, including increased competition from Chinese manufacturers, difficulty in obtaining Used Cores and component parts or increases in the costs of those parts, political or economic instability in any of the foreign countries where we conduct operations, unforeseen increases in operating costs and other factors discussed herein and in our other filings with the SEC.

**Critical Accounting Policies**

We prepare our consolidated financial statements in accordance with U.S. generally accepted accounting principles, or GAAP. Our significant accounting policies are discussed in detail below, in Note B to our unaudited consolidated financial statements included in this Form 10-Q and our consolidated financial statements included in our Annual Report on Form 10-K/A Amendment No. 2 filed on October 19, 2007.

In preparing our consolidated financial statements, it is necessary that we use estimates and assumptions for matters that are inherently uncertain. We base our estimates on historical experiences and reasonable assumptions. Our use of estimates and assumptions affects the reported amounts of assets, liabilities and the amount and timing of revenues and expenses we recognize for and during the reporting period. Actual results may differ from estimates.

*Inventory*

*Non-core Inventory*

Non-core inventory is comprised of non-core raw materials, the non-core value of work-in-process and the non-core value of finished goods. Used Cores, the Used Core value of work-in-process and the Remanufactured Core portion of finished goods are classified as long-term core inventory as described below.

Non-core inventory is stated at the lower of cost or market. The cost of non-core inventory approximates average historical purchase prices paid, and is based upon the direct costs of material and an allocation of labor and variable and fixed overhead costs. The cost of non-core inventory is evaluated at least quarterly during the fiscal year and adjusted to reflect current lower of cost or market levels. These adjustments are determined for individual items of inventory within each of the three classifications of non-core inventory as follows:

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

Non-core raw materials are recorded at average cost, which is based on the actual purchase price of raw materials on hand. The average cost is updated quarterly. This average cost is used in the inventory costing process and is the basis for allocation of materials to finished goods during the production process.

Non-core work in process is in various stages of production, is on average 50% complete and is valued at 50% of the cost of a finished good. Non-core work in process inventory historically comprises less than 3% of the total non-core inventory balance.

Finished goods cost includes the average cost of non-core raw materials and allocations of labor and variable and fixed overhead. The allocations of labor and variable and fixed overhead costs are determined based on the average actual use of the production facilities over the prior twelve months which approximates normal capacity. This method prevents the distortion in allocated labor and overhead costs that would occur during short periods of abnormally low or high production. In addition, we exclude certain unallocated overhead such as severance costs, duplicative facility overhead costs, and spoilage from the calculation and expense them as period costs as required in Financial Accounting Standards Board (FASB) Statement No. 151, Inventory Costs, an amendment of Accounting Research Bulletin ( ARB ) No. 43, Chapter 4 ( FAS 151 ). For the six months ended September 30, 2007, costs of approximately \$1,057,000 were considered abnormal and thus excluded from the cost calculation.

We provide an allowance for potentially excess and obsolete inventory based upon recent sales history, the quantity of inventory remaining on-hand, and a forecast of potential use of the inventory. We review inventory on a monthly basis to identify excess quantities and part numbers that are experiencing a reduction in demand. In general, part numbers with quantities representing a one to three-year supply are partially reserved for at rates based upon management's judgment and consistent with historical rates. Any part numbers with quantities representing more than a three-year supply are reserved for at a rate that considers possible scrap and liquidation values and may be as high as 100% if no liquidation market exists for the part.

The quantity thresholds and reserve rates are subjective and are based on management's judgment and knowledge of current and projected industry demand. The reserve estimates may, therefore, be revised if there are changes in the overall market for our products or market changes that in management's judgment, impact our ability to sell or liquidate potentially excess or obsolete inventory.

We apply the guidance provided by the Emerging Issues Task Force ( EITF ) Issue No. 02-16, Accounting by a Customer (Including a Reseller) for Cash Consideration Received from a Vendor ( EITF 02-16 ), by recording vendor discounts as a reduction of inventories that are recognized as a reduction to cost of sales as the inventories are sold.

*Inventory Unreturned*

Inventory Unreturned represents our estimate, based on historical data and prospective information provided directly by the customer, of finished goods shipped to customers that we expect to be returned, under our general right of return policy, after the balance sheet date. The inventory unreturned balance includes only the added unit value of a finished good (as previously mentioned, all cores are classified separately as long term assets). The return rate is calculated based on expected returns within a normal operating cycle, which is one year. Hence, the related amounts are classified in current assets.

Inventory unreturned is valued in the same manner as our finished goods inventory.

*Long-term Core Inventory*

Long-term core inventory consists of:

Used Cores purchased from core brokers and held in inventory at our facilities,

Used Cores returned by our customers and held in inventory at our facilities,

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

Used Cores expected to be returned by our customers and held at customer locations. Used Cores that have been returned by end-users to customers but have not yet been returned to us are classified as Remanufactured Cores until they are physically received by us,

Remanufactured Cores held in finished goods inventory at our facilities; and

Remanufactured Cores held at customer locations as a part of the finished goods sold to the customer. For these Remanufactured Cores, we expect the finished good containing the Remanufactured Core to be returned under our general right of return policy or a similar Used Core to be returned to us by the customer, in each case, for credit.

Long-term core inventory is recorded at average historical purchase prices determined based on actual purchases of inventory on hand. The cost and market value of Used Cores for which sufficient recent purchases have occurred are deemed the same as the purchases are made in arms length transactions.

Long-term core inventory recorded at average purchase price is primarily made up of Used Cores for newer products related to more recent automobile models or products for which there is a less liquid market. We must purchase these Used Cores from core brokers because our customers do not have a sufficient supply of these newer Used Cores available for the core exchange program.

Approximately 15% to 25% of Used Cores are obtained in core broker transactions and are valued based on average purchase price. The average purchase price of Used Cores for more recent automobile models is retained as the cost for these Used Cores in subsequent periods even as the source of these Used Cores shifts to our core exchange program.

Long-term core inventory is recorded at the lower of cost or market value. In the absence of sufficient recent purchases, we use core broker price lists to assess whether Used Core cost exceeds Used Core market value on an item by item basis. The primary reason for the insufficient recent purchases is that we obtain most of our Used Core inventory from the customer core exchange program.

In the fourth quarter of fiscal 2007, we reclassified all of our core inventories to a long-term asset account. The determination of the long-term classification was based on our view that the value of the cores is not consumed or realized in cash during our normal operating cycle, which is one year for most of the cores recorded in inventory. According to ARB No. 43, current assets are defined as assets or other resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. We do not believe that core inventories, which we classify as long-term, are consumed because the credits issued upon the return of Used Cores offset the amounts invoiced when the Remanufactured Cores included in finished goods were sold. We do not expect the core inventories to be consumed, and thus we do not expect to realize cash, until our relationship with a customer ends, a possibility that we consider remote based on existing long-term customer agreements and historical experience.

However, historically for approximately 4.5% of finished goods sold, our customer will not send us a Used Core to obtain the credit we offer under our core exchange program. Therefore, based on our historical estimate, we derecognize the core value for these finished goods upon sale, as we believe they have been consumed and we have realized cash.

We realize cash for only the core exchange program shortfall of approximately 4.5%. This shortfall represents the historical difference between the number of finished goods shipped to customers and the number of Used Cores returned to us by customers. We do not realize cash for the remaining portion of the cores because the credits issued upon the return of Used Cores offset the amounts invoiced when the Remanufactured Cores included in finished goods were sold. We do not expect to realize cash for the remaining portion of these cores until our relationship with a customer ends, a possibility that we consider remote based on existing long-term customer agreements and historical experience.

For these reasons, we concluded that it is more appropriate to classify core inventory as a long-term asset.



**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

*Long-term Core Inventory Deposit*

The long-term core inventory deposit account represents the value of Remanufactured Cores we have agreed to purchase from customers, which are held by the customers and remain on the customers' premises. The purchase is made through the issuance of credits against that customer's receivables either on a one-time basis or over an agreed-upon period. The credits against the customer's receivable are based upon the Remanufactured Core purchase price previously established with the customer. At the same time, we record the long-term core inventory deposit for the Remanufactured Cores purchased at its cost, determined as noted under Long-term Core Inventory. The long-term core inventory deposit is stated at the lower of cost or market. The cost is established at the time of the transaction based on the then-current cost, determined as noted under Long-term Core Inventory. The difference between the credit granted and the cost of the long-term core inventory deposit is treated as a sales allowance reducing revenue as required under EITF 01-9. When the purchases are made over an agreed-upon period, the long-term core inventory deposit is recorded at the same time the credit is issued to the customer for the purchase of the Remanufactured Cores. At least annually, and as often as quarterly, reconciliations and confirmations are performed to determine that the number of Remanufactured Cores purchased, but retained at the customer location, remains sufficient to support the amounts recorded in the long-term core inventory deposit account. At the same time, the mix of Remanufactured Cores is reviewed to determine that the aggregate value of Remanufactured Cores in the account has not changed during the reporting period. The Company evaluates the cost of Remanufactured Cores supporting the aggregate long-term core inventory deposit account each quarter. If the Company identifies any permanent reduction in either the number or the aggregate value of the Remanufactured Core inventory mix held at the customer location, the Company will record a reduction in the long-term core inventory deposit account during that period.

***Revenue Recognition***

We recognize revenue when our performance is complete, and all of the following criteria established by Staff Accounting Bulletin No. 104, Revenue Recognition (SAB 104), have been met:

Persuasive evidence of an arrangement exists,

Delivery has occurred or services have been rendered,

The seller's price to the buyer is fixed or determinable, and

Collectibility is reasonably assured.

For products shipped free-on-board (FOB) shipping point, revenue is recognized on the date of shipment. For products shipped FOB destination, revenues are recognized two days after the date of shipment based on our experience regarding the length of transit duration. We include shipping and handling charges in the gross invoice price to customers and classify the total amount as revenue in accordance with EITF Issue No. 00-10, Accounting for Shipping and Handling Fees and Costs. Shipping and handling costs are recorded in cost of sales.

***Revenue Recognition; Net-of-Core-Value Basis***

The price of a finished product sold to customers is generally comprised of separately invoiced amounts for the Remanufactured Core included in the product (Remanufactured Core value) and for the value added by remanufacturing (unit value). The unit value is recorded as revenue based on our then-current price list, net of applicable discounts and allowances. Based on our experience, contractual arrangements with customers and inventory management practices, more than 90% of the remanufactured alternators and starters we sell to customers are replaced by similar Used Cores sent back for credit by customers under our core exchange program. In accordance with our net-of-core-value revenue recognition policy, we do not recognize the Remanufactured Core value as revenue when the finished products are sold. We generally limit the number of Used Cores sent back under the core exchange program to the number of similar Remanufactured Cores previously shipped to each customer.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

*Revenue Recognition and Deferral Core Revenue*

**Full price Remanufactured Cores:** When we ship a product, we invoice certain customers for the Remanufactured Core portion of the product at full Remanufactured Core sales price but do not recognize revenue for the Remanufactured Core value at that time. For these Remanufactured Cores, we recognize core revenue based upon an estimate of the rate at which our customers will pay cash for Remanufactured Cores in lieu of sending back similar Used Cores for credits under our core exchange program.

**Nominal price Remanufactured Cores:** We invoice other customers for the Remanufactured Core portion of product shipped at a nominal Remanufactured Core price. Unlike the full price Remanufactured Cores, we only recognize revenue from nominal Remanufactured Cores not expected to be replaced by a similar Used Core sent back under the core exchange program when we believe that we have met all of the following criteria:

We have a signed agreement with the customer covering the nominally priced Remanufactured Cores not expected to be sent back under the core exchange program, and the agreement must specify the number of Remanufactured Cores our customer will pay cash for in lieu of sending back a similar Used Core under our core exchange program and the basis on which the nominally priced Remanufactured Cores are to be valued (normally the average price per Remanufactured Core stipulated in the agreement).

The contractual date for reconciling our records and customer's records of the number of nominally priced Remanufactured Cores not expected to be replaced by similar Used Cores sent back under our core exchange program must be in the current or a prior period.

The reconciliation must be completed and agreed to by the customer.

The amount must be billed to the customer.

**Deferral of Core Revenue.** As noted previously, we have in the past and may in the future agree to buy back Remanufactured Cores from certain customers. The difference between the credit granted and the cost of the Remanufactured Cores bought back is treated as a sales allowance reducing revenue as required under EITF 01-9. As a result of the increasing level of Remanufactured Core buybacks, we have now decided to defer core revenue from these customers until there is no expectation that sales allowances associated with Remanufactured Core buybacks from these customers will offset core revenues that would otherwise be recognized once the criteria noted above have been met. At September 30, 2007 and March 31, 2007, Remanufactured Core revenue of \$2,387,000 and \$1,575,000, respectively, was deferred.

*Revenue Recognition; General Right of Return*

We allow our customers to return goods to us that their end-user customers have returned to them, whether the returned item is or is not defective (warranty returns). In addition, under the terms of certain agreements with our customers and industry practice, our customers from time to time are allowed stock adjustments when their inventory of certain product lines exceeds the anticipated sales to end-user customers (stock adjustment returns). We seek to limit the aggregate of customer returns, including warranty and stock adjustment returns, to less than 20% of unit sales. In some instances, we allow a higher level of returns in connection with a significant update order.

We provide for such anticipated returns of inventory in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 48, Revenue Recognition When Right of Return Exists by reducing revenue and the related cost of sales for the units estimated to be returned.

Our allowance for warranty returns is established based on a historical analysis of the level of this type of return as a percentage of total unit sales. Stock adjustment returns do not occur at any specific time during the year, and the expected level of these returns cannot be reasonably estimated based on a historical analysis. Our allowance for stock adjustment returns is based on specific customer inventory levels, inventory movements and information on the estimated timing of stock adjustment returns provided by our customers.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

*Sales Incentives*

We provide various marketing allowances to our customers, including sales incentives and concessions. Marketing allowances related to a single exchange of product are recorded as a reduction of revenues at the time the related revenues are recorded or when such incentives are offered. Other marketing allowances, which may only be applied against future purchases, are recorded as a reduction to revenues in accordance with a schedule set forth in the relevant contract. Sales incentive amounts are recorded based on the value of the incentive provided.

*Accounting for Deferred Taxes*

The valuation of deferred tax assets and liabilities is based upon management's estimate of current and future taxable income using the accounting guidance in SFAS No. 109, Accounting for Income Taxes. As of September 30, 2007 and 2006 management determined that no valuation allowance was necessary for deferred tax assets.

*Financial Risk Management and Derivatives*

We are exposed to market risk from material movements in foreign exchange rates between the U.S. dollar and the currencies of the foreign countries in which we operate. As a result of our growing operations in Mexico, our primary risk relates to changes in the rates between the U.S. dollar and the Mexican peso associated with our growing operations in Mexico. To mitigate this currency risk, in August 2005 we began to enter into forward foreign exchange contracts to exchange U.S. dollars for Mexican pesos. The extent to which we use forward foreign exchange contracts is periodically reviewed in light of our estimate of market conditions and the terms and length of anticipated requirements. The use of derivative financial instruments allows us to reduce our exposure to the risk that the eventual net cash outflow resulting from funding the expenses of the foreign operations will be materially affected by changes in the exchange rates. We do not engage in currency speculation or hold or issue financial instruments for trading purposes. We had foreign exchange contracts with a U.S. dollar equivalent notional value of \$4,425,000 and \$2,716,000 and materially the same nominal fair value at September 30, 2007 and 2006, respectively. These contracts expire in a year or less. Any changes in the fair value of foreign exchange contracts are accounted for as an increase or offset to general and administrative expenses in current period earnings. For the six months ended September 30, 2007 and 2006, the net effect of the foreign exchange contracts was to decrease general and administrative expenses by \$55,000 and an increase in general and administrative expenses of \$115,000, respectively.

*New Accounting Pronouncements*

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( FAS No. 159 ). FAS No. 159 permits companies to choose to measure at fair value certain financial instruments and other items that are not currently required to be measured at fair value. FAS No. 159 is effective for fiscal years beginning after November 15, 2007. We expect to adopt FAS No. 159 in the first quarter of fiscal 2009. We are currently evaluating the impact of FAS No. 159 on our consolidated financial position and results of operations.

In September 2006, the FASB issued FAS No. 157, Fair Value Measurements ( FAS No. 157 ). FAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It also established a framework for measuring fair value under GAAP and expands disclosures about fair value measurement. FAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements. FAS No. 157 is effective for fiscal years ending after November 15, 2007 and interim periods within those fiscal years. We expect to adopt FAS No. 157 in the first quarter of fiscal 2009. We are currently evaluating the impact of FAS No. 157 on our consolidated financial position and results of operations.

**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES****Results of Operations for the six months ended September 30, 2007 and 2006**

The following discussion and analysis should be read in conjunction with the financial statements and notes thereto appearing elsewhere herein.

The following table summarizes certain key operating data for the periods indicated:

|  | <b>Six Months Ended</b> |                               |
|--|-------------------------|-------------------------------|
|  | <b>2007</b>             | <b>September 30,<br/>2006</b> |
| Gross profit percentage                  | 26.6%                   | 16.9%                         |
| Cash flow used in operations             | \$(15,760,000)          | \$(14,518,000)                |
| Finished goods turnover (annualized) (1) | 5.9                     | 4.5                           |
| Annualized return on equity (2)          | 8.6%                    | (0.7)%                        |

(1) Annualized finished goods turnover for the six months ended September 30, 2007 and 2006 is calculated by multiplying cost of sales for each six month period by 2 and dividing the result by the average between beginning and ending non-core finished goods inventory for each six month period. We believe this provides a useful measure of our ability to turn production into revenues. For the six months ended September 30, 2006, the calculation excludes pay-on-scan



inventory.

- (2) Annualized return on equity is computed as net income for the six months ended September 30, 2007 and 2006 multiplied by 2 and dividing the result by beginning shareholders equity. Annualized return on equity measures our ability to invest shareholders funds profitably. The calculation for the six months ended September 30, 2006 reflects the impact of the termination of the POS arrangement, the \$8,062,000 write-down of our long-term core deposit and the corresponding reduction in net sales.

Following is our unaudited results of operations, reflected as a percentage of net sales:

|                            | <b>Six Months Ended<br/>September 30,</b> |             |
|----------------------------|---|-------------|
|                            | <b>2007</b>                               | <b>2006</b> |
| Net sales                  | 100.0%                                    | 100.0%      |
| Cost of goods sold         | 73.4                                      | 83.1        |
| Gross profit               | 26.6                                      | 16.9        |
| Operating expenses:        |   |             |
| General and administrative | 13.7                                      | 10.1        |
| Sales and marketing        | 2.5                                       | 3.2         |

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|   |     |       |
|---|-----|-------|
| Research and development                | 0.8 | 1.1   |
| Operating income                        | 9.6 | 2.5   |
| Interest expense net of interest income | 4.6 | 3.0   |
| Income tax expense (benefit)            | 2.0 | (0.2) |
| Net income (loss)                       | 3.0 | (0.3) |

*Net Sales.* Net sales for the six months ended September 30, 2007 decreased by \$2,329,000 or 3.3%, to \$69,260,000 from the net sales for the six months ended September 30, 2006 of \$71,589,000. Our gross sales for the six months ended September 30, 2007 decreased by \$8,308,000 or 8.3% from gross sales in the six months ended September 30, 2006. While we had higher sales to existing customers during the six months ended September 30, 2007, this increase was more than offset by the impact of the termination of our POS arrangement that occurred during the six months ended September 30, 2006. Gross sales for the six months ended September 30, 2006 included the sale of products previously shipped on a POS basis totaling \$19,795,000. This increase in gross sales for the six months ended September 30, 2006 was offset by the \$8,062,000 sales incentive associated with the write-down we made to

**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

our long-term core deposit account that reduced net sales by a comparable amount. Excluding the impact of the termination of our POS arrangement, our sales for the six months ended September 30, 2007 increased by \$3,425,000 or 3.9% due primarily to higher sales to our existing customers. Our gross sales were offset by marketing allowances of \$11,500,000 for the six months ended September 30, 2007, a decrease of \$210,000 or 1.8%, from \$11,710,000 for the six months ended September 30, 2006. Our net sales for the six months ended September 30, 2007 were positively impacted by the \$6,097,000 decrease in the allowance for customer returns (which also reduce gross sales) from \$17,323,000 for the six months ended September 30, 2006 to \$11,226,000 for the six months ended September 30, 2007. This decrease was primarily due to lower stock adjustment returns expected at September 30, 2007 compared to those expected at September 30, 2006. Our anticipated returns at September 30, 2006 were significantly higher as a result of the increased sales volumes to new customers during that period and the sale of goods previously shipped on a POS basis.

*Cost of Goods Sold.* Cost of goods sold as a percentage of net sales decreased for the six months ended September 30, 2007 to 73.4% from 83.1% for the six months ended September 30, 2006 resulting in a corresponding increase in our gross profit percentage to 26.6% in the six months ended September 30, 2007 from 16.9% in the six months ended September 30, 2006. The increase in the gross profit percentage was primarily due to the decrease in marketing allowances and the allowance for customer returns (as noted in the preceding paragraph) which effectively increased our net sales for the six months ended September 30, 2007. In addition, our gross profit percentage was favorably impacted by the lower per unit manufacturing costs resulting from improvements in manufacturing efficiencies at our Mexican facility when compared to the six months ended September 30, 2006. Our gross profit increase was partly offset by the recording of a customs duties accrual of \$1,450,000 for the six months ended September 30, 2007.

*General and Administrative.* Our general and administrative expenses for the six months ended September 30, 2007 were \$9,513,000, which represents an increase of \$2,311,000 or 32.1% from the general and administrative expense for the six months ended September 30, 2006 of \$7,202,000. This increase was primarily due to increases in the following expenses that were incurred in the six months ended September 30, 2007: (i) \$604,000 of severance and other related expenses, (ii) \$666,000 of increased audit fees, (iii) \$406,000 of increased expenses incurred to meet the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 ( SOX ), (iv) \$216,000 of increased general and administrative expenses at our Mexico facility due primarily to the ramp-up of activities at that facility and (v) a \$159,000 increase in our bad debt reserve primarily resulting from the forced closure of one of our smaller customers. In addition, our general and administrative expenses in the six months ended September 30, 2006 were reduced by the recording of the shareholder note receivable of \$682,000 for reimbursement of indemnification costs. These increases in general and administrative expenses were partly offset by the \$385,000 of decreased compensation expenses associated with our recognition under SFAS No. 123 (revised 2004), Share-Based Payment of stock option compensation expense. These increases were partially offset by changes in the value of our foreign exchange contracts which decreased general and administrative expenses by \$55,000 during the six months ended September 30, 2007 and increased our general and administrative expenses by \$115,000 during the six months ended September 30, 2006.

*Sales and Marketing.* Our sales and marketing expenses for the six months ended September 30, 2007 decreased \$599,000 to \$1,726,000 from \$2,325,000 for the six months ended September 30, 2006. The sales and marketing expenses for the six months ended September 30, 2006 included the accrual of \$526,000 related to changeover expenses incurred in connection with a new customer.

*Research and Development.* Our research and development expenses decreased by \$207,000, or 27.3%, to \$550,000 for the six months ended September 30, 2007 from \$757,000 for the six months ended September 30, 2006. This decrease was primarily due to the expense incurred in the six months ended September 30, 2006 related to the development of new diagnostic equipment for our Mexico and Malaysia facilities.

*Interest Expense.* For the six months ended September 30, 2007, interest expense, net of interest income was \$3,186,000. This represents an increase of \$1,049,000 over interest expense, net of interest income of \$2,137,000 for the six months ended September 30, 2006. This increase was principally attributable to the increase in the amount of receivables that were discounted under our factoring agreements and the increase in the average days over which the receivables were factored associated with the extended payment terms we have provided certain of our customers.



**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

*Income Tax.* For the six months ended September 30, 2007 and 2006, we recognized income tax expense of \$1,412,000 and a tax benefit of \$124,000, respectively. As a result of our fiscal 2007 loss, we have a net operating loss carryforward of approximately \$1,921,000 that can be used to reduce future tax payments.

**Results of Operations for the three months ended September 30, 2007 and 2006**

The following discussion and analysis should be read in conjunction with the financial statements and notes thereto appearing elsewhere herein.

The following table summarizes certain key operating data for the periods indicated:

|  | <b>Three Months Ended<br/>September 30,</b> |               |
|--|---|---------------|
|  | <b>2007</b>                                 | <b>2006</b>   |
| Gross profit percentage                  | 24.4%                                       | 11.2%         |
| Cash flow from (used in) operations      | \$3,987,000                                 | \$(7,379,000) |
| Finished goods turnover (annualized) (1) | 6.4   | 5.7           |
| Annualized return on equity (2)          | 3.9%  | (13.1)%       |

(1) Annualized finished goods turnover for the fiscal quarter is calculated by multiplying cost of sales for the quarter by 4 and dividing the result by the average between beginning and ending non-core finished goods inventory for the fiscal quarter. We believe this provides a useful measure of our ability to turn production into revenues. For the three months ended September 30, 2006, the calculation excludes pay-on-scan inventory.

- (2) Annualized return on equity is computed as net income (loss) for the fiscal quarter multiplied by 4 and dividing the result by beginning shareholders equity. Annualized return on equity measures our ability to invest shareholders funds profitably. The calculation for the three months ended September 30, 2006 reflects the impact of the termination of the POS arrangement, the \$8,062,000 write-down of our long-term core deposit and the corresponding reduction in net sales.

Following is our unaudited results of operations, reflected as a percentage of net sales:

|   | <b>Three Months Ended<br/>September 30,</b> |             |
|---|---|-------------|
|   | <b>2007</b>                                 | <b>2006</b> |
| Net sales                               | 100.0%                                      | 100.0%      |
| Cost of goods sold                      | 75.6  | 88.8        |
| Gross profit                            | 24.4  | 11.2        |
| Operating expenses:                     |   |             |
| General and administrative              | 14.0  | 10.9        |
| Sales and marketing                     | 2.4   | 3.2         |
| Research and development                | 0.8   | 0.8         |
| Operating income (loss)                 | 7.2   | (3.7)       |
| Interest expense net of interest income | 4.6   | 3.0         |

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|                              |     |       |
|------------------------------|-----|-------|
| Income tax expense (benefit) | 1.3 | (2.7) |
| Net income (loss)            | 1.3 | (4.0) |

*Net Sales.* Net sales for the three months ended September 30, 2007, decreased by \$10,346,000 or 23.4%, to \$33,819,000 from the net sales for the three months ended September 30, 2006 of \$44,165,000. Our gross sales for the three months ended September 30, 2007 decreased by \$15,505,000 or 24.7% from gross sales in the three months ended September 30, 2006 primarily as the result of the termination of our POS arrangement during the three months ended September 30, 2006. Our gross sales for the three months ended September 30, 2006 included the sale

**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

of products previously shipped on a POS basis totaling \$19,795,000. This increase in gross sales for the three months ended September 30, 2006 was offset by the \$8,062,000 sales incentive associated with the write-down we made to our long-term core deposit account that reduced net sales by a comparable amount. Excluding the impact of the termination of our POS arrangement, our sales for the three months ended September 30, 2007 decreased by \$3,772,000 or 7.4%, due primarily to lower sales to existing customers. Our gross sales were offset by marketing allowances of \$5,996,000 for the three months ended September 30, 2007, a decrease of \$1,173,000 or 16.4%, from \$7,169,000 for the three months ended September 30, 2006. The marketing allowances for the three months September 30, 2006 included the front-loaded marketing allowances of \$2,600,000 to our new and existing customers. Our net sales for the three months ended September 30, 2007 were positively impacted by the \$4,171,000 decrease in the allowance for customer returns (which also reduce gross sales) from \$11,642,000 for the three months ended September 30, 2006 to \$7,471,000 for the three months ended September 30, 2007. The decrease in the allowance for customer returns was primarily due to lower stock adjustment returns expected at September 30, 2007 compared to those expected at September 30, 2006. Our anticipated returns at September 30, 2006 were significantly higher as a result of the increased sales volumes to new customers during that period and the sale of goods previously shipped on a POS basis.

*Cost of Goods Sold.* Cost of goods sold as a percentage of net sales decreased for the three months ended September 30, 2007 to 75.6% from 88.8% for the three months ended September 30, 2006 resulting in a corresponding increase in our gross profit percentage to 24.4% in the three months ended September 30, 2007 from 11.2% in the three months ended September 30, 2006. The increase in the gross profit percentage was primarily due to the decrease in marketing allowances and the allowance for customer returns (as noted in the preceding paragraph) which effectively increased our net sales for the three months ended September 30, 2007. In addition, our gross profit percentage was favorably impacted by the lower per unit manufacturing costs resulting from improvements in manufacturing efficiencies at our Mexican facility when compared to the three months ended September 30, 2006. Our gross profit increase was partly offset by the recording of a customs duties accrual of \$1,450,000 in the three months ended September 30, 2007.

*General and Administrative.* Our general and administrative expenses for the three months ended September 30, 2007 were \$4,725,000, which represents a decrease of \$87,000 or 1.8%, from the general and administrative expense for the three months ended September 30, 2006 of \$4,812,000. This decrease was due primarily to the decrease of \$548,000 in compensation expenses associated with our recognition under SFAS No. 123 (revised 2004), Share-Based Payment of stock option compensation expense. This decrease was partly offset by increases in the following expenses during the three months ended September 30, 2007: (i) \$169,000 of severance and other related expenses, (ii) \$160,000 of increased audit fees, and (iii) \$83,000 of increased general and administrative expenses at our Mexico facility.

*Sales and Marketing.* Our sales and marketing expenses for the three months ended September 30, 2007 decreased \$623,000 to \$797,000 from \$1,420,000 for the three months ended September 30, 2006. The sales and marketing expenses for the three months ended September 30, 2006 included the accrual of \$526,000 related to changeover expenses incurred in connection with a new customer. In addition, the compensation expense for sales and marketing personnel were lower by \$74,000 for the three months ended September 30, 2007 compared to the three months ended September 30, 2006.

*Research and Development.* Our research and development expenses decreased by \$66,000, or 19.4%, to \$275,000 for the three months ended September 30, 2007 from \$341,000 for the three months ended September 30, 2006. This decrease was primarily due to the expense incurred in the three months ended September 30, 2006 related to the development of new diagnostic equipment for our Mexico and Malaysia facilities.

*Interest Expense.* For the three months ended September 30, 2007, interest expense, net of interest income was \$1,543,000. This represents an increase of \$228,000 over interest expense, net of interest income of \$1,315,000 for the three months ended September 30, 2006. This increase was principally attributable to the increase in the amount of receivables that were discounted under our factoring agreements and the increase in the average days over which the receivables were factored associated with the extended payment terms we have provided certain of our customers.



*Income Tax.* For the three months ended September 30, 2007, we recognized income tax expense of \$439,000 and an income tax benefit of \$1,179,000 for the three months ended September 30, 2006. As a result of our fiscal 2007

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

loss, we have a net operating loss carryforward of approximately \$1,921,000 that can be used to reduce future tax payments.

**Liquidity and Capital Resources**

We have financed our operations through the use of our bank credit facility, the receivable discount programs we have with two of our customers and a capital financing sale-leaseback transaction with our bank. Our working capital needs have increased significantly in light of Remanufactured Core inventory purchases, ramped-up production demands and related higher inventory levels and increased marketing allowances associated with our new or expanded business. To respond to our growing working capital needs and strengthen our financial position, in May 2007 we completed a private placement of common stock and warrants that resulted in aggregate gross proceeds before expenses of \$40,061,000 and net proceeds of approximately \$37,000,000.

We believe the proceeds from our recent private placement together with amounts available under our amended bank credit facility and our cash and short term investments on hand should be sufficient to satisfy our expected future working capital needs, capital lease commitments and capital expenditure obligations over the next year.

***Working Capital and Net Cash Flow***

At September 30, 2007, we had working capital of \$11,254,000, a ratio of current assets to current liabilities of 1.3:1, and cash of \$1,345,000, which compares to a negative working capital of \$26,746,000, a ratio of current assets to current liabilities of 0.7:1, and cash of \$349,000 at March 31, 2007. The significant improvement in our working capital was due primarily to our recently-completed private placement of common stock and warrants that resulted in aggregate gross proceeds before expenses of \$40,061,000 and net proceeds of approximately \$37,000,000. The proceeds from this private placement were used to repay the borrowed amounts under our line of credit and to reduce our accounts payable balances.

Net cash used in operating activities was \$15,760,000 for the six months ended September 30, 2007 compared to \$14,518,000 for the three months ended September 30, 2006. The most significant changes in operating activities for the three months ended September 30, 2007 were the reduction in accounts payable and accrued liabilities of \$20,418,000, the increase in accounts receivables of \$6,440,000, the increase in our long-term core inventory of \$1,750,000, partly offset by a decrease in our on-hand non-core inventory of \$5,712,000. Inventory levels were reduced through our concerted effort to improve inventory turns and to reduce excess inventory levels. These initiatives will continue in the future but the impact on inventory levels may be less material for the remainder of fiscal 2008.

Net cash used in investing activities totaled \$991,000 in the six months ended September 30, 2007. These investing activities were primarily related to capital expenditures of \$891,000 made in conjunction with our new manufacturing facility in Mexico. We expect to continue to use cash in investing activities during fiscal 2008.

Net cash provided by financing activities was \$17,704,000 in the six months ended September 30, 2007. In May 2007, we completed a private placement of our common stock and warrants that resulted in aggregate gross proceeds before expenses of \$40,061,000 and net proceeds of approximately \$37,000,000. For the six months ended September 30, 2007, we charged approximately \$3,079,000 of fees and costs related to this private placement to additional paid-in-capital. The net proceeds from this private placement were substantially used to repay the borrowed amounts under our line of credit and reduce our accounts payable balances.

***Capital Resources***

***Equity Transaction***

On May 23, 2007, we completed the sale of 3,641,909 shares of our common stock and warrants to purchase up to 546,283 shares of our common stock at an exercise price of \$15.00 per share. This sale was made through a private placement to accredited investors. The warrants are callable by us if, among other things, the volume weighted average trading price of our common stock as quoted by Bloomberg L.P. is greater than \$22.50 for 10 consecutive trading days. As of September 30, 2007, we charged approximately \$3,079,000 of fees and costs related to this

**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

private placement to additional paid-in-capital. The fair value of the warrants at the date of grant was estimated to be approximately \$4.44 per warrant using the Black-Scholes pricing model. The following assumptions were used to calculate the fair value of the warrants: dividend yield of 0%; expected volatility of 40.01%; risk-free interest rate of 4.5766%; and an expected life of five years.

On July 26, 2007, we filed a registration statement under the Securities Act of 1933 to register the shares of common stock sold and the shares to be issued upon the exercise of the warrants. This registration statement was declared effective by the SEC on October 19, 2007. We are obligated to use our commercially reasonable efforts to keep the registration statement continuously effective until the earlier of (i) five years after the registration statement is declared effective by the SEC, (ii) such time as all of the securities covered by the registration statement have been publicly sold by the holders, or (iii) such time as all of the securities covered by the registration statement may be sold pursuant to Rule 144(k) of the Securities Act. If we fail to satisfy this requirement, we are obligated to pay each purchaser of the common stock and warrants sold in the private placement partial liquidated damages equal to 1% of the aggregate amount invested by such purchaser, and an additional 1% for each subsequent month this requirement is not met, until the partial liquidated damages paid equals a maximum of 19% of such aggregate investment amount or approximately \$7,612,000. As required under FASB Staff Position EITF 00-19-2, Accounting for Registration Payment Arrangements, ( FSP EITF 00-19-2 ), we have determined that as of the date of this filing, the payment of such liquidated damages is not probable, as that term is defined in FASB Statement No. 5, Accounting for Contingencies. As a result, we have not recorded a liability for this contingent obligation as of June 30, 2007. Any subsequent accruals of a liability or payments made under this registration rights agreement will be charged to earnings as interest expense in the period they are recognized or paid.

*Line of Credit*

In April 2006, we entered into an amended credit agreement with our bank that increased our credit availability from \$15,000,000 to \$25,000,000, extended the expiration date of the credit facility from October 2, 2006 to October 1, 2008, and changed the manner in which the margin over the benchmark interest rate was calculated. Starting June 30, 2006, the line of credit bears interest at a base rate per annum plus an applicable margin based on our leverage ratio. In connection with the April 2006 amendment to our credit agreement, we also agreed to pay a quarterly fee of 0.375% per year if the leverage ratio as of the last day of the previous fiscal quarter was greater than or equal to 1.50 to 1.00 or 0.25% per year if the leverage ratio is less than 1.50 to 1.00, as of the last day of the previous fiscal quarter. A fee of \$125,000 is charged by the bank in connection with the April 2006 amendment. The amendment completion fee is payable in three installments of \$41,666. The first payment was made on the date of the amendment to the credit agreement, the second was made in the fourth quarter of fiscal 2007 and the third is to be paid on or before February 1, 2008. The fee was deferred and is being amortized on a straight-line basis over the remaining term of the credit facility.

In August 2006, the bank credit agreement was amended to increase the credit availability from \$25,000,000 to \$35,000,000. In March 2007, this credit agreement with the bank was further amended to provide us with a non-revolving loan of up to \$5,000,000. This non-revolving loan bore interest at the bank's prime rate and was due on June 15, 2007. On May 24, 2007, we repaid the \$5,000,000 from the proceeds of our private placement of common stock and warrants.

As a result of the August 2006 amendment, the bank increased the minimum fixed charge coverage ratio and the maximum leverage ratio and increased the amount of allowable capital expenditures. In addition, the unused facility fee is now applied against any difference between the \$35,000,000 commitment and the average daily outstanding amount of the credit we actually use during each quarter. The bank charged an amendment fee of \$30,000 which was paid and expensed on the effective date of the amendment to the credit agreement.

In November 2006, the bank credit agreement was further amended to eliminate the impact of a \$8,062,000 reduction in the carrying value of the long-term core deposit account that was made in connection with the termination of our pay-on-scan ( POS ) arrangement with our largest customer, for purposes of determining our compliance with the minimum cash flow covenant, and to decrease the minimum required current ratio. This amendment was effective as of September 30, 2006.



**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

In addition, in conjunction with a March 2007 amendment to the credit agreement, we agreed to provide the bank with monthly financial statements, monthly aged reports of accounts receivable and accounts payable and monthly inventory reports. We also agreed to allow the bank, at its request, to inspect our assets, properties and records and conduct on-site appraisals of our inventory.

In conjunction with a waiver granted to us by the bank in June 2007, the credit agreement was amended to eliminate the impact of the \$8,062,000 reduction in the carrying value of the long-term core deposit account for purposes of determining our compliance with the fixed charge coverage ratio and the leverage ratio. The effective date of the amendment for the fixed charge coverage ratio was March 31, 2007.

In August 2007, the bank credit agreement was further amended to reduce the minimum level of cash flow for each trailing twelve months and to reduce the fixed charge coverage ratio. These changes were effective June 30, 2007. As a result of this amendment we were in compliance with all our bank covenants.

On October 24, 2007, we entered into an amended and restated credit agreement (the *New Credit Agreement*) with our bank. While many provisions of the prior bank credit agreement were retained in the *New Credit Agreement*, the *New Credit Agreement* eliminated two financial covenants and modified other covenants. Under the *New Credit Agreement*, the bank will continue to provide us with a revolving loan (the *Revolving Loan*) of up to \$35,000,000, including obligations under outstanding letters of credit, which may not exceed \$7,000,000. The *New Credit Agreement* will expire on October 1, 2008. The *New Credit Agreement* was effective as of the last day of the fiscal quarter ended September 30, 2007.

The bank holds a security interest in substantially all of our assets. At September 30, 2007, we had borrowed \$3,900,000 under the *Revolving Loan* and reserved \$4,126,000 of the *Revolving Loan* primarily for standby letters of credit for worker's compensation insurance.

The *New Credit Agreement*, among other things, continues to require us to maintain certain financial covenants, including cash flow, fixed charge coverage ratio and leverage ratio and includes a number of restrictive covenants, including limits on capital expenditures and operating leases, prohibitions against additional indebtedness, payment of dividends, pledge of assets and loans to officers and/or affiliates. In addition, it is an event of default under the loan agreement if Selwyn Joffe is no longer the Company's CEO.

We were in compliance with all financial covenants under the *New Credit Agreement* as of September 30, 2007.

Borrowings under the *Revolving Loan* bear interest at a base rate per annum plus an applicable margin which fluctuates as noted below:

|  | <b>Leverage ratio as of the end of the fiscal quarter</b> |                               |
|--|---|-------------------------------|
|  | <b>Greater than or</b>                                    |                               |
| <b>Base Interest Rate Selected by us</b> | <b>equal to 1.50 to 1.00</b>                              | <b>Less than 1.50 to 1.00</b> |
| Bank's Reference Rate, plus              | 0.0% per year   | -0.25% per year               |
| Bank's LIBOR Rate, plus                  | 2.0% per year   | 1.75% per year                |

Our ability to comply in future periods with the financial covenants in the amended credit agreement will depend on our ongoing financial and operating performance, which, in turn, will be subject to economic conditions and to financial, business and other factors, many of which are beyond our control and will be substantially dependent on the selling prices and demand for our products, customer demands for marketing allowances and other concessions, raw material costs, and our ability to successfully implement our overall business strategy. If a violation of any of the covenants occurs in the future, we would attempt to obtain a waiver or an amendment from our lenders. No assurance can be given that we would be successful in this regard.

*Receivable Discount Program*

Our liquidity has been positively impacted by receivable discount programs we have established with two of our customers and their respective banks. Under this program, we have the option to sell those customers' receivables to those banks at a discount to be agreed upon at the time the receivables are sold. The discount has averaged 5.0% during the six months ended September 30, 2007 and has allowed us to accelerate collection of receivables



**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

aggregating \$44,083,000 by an average of 264 days. On an annualized basis, the weighted average discount rate on receivables sold to banks during the six months ended September 30, 2007 was 6.6%. While this arrangement has reduced our working capital needs, there can be no assurance that it will continue in the future. These programs resulted in interest costs of \$2,475,000 during the six months ended September 30, 2007. These interest costs will increase as interest rates rise, as utilization of this discounting arrangement expands and as the discount period is extended to reflect the more favorable payment terms we have provided to certain customers.

*Multi-Year Vendor Agreements*

We have long-term agreements with substantially all of our major customers. Under these agreements, which typically have initial terms of at least four years, we are designated as the exclusive or primary supplier for specified categories of remanufactured alternators and starters. In consideration for our designation as a customer's exclusive or primary supplier, we typically provide the customer with a package of marketing incentives. These incentives differ from contract to contract and can include (i) the issuance of a specified amount of credits against receivables in accordance with a schedule set forth in the relevant contract, (ii) support for a particular customer's research or marketing efforts provided on a scheduled basis, (iii) discounts granted in connection with each individual shipment of product and (iv) other marketing, research, store expansion or product development support. We have also entered into agreements to purchase certain customers' Remanufactured Core inventory and to issue credits to pay for that inventory according to a schedule set forth in the agreement. These contracts typically require that we meet ongoing performance, quality and fulfillment requirements. Our contracts with major customers expire at various dates ranging from December 2007 through December 2012. There are Remanufactured Core purchase obligations with certain customers that expire at various dates through March 2010.

In March 2005, we entered into an agreement with another major customer. As part of this agreement, our designation as this customer's exclusive supplier of remanufactured import alternators and starters was extended from February 28, 2008 to December 31, 2012. In addition to customary marketing allowances, we agreed to acquire the customer's import alternator and starter Remanufactured Core inventory by issuing \$10,300,000 of credits over a five-year period. The amount of credits issued is subject to adjustment if sales to the customer decrease in any quarter by more than an agreed upon percentage. As of September 30, 2007 and March 31, 2007, approximately \$4,820,000 and \$5,613,000, respectively, of credits remain to be issued. The customer is obligated to purchase the Remanufactured or Used Cores in the customer's inventory upon termination of the agreement for any reason. As we issue credits to this customer, we establish a long-term core inventory deposit account for the value of the Remanufactured Core inventory estimated to be on hand with the customer and subject to purchase upon termination of the agreement, and reduce revenue by the amount by which the credit exceeds the estimated Remanufactured Core inventory value. As of September 30, 2007 and March 31, 2007, the long-term core inventory deposit related to this agreement was approximately \$2,379,000 and \$1,938,000, respectively.

In the fourth quarter of fiscal 2005, we entered into a five-year agreement with one of the largest automobile manufacturers in the world to supply this manufacturer with a new line of remanufactured alternators and starters for the United States and Canadian markets. We expanded our operations and built-up our inventory to meet the requirements of this contract and incurred certain transition costs associated with this build-up. As part of the agreement, we also agreed to grant this customer \$6,000,000 of credits that are issued as sales to this customer are made. Of the total credits, \$3,600,000 was issued during fiscal 2006 and \$600,000 was issued in each of the second quarter of fiscal 2007 and 2008. The remaining \$1,200,000 is scheduled to be issued in two annual payments of \$600,000 in each of the second fiscal quarter of fiscal 2009 and 2010. The agreement also contains other typical provisions, such as performance, quality and fulfillment requirements that we must meet, a requirement that we provide marketing support to this customer and a provision (standard in this manufacturer's vendor agreements) granting the customer the right to terminate the agreement at any time for any reason.

In July 2006, we entered into an agreement with a new customer to become its primary supplier of alternators and starters. As part of this agreement, we agreed to acquire a portion of the customer's import alternator and starter Remanufactured Core inventory by issuing approximately \$950,000 of credits over twenty quarters. On May 22, 2007, the agreement was amended to eliminate our obligation to acquire this Remanufactured Core inventory, and the

customer refunded approximately \$142,000 in accounts receivable credits previously issued. Certain promotional allowances were earned by the customer on an accelerated basis during the first year of the agreement.



**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

The longer-term agreements strengthen our customer relationships and business base. However, they also result in a continuing concentration of our revenue sources among a few key customers and require a significant increase in our use of working capital to build inventory and increase production. This increased production caused significant increases in our inventories, accounts payable and employee base, and customer demands that we purchase their Remanufactured Core inventory has been a significant strain on our available capital. In addition, the marketing and other allowances that we have typically granted our customers in connection with these new or expanded relationships adversely impact the near-term revenues and associated cash flows from these arrangements. However, we believe this incremental business will improve our overall liquidity and cash flow from operations over time.

**Capital Expenditures and Commitments**

Our capital expenditures were \$891,000 for the six months ended September 30, 2007. A significant portion of these expenditures relate to our Mexico production facility. The amount and timing of capital expenditures may vary depending on the final build-out schedule for the Mexico production facility as well as the logistics facility. We expect our fiscal 2008 capital expenditure to be in the range of \$3.5 million to \$4.5 million. These capital expenditures will be financed by our working capital.

**Contractual Obligations**

The following summarizes our contractual obligations and other commitments as of September 30, 2007, and the effect such obligations could have on our cash flow in future periods:

| <b>Contractual obligations</b>              | <b>Total</b>        | <b>Less than<br/>1 year</b> | <b>Payments Due by Period</b> |                         |                          |
|---|---------------------|-----------------------------|-------------------------------|-------------------------|--------------------------|
|   |                     |                             | <b>1 to 3<br/>years</b>       | <b>4 to 5<br/>years</b> | <b>After 5<br/>years</b> |
| Line of Credit                              | \$ 3,900,000        | \$ 3,900,000                | \$                            | \$                      | \$                       |
| Capital (Finance) Lease<br>Obligations      | 5,452,000           | 1,976,000                   | 3,223,000                     | 253,000                 |                          |
| Operating Lease Obligations                 | 18,708,000          | 1,653,000*                  | 5,549,000                     | 5,072,000               | 6,434,000                |
| Remanufactured Core Purchase<br>Obligations | 6,157,000           | 1,486,000*                  | 4,588,000                     | 24,000                  | 59,000                   |
| Other Long-Term Obligations                 | 19,559,000          | 5,238,000*                  | 10,166,000                    | 3,105,000               | 1,050,000                |
| <b>Total</b>                                | <b>\$53,776,000</b> | <b>\$ 14,253,000</b>        | <b>\$ 23,526,000</b>          | <b>\$ 8,454,000</b>     | <b>\$ 7,543,000</b>      |

\* Represents six months of obligations in fiscal year 2008.

Capital Lease Obligations represent amounts due under finance leases of various types of machinery and computer equipment that are accounted for as capital leases.

Operating Lease Obligations represent amounts due for rent under our leases for office and warehouse facilities in California, Tennessee, Malaysia, Singapore and Mexico.

Remanufactured Core Purchase Obligations represent our obligations to issue credits to two large and several smaller customers for the acquisition of the customers' core inventory.

Other Long-Term Obligations represent commitments we have with certain customers to provide marketing allowances in consideration for supply agreements to provide products over a defined period.

**Customer Concentration**

We are substantially dependent upon sales to our major customers. During the six months ended September 30, 2007 and 2006, sales to our five largest customers constituted approximately 94% and 96% of our net sales, respectively. Any meaningful reduction in the level of sales to any of our significant customers, deterioration of any customer's financial condition or the loss of a customer could have a materially adverse impact upon us. In addition, the concentration of our sales and the competitive environment in which we operate has increasingly limited our ability to negotiate favorable prices and terms for our products. Because of the very competitive nature of the market for

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

remanufactured starters and alternators and the limited number of customers for these products, our customers have increasingly sought and obtained price concessions, Remanufactured Core purchase commitments, significant marketing allowances and more favorable payment terms. The increased pressure we have experienced from our customers may increasingly and adversely impact our profit margins in the future.

*Offshore Remanufacturing*

The majority of our remanufacturing operations including core receipt, sorting and storage are now conducted at our remanufacturing facilities in Tijuana, Mexico and Malaysia. We also operate a shipping and receiving warehouse and testing facility in Singapore. These foreign operations have quality control standards similar or identical to those currently implemented at our remanufacturing facilities in Torrance, California. Our foreign operations are growing in importance as we take advantage of lower production costs, and we expect to continue to grow the portion of our remanufacturing operations that is conducted outside the United States. In the six months ended September 30, 2007 and 2006, our foreign operations produced approximately 86% and 61%, respectively, of our total production. Finished goods storage and distribution are currently performed at our facility in Torrance. We continue to transition the remaining warehousing and shipping/receiving operations currently conducted in Torrance to our facilities in Mexico. By the end of fiscal 2008, we expect that approximately 95% of our remanufactured units will be produced outside the United States.

*Seasonality of Business*

Extreme weather conditions impact alternator and starter failures, resulting in a modest seasonal impact on our business. Due to their nature and design, as well as the limits of technology, alternators and starters traditionally failed when operating in extreme conditions. During the summer months, when the temperature typically increases over a sustained period of time, alternators were more likely to fail. Similarly, during winter months, starters were more likely to fail. Since alternators and starters are critical for the operation of the vehicle, failed units require immediate replacement. As a result, during the summer months we experienced an increase in alternator sales, and during the winter months we experienced an increase in starter sales. This seasonality impact has been diminished by the improvement in the quality of alternators and starters.

*Off-Balance Sheet Arrangements*

We do not have any off-balance sheet financing arrangements or liabilities. In addition, we do not have any majority-owned subsidiaries or any interests in, or relationships with, any material special-purpose entities that are not included in the consolidated financial statements.

*Litigation*

In December 2003, the SEC and the United States Attorney's Office brought actions against Richard Marks, our former President and Chief Operating Officer. (Mr. Marks is also the son of Mel Marks, our founder, largest shareholder and member of our Board.) Mr. Marks agreed to plead guilty to the criminal charges, and on June 17, 2005 he was sentenced to nine months in prison, nine months of home detention, 18 months of probation and fined \$50,000. In settlement of the SEC's civil fraud action, Mr. Marks paid over \$1.2 million and was permanently barred from serving as an officer or director of a public company.

Based upon the terms of agreements we had previously entered into with Mr. Richard Marks, we paid the costs he incurred in connection with the SEC and United States Attorney's Office investigations. Following the conclusion of these investigations, we sought reimbursement from Mr. Marks of certain of the legal fees and costs we advanced. In June 2006, we entered into a Settlement Agreement and Mutual Release with Mr. Marks. Under this agreement Mr. Marks is obligated to pay us \$682,000 on January 15, 2008 and to pay interest at the prime rate plus one percent on June 15, 2007 and January 15, 2008. Mr. Marks made the June interest payment on June 22, 2007. In June 2006, we recorded a shareholder note receivable for the \$682,000 Mr. Marks owes us. The note is classified in shareholders equity as it is collateralized by our common stock. Mr. Marks has pledged 80,000 shares of our common stock that he owns to secure this obligation. If at any time the market price of the stock pledged by Mr. Marks is less than 125% of Mr. Marks' obligation, he is required to pledge additional stock so as to maintain no less than the 125%

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

coverage level. The settlement with Mr. Marks was unanimously approved by a Special Committee of the Board consisting of Messrs. Borneo, Gay and Siegel.

The United States Attorney's Office has informed us that it does not intend to pursue criminal charges against us arising from the events involved in the SEC complaint.

We are subject to various other lawsuits and claims in the normal course of business. Management does not believe that the outcome of these matters will have a material adverse effect on our financial position or future results of operations.

*Related Party Transactions*

Our related party transactions primarily consist of employment and director agreements and stock option agreements. Our related party transactions have not changed since March 31, 2007.

*Customs Duties*

We received a request for information dated April 16, 2007 from the U.S. Bureau of Customs and Border Protection (CBP) concerning our importation of products remanufactured at our Malaysian facilities. In response to the CBP's request, we began an internal review, with the assistance of customs counsel, of our custom duties procedures. During this review process, we identified a potential exposure related to the omission of certain cost elements in the appraised value of used alternators and starters, which were remanufactured in Malaysia and returned to the United States since June 2002.

We provided a prior disclosure letter dated June 5, 2007 to the customs authorities in order to provide more time to complete our internal review process. This prior disclosure letter also provides us with the opportunity to self report any underpayment of customs duties in prior years which could reduce financial penalties, if any, imposed by the CBP.

We have until December 7, 2007 to respond to the CBP with the final results of our internal review. We have currently determined that it is probable that the CBP will make a claim for additional duties, fees, and interest on the value of remanufactured units shipped back to us during the period from June 5, 2002 to September 30, 2007. As a result, we accrued \$1,450,000 as of September 30, 2007, representing the estimated value of the claim.

The ultimate outcome of the CBP review of the results of our review process is not yet known. While we intend to vigorously defend our amended classification of these imported units, it is possible the CBP may assess a claim other than the amount accrued.

**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES****Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Our primary market risk relates to changes in interest rates and currency exchange rates. Market risk is the potential loss arising from adverse changes in market prices and rates, including interest rates and currency exchange rates. We do not enter into derivatives or other financial instruments for trading or speculative purposes. As our overseas operations expand, our exposure to the risks associated with currency fluctuations will continue to increase.

Our primary interest rate exposure relates to our outstanding line of credit and receivables discount arrangements which have interest costs that vary with interest rate movements. Our \$35,000,000 credit facility bears interest at variable base rates equal to the LIBOR rate or the bank's reference rate, at our option, plus a margin rate dependant upon our most recently reported leverage ratio. This obligation is the only variable rate facility we have outstanding. Based upon the \$3,900,000 that was outstanding under our line of credit as of September 30, 2007, an increase in interest rates of 1% would increase our annual net interest expense by \$39,000. In addition, for each \$100,000,000 of accounts receivable we discount over a period of 180 days, a 1% increase in interest rates would decrease our operating results by \$500,000.

We are exposed to foreign currency exchange risk inherent in our anticipated purchases and assets and liabilities denominated in currencies other than the U.S. dollar. We transact business in three foreign currencies which affect our operations: the Malaysian ringit, the Singapore dollar, and the Mexican peso. Our total foreign assets were \$7,002,000 and \$6,422,000 as of September 30, 2007 and March 31, 2007, respectively. In addition, as of September 30, 2007 and March 31, 2007 we had \$2,398,000 and \$2,573,000, respectively, due from our foreign subsidiaries. While these amounts are eliminated in consolidation, they impact our foreign currency translation gains and losses.

During the six months ended September 30, 2007 and 2006, we have experienced immaterial gains relative to our transactions involving the Malaysian ringit and the Singapore dollar. Based upon our current operations related to these two currencies, a change of 10% in exchange rates would result in an immaterial change in the amount reported in our financial statements.

Our exposure to currency risks has increased since the expansion of our remanufacturing operations in Mexico. Since these operations will be accounted for primarily in pesos, fluctuations in the value of the peso are expected to have a growing level of impact on our reported results. To mitigate the risk of currency fluctuation between the U.S. dollar and the peso, in August 2005 we began to enter into forward foreign exchange contracts to exchange U.S. dollars for pesos. The extent to which we use forward foreign exchange contracts is periodically reviewed in light of our estimate of market conditions and the terms and length of anticipated requirements. The use of derivative financial instruments allows us to reduce our exposure to the risk that the eventual net cash outflow resulting from funding the expenses of the foreign operations will be materially affected by changes in exchange rates. These contracts expire in a year or less. Any changes in fair values of foreign exchange contracts are reflected in current period earnings. During the six months ended September 30, 2007 and 2006, respectively, we recognized a decrease in general and administrative expenses of \$55,000 and an increase in general and administrative expenses of \$115,000, respectively, associated with these forward exchange contracts.

**Item 4. Controls and Procedures****a. Disclosure Controls and Procedures**

Management is responsible for establishing and maintaining an adequate level of internal controls over financial reporting.

In connection with the preparation and filing of our Annual Report on Form 10-K for the year ended March 31, 2007, we completed an evaluation of the effectiveness of our disclosure controls and procedures under the supervision and with the participation of our chief executive officer and chief financial officer. This evaluation was conducted pursuant to rules promulgated under the Securities Exchange Act of 1934, as amended.

In making this assessment, management used the framework set forth in the report *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission, or COSO. The

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

COSO framework summarizes each of the components of a company's internal control system, including (i) the control environment, (ii) risk assessment, (iii) control activities, (iv) information and communication, and (v) monitoring.

Based on the evaluation, management concluded that our disclosure controls and procedures were not effective as of March 31, 2007 due to the material weaknesses noted below in Management's Report on Internal Control over Financial Reporting (ICFR). A material weakness is a deficiency or combination of deficiencies in ICFR such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented or detected on a timely basis by employees in the normal course of their work.

***b. Management's Report on Internal Control Over Financial Reporting***

As described in our Annual Report on Form 10-K for the year ended March 31, 2007 filed with the SEC on June 29, 2007, we determined that entity-level controls related to the control environment and control activities did not operate effectively, resulting in material weaknesses in each of these respective COSO components. The deficiency in each of these individual COSO components represents a separate material weakness. These material weaknesses contributed to an environment where there is a more than a remote likelihood that a material misstatement of the interim and annual financial statements could occur and not be prevented or detected.

Because of the material weaknesses and significant deficiency, management assessed that, as of March 31, 2007, we did not maintain effective internal control over financial reporting based on the COSO criteria.

Despite the remediation of certain deficiencies, noted below, management has concluded that our disclosure controls and procedures were still not effective as of September 30, 2007. Based on this conclusion and as part of the preparation of this report, we have applied compensating procedures and processes as necessary to ensure the reliability of our financial reporting.

***c. Changes in Internal Control Over Financial Reporting***

Management has established a goal to remediate all material weaknesses in internal control over financial reporting by March 31, 2008, although there can be no assurance that this goal will be attained.

Management has reported to the Audit Committee of our Board of Directors the content of the material weaknesses identified in our assessment. Addressing these weaknesses is a priority of management, and we are in the process of remediating the cited material weaknesses and evaluating the operation of existing and new mitigation controls. Key elements of the remediation effort include, but are not limited to, the following initiatives:

The material weakness in the control environment exists due to the understaffing of the finance and accounting department and their lack of sufficient training and experience.

- i) We are actively recruiting suitably qualified financial reporting personnel, and we have already added sufficient staffing for our revenue recording cycle to provide for adequate coverage and proper segregation of duties. In addition, we established an internal audit and Sarbanes-Oxley compliance function reporting directly to the Audit Committee and recruited and hired a qualified director to manage this function.
- ii) We have instituted training sessions for existing financial reporting and accounting personnel. We are conducting internal training sessions and are requiring completion of continuing professional education for all key financial reporting and accounting personnel. Our internal training includes formal and informal training and orientation on internal controls and the Company's accounting policies and information systems. This initiative will require time to hire and train personnel and build institutional knowledge to an acceptable level.

The material weakness attributed to the operating effectiveness of control activities included the lack of consistent completion, review and approval of key balance sheet account analyses and reconciliations. To remediate this failure, we have taken following steps:

- i) Although we have increased the extent and scope of our review with existing staff; a senior general accountant and financial analyst are being actively recruited to ensure thorough and consistent completion, review and approval of account analyses and reconciliations.



**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES**

- ii) We previously cited and have now remediated the lack of journal entry and supporting documentation review by implementing a new review process.
- iii) We previously cited and have now remediated the appropriate review for the completeness and accuracy of information input to and output from financial reporting and accounting systems by implementing a new review process.
- iv) We previously cited and have now remediated our analysis of intercompany activity and the consolidation of subsidiary financial information. We have now implemented an improved review process. We strengthened the oversight of the accounting operations and transactions at our foreign subsidiaries by performing additional review work. Additionally, we are standardizing our information systems currently by extending the use of our domestic information technology operating system to all operating and accounting functions at our Mexico subsidiary and the inventory control functions at our Malaysia and Singapore subsidiaries, which will soon have use of the accounting functions. We also hired additional tax professionals at our foreign locations to assist us in developing additional internal controls over the recording and disclosure of tax-related accounting issues. Management also performs daily reviews of key metrics on our foreign subsidiaries.
- v) We previously cited and have now remediated our accounting treatment in accordance with GAAP that resulted in restatements to our financial statements. Steps taken to correct the previously issued financial statements included a review of authoritative accounting literature and consultation with accounting experts at the SEC and with external accountants. Upon completion of this review, we corrected our treatment related to accounting for core inventory and revenue recognition.

The material weaknesses attributed to the entity level controls included the failures noted below along with subsequent remediation efforts:

- i) There is lack of documentation in the IT strategy. To remediate this failure, our Vice President of IT consults with and reviews IT projects on a regular basis with our Chief Financial Officer; and remediation efforts are in place to develop a more formalized IT strategy policy.
- ii) We previously cited and have now begun remediation of an asset protection program through the addition of our internal audit function that will include enhanced test work to aid in the safeguarding of assets.
- iii) There is a lack of comprehensive accounting policies and procedures. To remediate this failure, while not comprehensive, key accounting policies and procedures are communicated through job descriptions, individual trainings, checklists, white papers on accounting treatments and other supplementary informal documentation. Management does not expect to have a comprehensive accounting manual for all positions completed by March 31, 2008, but believes that the aforementioned compensating controls, while not optimal are sufficient.
- iv) There is a lack of comprehensive human resources policies and procedures. To remediate this failure, management is in process of preparing human resources policies and procedures manual and an updated employee manual that will be distributed prior to March 31, 2008.
- v) The Audit Committee failed to conduct a self assessment of their effectiveness, but plans on conducting this prior to March 31, 2008. The addition of the internal audit director has provided additional support to our Audit Committee which has oversight responsibility for our internal control over financial reporting.

We expect our SOX compliance work will continue to require significant commitment of management's time and the incurrence of significant general and administrative expenses.



Except as disclosed in the preceding paragraphs, there have been no changes in our internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES****PART II OTHER INFORMATION****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

On May 23, 2007, we completed the sale of 3,641,909 shares of our common stock at a price of \$11.00 per share, resulting in aggregate gross proceeds before expenses of \$40,061,000 and net proceeds of approximately \$37,000,000, and five-year warrants to purchase up to 546,283 shares of our common stock at an exercise price of \$15.00 per share. This sale was made through a private placement to accredited investors pursuant to an exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended, and the rules and regulations promulgated thereunder. The warrants are callable by us if, among other things, the volume weighted average trading price of our common stock as quoted by Bloomberg L.P. is greater than \$22.50 for 10 consecutive trading days. As of September 30, 2007, we charged approximately \$3,079,000 of fees and costs related to this private placement to additional paid-in-capital. The fair value of the warrants at the date of grant was estimated to be approximately \$4.44 per warrant using the Black-Scholes pricing model. The following assumptions were used to calculate the fair value of the warrants: dividend yield of 0%; expected volatility of 40.01%; risk-free interest rate of 4.5766%; and an expected life of five years.

The net proceeds have been used to repay the entire outstanding loan balance on our bank credit facility and reduce our accounts payable.

On July 26, 2007, we filed a registration statement under the Securities Act of 1933 to register the shares of common stock sold and the shares to be issued upon the exercise of the warrants. This registration statement was declared effective by the SEC on October 19, 2007. We are obligated to use our commercially reasonable efforts to keep the registration statement continuously effective until the earlier of (i) five years after the registration statement is declared effective by the SEC, (ii) such time as all of the securities covered by the registration statement have been publicly sold by the holders, or (iii) such time as all of the securities covered by the registration statement may be sold pursuant to Rule 144(k) of the Securities Act. If we fail to satisfy this requirement, we are obligated to pay each purchaser of the common stock and warrants sold in the private placement partial liquidated damages equal to 1% of the aggregate amount invested by such purchaser, and an additional 1% for each subsequent month this requirement is not met, until the partial liquidated damages paid equals a maximum of 19% of such aggregate investment amount or approximately \$7,612,000. As required under FSP EITF 00-19-2, we have determined that as of the date of this filing, the payment of such liquidated damages is not probable, as that term is defined in FASB Statement No. 5, Accounting for Contingencies. As a result, we have not recorded a liability for this contingent obligation as of September 30, 2007. Any subsequent accruals of a liability or payments made under this registration rights agreement will be charged to earnings as interest expense in the period they are recognized or paid.

*Limitation on Payment of Dividends* The New Credit Agreement prohibits the declaration or payment of any dividend in respect of stock or the stock of any of our subsidiaries other than dividends payable in the capital stock of the Company.

**Item 6. Exhibits.**

(a) Exhibits:

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**Table of Contents**

**MOTORCAR PARTS OF AMERICA, INC. AND SUBSIDIARIES  
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.

MOTORCAR PARTS OF AMERICA, INC

Dated: November 9, 2007

By: /s/ Mervyn McCulloch  
Mervyn McCulloch  
Chief Financial Officer

45