UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-Q

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

For the quarterly period ended July 2, 2005

OR

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

Commission file number 0-19621

APPLIANCE RECYCLING CENTERS of AMERICA, INC.

Minnesota (State or other jurisdiction of incorporation or organization)	**41-1454591** (I.R.S. Employer Identification No.)

7400 Excelsior Blvd.
Minneapolis, Minnesota 55426-4517
(Address of principal executive offices)

(952) 930-9000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12B-2 of the Exchange Act). Yes☐ No ☒

As of August 12, 2005, the number of shares outstanding of the registrant's no par value Common Stock was 4,311,277 shares.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

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EXHIBITS

Appliance Recycling Centers of America, Inc. and Subsidiaries
CONSOLIDATED BALANCE SHEETS

	July 2, 2005 (Unaudited)	January 1, 2005
ASSETS		
Current Assets		
Cash and cash equivalents	$ 2,676,000	$ 4,362,000
Accounts receivable, net of allowance of $102,000	3,331,000	2,034,000
Inventories, net of reserves of $382,000 and $385,000, respectively	13,390,000	10,154,000
Deferred income taxes	468,000	468,000
Other current assets	678,000	338,000
Total current assets	20,543,000	17,356,000
Property and Equipment, at cost		
Land	2,050,000	2,050,000
Buildings and improvements	4,450,000	4,338,000
Equipment	6,172,000	5,928,000
	12,672,000	12,316,000
Less accumulated depreciation	6,386,000	5,982,000
Net property and equipment	6,286,000	6,334,000
Other Assets	356,000	300,000
Restricted Cash	350,000	350,000
Total assets	$ 27,535,000	$ 24,340,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of credit	$ 7,159,000	$ 5,415,000
Current maturities of long-term obligations	213,000	615,000
Accounts payable	5,276,000	3,889,000
Accrued expenses	3,054,000	2,779,000
Income taxes payable	58,000	58,000
Total current liabilities	15,760,000	12,756,000
Long-Term Obligations, less current maturities	4,987,000	5,053,000
Deferred Income Tax Liabilities	468,000	468,000
Total liabilities	$ 21,215,000	$ 18,277,000
Shareholders' Equity		
Common stock, no par value; authorized 10,000,000 shares; issued and outstanding 4,311,000 and 4,136,000 shares, respectively	14,835,000	14,549,000
Accumulated deficit	(8,515,000)	(8,486,000)
Total shareholders' equity	6,320,000	6,063,000
Total liabilities and shareholders' equity	$ 27,535,000	$ 24,340,000

See Notes to Consolidated Financial Statements.

Appliance Recycling Centers of America, Inc. and Subsidiaries
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended		Six Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Revenues				
Retail	$ 16,285,000	$ 10,589,000	$ 31,196,000	$ 20,323,000
Recycling	2,462,000	2,060,000	4,216,000	3,655,000
Byproduct	395,000	346,000	639,000	614,000
Total revenues	19,142,000	12,995,000	36,051,000	24,592,000
Cost of Revenues	12,988,000	9,160,000	24,794,000	17,620,000
Gross profit	6,154,000	3,835,000	11,257,000	6,972,000
Selling, General and Administrative Expenses	5,534,000	3,755,000	10,872,000	7,430,000
Operating income (loss)	620,000	80,000	385,000	(458,000)
Other Income (Expense)				
Other income (expense)	1,000	(3,000)	(1,000)	(11,000)
Interest expense	(217,000)	(185,000)	(413,000)	(371,000)
Income (loss) before provision for (benefit of) income taxes	404,000	(108,000)	(29,000)	(840,000)

Provision for (Benefit of) Income Taxes	—	(66,000)	—	(66,000)
Net income (loss)	$ 404,000	$ (42,000)	$ (29,000)	$ (774,000)
Basic income (loss) per common share	$ 0.09	$ (0.02)	$ (0.01)	$ (0.32)
Diluted income (loss) per common share	$ 0.09	$ (0.02)	$ (0.01)	$ (0.32)
Weighted Average Number of Common Shares Outstanding:				
Basic	4,266,000	2,506,000	4,205,000	2,421,000
Diluted	4,341,000	2,506,000	4,205,000	2,421,000

See Notes to Consolidated Financial Statements.

Appliance Recycling Centers of America, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended	
	July 2, 2005	**July 3, 2004**
Cash Flows from Operating Activities		
Net loss	$ (29,000)	$ (774,000)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	404,000	317,000
Changes in current assets and liabilities:		
Accounts receivables	(1,297,000)	(316,000)
Inventories	(3,236,000)	952,000
Other current assets	(340,000)	1,016,000
Other assets	(56,000)	—
Accounts payable	1,387,000	(65,000)
Accrued expenses	275,000	(75,000)
Income taxes payable	—	(2,000)
Net cash provided by (used in) operating activities	(2,892,000)	1,053,000
Cash Flows from Investing Activities		
Purchase of property and equipment	(337,000)	(175,000)
Cash Flows from Financing Activities		
Net borrowings (payments) under line of credit	1,744,000	(86,000)
Stock placement costs	(76,000)	—
Proceeds from issuance of common stock	—	34,000
Proceeds from stock option exercises	362,000	—
Payments on long-term obligations	(487,000)	(136,000)
Net cash provided by (used in) financing activities	1,543,000	(188,000)
Increase (decrease) in cash and cash equivalents	(1,686,000)	690,000
Cash and Cash Equivalents		
Beginning	4,362,000	1,196,000
Ending	$ 2,676,000	$ 1,886,000
Supplemental Disclosures of Cash Flow Information		
Cash payments (receipts) for:		
Interest	$ 413,000	$ 371,000
Income taxes	3,000	(972,000)
Equipment acquired under capital lease	19,000	—

See Notes to Consolidated Financial Statements.

Appliance Recycling Centers of America, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Financial Statements

In our opinion, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal, recurring accruals) necessary to present fairly our financial position, including our subsidiaries, as of July 2, 2005 and the results of operations and cash flows for the three-month and six-month periods ended July 2, 2005 and July 3, 2004. The three and six months presented are 13 and 26 week periods, respectively. The results of operations for any interim period are not necessarily indicative of the results for the year. These interim consolidated financial statements should be read in conjunction with our annual consolidated financial statements and related notes in our Annual Report on Form 10-K for the year ended January 1, 2005. Therefore, certain information and footnote disclosures included in the annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted.

2. Accrued Expenses

Accrued expenses were as follows:

	July 2, 2005	**January 1, 2005**
Compensation and Benefits	$ 1,341,000	$ 1,083,000
	29,000	35,000
Warranty Expense		

Accrued Recycling Incentive Checks	909,000	909,000
Other	775,000	752,000
	$ 3,054,000	$ 2,779,000

3. Earnings (Loss) Per Share

Basic per-share amounts are computed, generally, by dividing net income or loss by the weighted-average number of common shares outstanding. Diluted per-share amounts assume the conversion, exercise, or issuance of all potential common stock instruments unless their effect is antidilutive, thereby reducing the loss or increasing the income per common share.

In arriving at diluted weighted-average shares and per-share amounts for the three months ended July 2, 2005, the potential dilutive common shares for options and warrants with exercise prices below the average market price for the quarter were calculated using the treasury stock method.

Since we incurred losses for the six months ended July 2, 2005 and the three and six months ended July 3, 2004, the inclusion of potential option and warrant common shares in the calculation of diluted loss per common share would have been antidilutive. Therefore, basic and diluted weighted-average shares and per-share amounts are the same for these periods.

4. Critical Accounting Policies

Our significant accounting policies and estimates are summarized in the footnotes to our annual consolidated financial statements. Some of the most critical policies and estimates are also discussed below:

Revenue recognition: We recognize revenue from appliance sales in the period the consumer purchases and pays for the appliances. We recognize revenue from appliance recycling when we collect and process a unit. We recognize byproduct revenue upon shipment.

We defer revenue under certain appliance extended warranty arrangements we service, and we recognize the revenue over the related terms of the warranty contracts. On extended warranty arrangements we sell but others service for a fixed portion of the warranty sales price, we recognize revenue for the net amount retained at the time of sale of the extended warranty to the consumer.

We include shipping and handling charges to customers in revenues. Shipping and handling costs that we incur are included in cost of revenues.

Product warranty: We provide a warranty for the replacement or repair of certain defective units. Our standard warranty policy requires us to repair or replace certain defective units at no cost to our customers. We estimate the costs that may be incurred under our warranty and record a liability reserve in the amount of such costs at the time we recognize product revenue. Factors that affect our warranty liability reserve for covered units include the number of units sold, historical and anticipated rates of warranty claims on these units, and the cost of such claims. We periodically assess the adequacy of our recorded warranty liability reserve and adjust the amounts as necessary.

Changes in our warranty liability reserve are as follows:

	Three Months Ended		Six Months Ended	
(Unaudited)	**July 2, 2005**	**July 3, 2004**	**July 2, 2005**	**July 3, 2004**
Balance, beginning	$ 22,000	$ 29,000	$ 35,000	$ 54,000
Standard accrual based on units sold	24,000	30,000	29,000	36,000
Actual costs incurred	(1,000)	(15,000)	(2,000)	(27,000)
Periodic accrual adjustments	(16,000)	(9,000)	(33,000)	(28,000)
Balance, ending	$ 29,000	$ 35,000	$ 29,000	$ 35,000

Trade receivables: We carry trade receivables at original invoice amount less an estimate made for doubtful receivables based on a review of all outstanding amounts on a monthly basis. Management determines the allowance for doubtful accounts by regularly evaluating individual customer receivables and considering a customer's financial condition, credit history, and current economic conditions. We write off trade receivables when we deem

them uncollectible. We record recoveries of trade receivables previously written off when we receive them. We consider a trade receivable to be past due if any portion of the receivable balance is outstanding for more than 90 days. We do not charge interest on past due receivable balances. Our management considers the reserve for doubtful accounts of $102,000 to be adequate to cover any exposure to loss in our July 2, 2005 accounts receivable.

Restricted cash: In connection with our consumer credit card processing arrangements, we are required to maintain a cash balance that is restricted. At July 2, 2005, we were required to maintain a balance of $350,000, which is reflected in the consolidated balance sheets as long-term restricted cash.

Inventories: Inventories, consisting principally of appliances, are stated at the lower of cost, first-in, first-out (FIFO), or market. We provide estimated reserves for the realizability of our appliance inventories, including adjustments to market, based on various factors including the age of such inventory and our management's assessment of the need for such allowances. We look at historical inventory agings and margin analysis in determining our reserve estimate. We believe the reserve of $382,000 as of July 2, 2005 is adequate.

Property and equipment: We compute depreciation using straight-line and accelerated methods over the following estimated useful lives:

	Years
Buildings and improvements	18 - 30
Equipment	3 - 8

We amortize leasehold improvements on a straight-line basis over the shorter of their estimated useful lives or the underlying lease term.

We did not identify any items that were impaired as of July 2, 2005.

Income taxes: Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards, and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. Realization of deferred tax assets is dependent upon sufficient future taxable income during the periods when deductible temporary differences and carryforwards are expected to be available to reduce taxable income. At July 2, 2005 a valuation allowance has been recorded against deferred tax assets principally relating to net operating loss and tax credit carryforwards whose use is limited under Section 382 of the Internal Revenue Code.

We did not record a tax benefit for the first quarter of 2005 due to the uncertainty of being able to use the benefit in the future. Therefore, we did not record a tax provision for the

second quarter of 2005 since we did not record a benefit for the first quarter of 2005 and we have a year-to-date loss as of the end of the second quarter. At the end of the third quarter of 2005, this will be reviewed to determine the amount, if any, that should be recorded for a tax provision or benefit.

Stock-based compensation: We regularly grant options to our employees under various plans. As permitted under accounting principles generally accepted in the United States of America, these grants are accounted for following APB Opinion No. 25 and related interpretations. Accordingly, compensation cost would be recognized for those grants where the exercise price is less than the fair market value of the stock on the date of grant. We recorded no compensation expense for employee grants during the three and six months ended July 2, 2005 and July 3, 2004.

In December 2002, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure." SFAS No. 148 is an amendment to SFAS No. 123 providing alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation and also provides required additional disclosures about the method of accounting for stock-based employee compensation. We adopted the annual disclosure provision of SFAS No. 148 during the year ended December 31, 2003. We chose to not adopt the voluntary change to the fair value based method of accounting for stock-based employee compensation, pursuant to SFAS No. 148.

Had compensation cost for all of the employee stock-based compensation grants and warrants issued been determined based on the fair values at the grant date consistent with the provisions of Statement No. 123 and 148, our net income (loss) and net income (loss) per basic and diluted common share would have been as indicated below.

	Three Months Ended		Six Months Ended	
(Unaudited)	**July 2, 2005**	**July 3, 2004**	**July 2, 2005**	**July 3, 2004**
Net income (loss):				
As reported	$ 404,000	$ (42,000)	$ (29,000)	$ (774,000)
Deduct pro forma stock-based compensation	(24,000)	(17,000)	(24,000)	(23,000)
Pro forma	$ 380,000	$ (59,000)	$ (53,000)	$ (797,000)
Basic income (loss) per share:				
As reported	$ 0.09	$ (0.02)	$ (0.01)	$ (0.32)
Pro forma	$ 0.09	$ (0.02)	$ (0.01)	$ (0.33)
Diluted income (loss) per share:				
As reported	$ 0.09	$ (0.02)	$ (0.01)	$ (0.32)
Pro forma	$ 0.09	$ (0.02)	$ (0.01)	$ (0.33)

The above pro forma effects on net income (loss) and net income (loss) per basic and diluted common share are not likely to be representative of the effects on reported net income (loss) or net income (loss) per common share for future years because options vest over several years and additional awards generally are made each year.

In December 2004, FASB published FASB Statement No. 123 (revised 2004), *Share-Based Payment* ("FAS 123(R)" or the "Statement"). FAS 123(R) requires that the compensation cost relating to share-based payment transactions, including grants of employee stock options, be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. FAS 123(R) covers a wide range of share-based compensation arrangements, including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. FAS 123(R) is a replacement of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related interpretive guidance. The effect of the Statement will be to require entities to measure the cost of employee services received in exchange for stock options based on the grant-date fair value of the award, and to recognize the cost over the period the employee is required to provide services for the award. FAS 123(R) permits entities to use any option-pricing model that meets the fair value objective in the Statement.

We will be required to apply FAS 123(R) as of the beginning of our first fiscal year that begins after June 15, 2005, which will be the fiscal year beginning January 1, 2006. FAS 123(R) allows two methods for determining the effects of the transition: the modified prospective transition method and the modified retrospective method of transition. Under the modified prospective transition method, an entity would use the fair value based accounting method for all employee awards granted, modified or settled after the effective date. As of the effective date, compensation cost related to the nonvested portion of awards outstanding as of that date would be based on the grant-date fair value of those awards as calculated under the original provisions of Statement No. 123; that is, an entity would not remeasure the grant-date fair value estimate of the unvested portion of awards granted prior to the effective date of FAS 123(R). Under the modified retrospective method of transition, an entity would revise its previously issued financial statements to recognize employee compensation cost for prior periods presented in accordance with the original provisions of Statement No. 123.

We have not yet completed our study of the transition methods or made any decisions about how we will adopt FAS 123(R). However, the pro forma net income effect of using the fair value method for the three and six months ended July 2, 2005 and July 3, 2004 is presented in the table above. The pro forma compensation costs presented in the table above and in our prior filings have been calculated using a Black-Scholes option pricing model and may not be indicative of amounts that should be expected in future years. We have not made any decisions about which option-pricing model is most appropriate for us for future awards.

5. Line of Credit

At July 2, 2005, we had an $8.0 million line of credit with a lender. The interest rate on the line as of July 2, 2005 was prime plus 2.95 percentage points (9.2%). The amount of borrowings available under the line of credit is based on a formula using receivables and inventories. The line of credit has a stated maturity date of December 31, 2007, if not renewed, and provides that the lender may demand payment in full of the entire outstanding balance of the loan at any time. The line of credit is secured by substantially all our assets and requires minimum monthly interest payments of $37,500, regardless of the outstanding principal balance. The lender is also secured by an inventory repurchase agreement with

Whirlpool Corporation for purchases from Whirlpool only. The line requires that we meet certain financial covenants, provides payment penalties for noncompliance and prepayment, limits the amount of other debt we can incur, limits the amount of spending on fixed assets, and limits payments of dividends. As of July 2, 2005, we were in compliance with all covenants. At July 2, 2005, we had unused borrowing capacity of $337,000.

6. Long-Term Obligations

Long-term obligations consisted of the following:

		July 2, 2005 (Unaudited)		January 1, 2005
6.85% mortgage, due in monthly installments of $15,326, including interest, due January 2013, secured by land and building	$	1,877,000	$	1,904,000
Adjustable rate mortgage based on the 30-day LIBOR rate (1.84% as of July 2, 2005) plus 2.70%, adjusted yearly, monthly payments include interest and principal, and are based on a 20-year amortization, due October 2012, secured by land and building		3,159,000		3,216,000
13.00% note payable, paid in full		—		50,000
Other		164,000		498,000
		5,200,000		5,668,000
Less current maturities		213,000		615,000
	$	4,987,000	$	5,053,000

The future annual maturities of long-term obligations are as follows:

Fiscal year		
Remaining 2005	$	128,000
2006		248,000
2007		249,000
2008		187,000
2009		241,000
2010 and thereafter		4,147,000
	$	5,200,000

PART I: ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis provides information that we believe is relevant to an assessment and understanding of our operations and financial condition. This discussion should be read with the consolidated financial statements appearing in Item 1.

OVERVIEW

We generate revenues from three sources: retail, recycling and byproduct. Retail revenues are sales of appliances, warranty and service revenue, and delivery fees. Recycling revenues are fees charged for the disposal of appliances. Byproduct revenues are sales of scrap metal and reclaimed chlorofluorocarbons (CFCs) generated from processed appliances. We are managed as a unit and do not measure profit or loss separately for our three primary revenue sources. Therefore, we believe that we have one operating segment.

RESULTS OF OPERATIONS

Total revenues for the three and six months ended July 2, 2005 were $19,142,000 and $36,051,000, respectively, compared to $12,995,000 and $24,592,000 for the same periods in the prior year, increases of 47% for each period.

Retail revenues accounted for approximately 85% of revenues in the second quarter of 2005. Retail revenues for the three and six months ended July 2, 2005 were $16,285,000 and $31,196,000 compared to $10,589,000 and $20,323,000 for the same periods in 2004, increases of 54% for each period. Same-store retail sales increased 16% (a sales comparison of nine stores that were open the entire second quarters of both 2005 and 2004). The increase in retail revenues was due primarily to:

1. Operating three additional stores during the first and second quarters of 2005 compared to the first and second quarters of 2004, which resulted in an increase of retail revenues of approximately $3,600,000 for the second quarter and $6,900,000 for the first six months of 2005.
2. An increase in same-store sales of 16% or $1,657,000 for the second quarter of 2005 and 17% or $3,364,000 for the six months ended July 2, 2005.

Our retail outlets carry a wide range of new in-the-box and special-buy appliances, which include manufacturer closeouts, factory overruns, floor samples, returned or exchanged items, open carton items, and scratch and dent appliances. All of these appliances are new, not used. Some are in the carton while others are out of the carton.

We continue to purchase both new in-the-box and special-buy appliances from Whirlpool Corporation (Whirlpool), Maytag Corporation (Maytag), GE Corporation (GE) and Frigidaire. We have no minimum purchase requirements with any of these manufacturers. We believe purchases from these four manufacturers will provide an adequate supply of high-quality appliances for our retail outlets; however, there is a risk that one or more of these sources could be curtailed or lost.

Currently, we operate twelve retail stores. In April 2005, we announced that we will be opening a second retail store in the San Antonio, Texas market in September 2005.

Recycling revenues for the three and six months ended July 2, 2005 increased to $2,462,000 and $4,216,000 from $2,060,000 and $3,655,000 for the same periods in 2004, an increase of 20% and 15%, respectively. The increase in recycling revenues is primarily due to the recycling contract in Connecticut that did not begin until the end of the second quarter of 2004 and the recycling contracts for Austin Energy and Wisconsin Public Power that were not operating in 2004. During the first and second quarters of 2005, we managed appliance recycling operations under five contracts with electric utility companies. We provided services in the territories of:

1. Southern California Edison Company (Edison), for their 2004-2005 program.
2. San Diego Gas & Electric Company (SDG&E) for their 2005 program.
3. The United Illuminating Company (UI) and The Connecticut Light & Power Company (CL&P), for a joint program for 2005.
4. Austin Energy in Austin, Texas, for their 2005 program.
5. Wisconsin Public Power, Inc., for their 2005 program.

Currently, each utility is responsible for advertising in its service territory.

Byproduct revenues for the three and six months ended July 2, 2005 increased to $395,000 and $639,000 from $346,000 and $614,000 for the same periods of 2004. The increase was due primarily to an increase in volume of CFC and scrap metal offset by a decrease in price of CFC and scrap metal from recycling operations.

Gross profit as a percentage of total revenues for the three and six months ended July 2, 2005 increased to 32% and 31%, respectively, from 30% and 28% for the same periods in 2004. The increase was primarily due to an increase in total revenues of 47% and a decrease in cost of revenues as a percentage of total revenues of 3 percentage points primarily related to cost of freight, receiving and distribution, and delivery and service of the inventory after it is sold to the consumer. Gross profit as a percentage of total revenues for future periods can be affected favorably or unfavorably by numerous factors, including:

1. The mix of retail products we sell.
2. The prices at which we purchase product from the four manufacturers.
3. The volume of appliances we receive through our recycling contracts.
4. The price and volume of byproduct revenues.

We expect gross profit percentages to remain about the same for future periods.

Selling, general and administrative expenses for the three and six months ended July 2, 2005 increased by $1,779,000 or 47% and $3,442,000 or 46%, respectively, from the same periods in 2004. As a percentage of total revenues, selling, general and administrative expenses remained at 29% for the second quarter of 2005 compared to the second quarter of 2004 and 30% for the first six months of both 2005 and 2004. Selling expenses for the three and six months ended July 2, 2005 increased by $1,087,000 or 41% and $2,255,000 or

45%, respectively, from the same periods in 2004. The increase in selling expenses was due primarily to:

1. The expense of operating three additional stores during the first six months of 2005 compared to the first six months of 2004 of approximately $1,000,000 for the second quarter of 2005 and approximately $2,000,000 for the first six months of 2005.
2. An increase in advertising expense of approximately $160,000 for the second quarter and $380,000 for the first six months of 2005, which includes two new retail markets compared to the same period in the previous year.

General and administrative expenses for the three and six months ended July 2, 2005 increased by $692,000 or 61% and $1,187,000 or 49%, respectively, from the same periods in 2004. The increase in general and administrative expense was due primarily to additional personnel costs associated with operating additional retail stores and recycling contracts and legal costs associated with the legal proceedings discussed in Part II, Item 1, Legal Proceedings.

Interest expense increased to $217,000 for the three months and $413,000 for the six months ended July 2, 2005 compared to $185,000 and $371,000 for the same periods in 2004. The increase was due primarily to an increase in the minimum interest rate of the line of credit at renewal and an increase in the outstanding amount on the line of credit.

We had net operating loss carryovers and credit carryforwards of approximately $8.6 million at July 2, 2005, which may be available to reduce taxable income and therefore income taxes payable in future years. However, future utilization of these loss and credit carryforwards is subject to certain significant limitations under provisions of the Internal Revenue Code, including limitations subject to Section 382, which relate to a 50 percent change in control over a three-year period and are further dependent upon our maintaining profitable operations. The issuance of Common Stock during 1999 resulted in an “ownership change” under Section 382. Accordingly, our ability to use net operating loss carryforwards generated prior to February 1999 is limited to approximately $56,000 per year, or less than $1 million through 2018.

At July 2, 2005, we had recorded cumulative valuation allowances of approximately $4,445,000 against our net deferred tax assets due to the uncertainty of their realization. The realization of deferred tax assets is dependent upon sufficient future taxable income during the periods when deductible temporary differences and carryforwards are expected to become available to reduce taxable income.

We did not record a tax benefit for the first quarter of 2005 due to the uncertainty of being able to use the benefit in the future. Therefore, we did not record a tax provision for the second quarter of 2005 since we did not record a benefit for the first quarter of 2005 and we have a year-to-date loss as of the end of the second quarter. At the end of the third quarter of 2005, this will be reviewed to determine the amount, if any, that should be recorded for a tax provision or benefit.

We recorded net income of $404,000 or $0.09 per basic and diluted share for the second quarter ended July 2, 2005 compared to a net loss of $42,000 or $0.02 per basic and diluted

share for the same period of 2004. We recorded a net loss of $29,000 or $0.01 per basic and diluted share for the six months ended July 2, 2005 compared to a net loss of $774,000 or $0.32 per basic and diluted share for the same period in 2004. The increase in net income was due to an increase in revenues combined with an increase in the gross profit percentage and selling, general and administrative expenses as a percentage of total revenues remaining the same as prior year periods for the three and six months ended July 2, 2005 compared to the same periods in 2004.

LIQUIDITY AND CAPITAL RESOURCES

At July 2, 2005, we had working capital of $4,783,000 compared to $4,600,000 at January 1, 2005. Cash and cash equivalents decreased to $2,676,000 at July 2, 2005 from $4,362,000 at January 1, 2005. Net cash used in operating activities was $2,892,000 for the six months ended July 2, 2005 compared to net cash provided by operating activities of $1,053,000 in the same period of 2004. The cash used in operating activities was primarily due to an increase in inventory, accounts receivable and accounts payable offset slightly by a decrease in the net loss.

Our capital expenditures for the six months ended July 2, 2005 and July 3, 2004 were approximately $337,000 and $175,000, respectively. The 2005 capital expenditures were primarily related to continued software development and building improvements primarily related to the opening of a recycling center in Austin, Texas. Also, we estimate that there will be approximately $80,000 of capital expenditures related to the opening of the second retail store in the San Antonio, Texas market during the third quarter of 2005. The 2004 capital expenditures were primarily related to continued software development of our enterprise-wide software and leasehold improvements related to the opening of the Atlanta, Georgia, retail store.

Net cash provided by financing activities was $1,543,000 for the six months ended July 2, 2005 compared to net cash used in financing activities of $188,000 in the same period in 2004. The cash provided by financing was primarily due to borrowing under the line of credit offset by payments on long-term obligations during the six months ended July 2, 2005.

As of July 2, 2005, we had an $8.0 million line of credit with a lender. The interest rate on the line as of July 2, 2005 was prime plus 2.95 percentage points (9.20%). The amount of borrowings available under the line of credit is based on a formula using receivables and inventories. The line of credit has a stated maturity date of December 31, 2007, if not renewed, and provides that the lender may demand payment in full of the entire outstanding balance of the loan at any time. The line of credit is secured by substantially all our assets and requires minimum monthly interest payments of $37,500, regardless of the outstanding principal balance. The lender is also secured by an inventory repurchase agreement with Whirlpool Corporation for purchases from Whirlpool only. The line requires that we meet certain financial covenants, provides payment penalties for noncompliance and prepayment, limits the amount of other debt we can incur, limits the amount of spending on fixed assets, and limits payments of dividends. As of July 2, 2005, we were in compliance with all covenants. At July 2, 2005, we had unused borrowing capacity of $337,000. Currently, we do not have an over-advance agreement for the line of credit. We are currently working

with our lender to increase our availability under this line of credit. However, there is no assurance that our current lender will be able to increase the limit on the line of credit or that additional sources of borrowings will be available.

A summary of our contractual cash obligations at July 2, 2005 is as follows:

	Cash Payments Due by Period						
Contractual Cash Obligations	**Total**	**Remainder of 2005**	**2006**	**2007**	**2008**	**2009**	**2010 and Thereafter**
Long-term debt, including interest	$7,976,000	$278,000	$519,000	$507,000	$449,000	$448,000	$5,775,000
Operating leases	$12,417,000	$1,358,000	$2,323,000	$1,957,000	$1,660,000	$1,069,000	$4,050,000
Total contractual cash obligations	$20,393,000	$1,636,000	$2,842,000	$2,464,000	$2,109,000	$1,517,000	$9,825,000

We also have a commercial commitment as described below:

Other Commercial Commitment	**Total Amount Committed**	**Outstanding at 07/02/05**	**Date of Expiration**
Line of credit	$ 8,000,000	$ 7,159,000	December 31, 2007

We believe, based on the anticipated revenues from our recycling contracts, the anticipated sales per retail store and our anticipated gross profit, that our cash balance, anticipated funds generated from operations and our line of credit will be sufficient to finance our operations and capital expenditures for at least the next twelve months. Our total capital requirements for 2005 will depend upon, among other things as discussed below, the number and size of retail stores operating during the fiscal year and the recycling volumes generated from the recycling contracts in 2005. Currently, we have twelve retail stores and five recycling centers in operation. If revenues are lower than anticipated or expenses are higher than anticipated, we may require additional capital to finance operations. Sources of additional financing, if needed in the future, may include further debt financing or the sale of equity (common or preferred stock) or other securities. There can be no assurance that such additional sources of financing will be available or available on terms satisfactory to us or permitted by our current lender.

FORWARD-LOOKING STATEMENTS

Statements contained in this quarterly report regarding our future operations, performance and results, and anticipated liquidity discussed herein are forward-looking and therefore are subject to certain risks and uncertainties, including, but not limited to, those discussed herein. Any forward-looking information regarding our operations will be affected primarily by our continued ability to purchase product from Whirlpool, Maytag, GE and

Frigidaire at acceptable prices and the ability and timing of the utility companies to deliver units under recycling contracts with us. In addition, any forward-looking information will also be affected by the ability of individual retail stores to meet planned revenue levels, the rate of sustainable growth in the number of retail stores, the speed at which individual retail stores reach profitability, costs and expenses being realized at higher than expected levels, our ability to secure an adequate supply of special-buy appliances for resale and the continued availability of our current line of credit.

PART I: ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

MARKET RISK AND IMPACT OF INFLATION

We do not believe there is any significant risk related to interest rate fluctuations on the long-term fixed rate debt. However, there are interest rate risks on the line of credit, since our interest rate floats with prime, and on approximately $3,100,000 in long-term debt entered into in September 2002, since our interest rate is based on the 30-day LIBOR rate. Based on average floating rate borrowings of approximately $10,318,000, a one-percent change in the applicable rate would have caused our interest expense to change by approximately $51,000 for a six month period. Also, we believe that inflation has not had a material impact on the results of operations for the three and six months ended July 2, 2005. However, there can be no assurance that future inflation will not have an adverse impact on our operating results and financial conditions.

PART I: ITEM 4 CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports we file with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Commission and that such information is accumulated and communicated to our management, including our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), as appropriate, to allow timely decisions regarding required disclosures.

Our management, under the supervision and with the participation of our CEO and CFO, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this quarterly report. Based on that evaluation, our CEO and CFO have concluded that these controls and procedures were effective.

We also maintain a system of internal accounting controls designed to provide reasonable assurance that our books and records accurately reflect our transactions and that our policies and procedures are followed. There have been no changes in our internal control over financial reporting during the six months ended July 2, 2005, or thereafter, except as described below, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

During the first quarter ended April 2, 2005, we enhanced and formalized our period-end closing process to ensure that all significant elements of our financial statements are adequately reviewed. We have continued this process during the second quarter of 2005.

Any control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. The design of a control system inherently has limitations, and the benefits of controls must be weighed against their costs. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. Therefore, no evaluation of a cost-effective system of controls can provide absolute assurance that all control issues and instances of fraud, if any, will be detected.

PART II. OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

In December 2004, we filed suit in the U.S. District Court for the Central District of California alleging that JACO Environmental, Inc. (JACO) and a former consultant of ours fraudulently obtained a patent (U.S. Patent No.6,732,416) in May 2004. The patent covers appliance recycling methods and systems we originally developed beginning in 1987 and have used in serving more than forty electric utility appliance recycling programs since that time. We are seeking a judgment that the JACO patent is invalid and unenforceable, since it is almost entirely based on methods and processes we developed and have used. We are also asking the court for unspecified damages related to charges that JACO, in using a fraudulently based patent, has engaged in unfair competition under federal statutes and false and misleading advertising under California statutes. The suit is currently scheduled with a trial date during the fourth quarter of 2006. We expect recycling operations to continue without interruption during the period of litigation, but if the court were to issue rulings in favor of the defendants, this could change. Moreover, failure to win this lawsuit could have a long-term material adverse effect on our recycling operations. In addition, we may incur substantial costs in pursuing this litigation, which could have an adverse effect on our results of operations.

ITEM 2 - UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS - None

ITEM 3 - DEFAULTS UPON SENIOR SECURITIES - None

ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On May 5, 2005, we held our Annual Meeting of Shareholders to obtain the approval of shareholders of record as of March 18, 2005 in connection with the matter listed below. Proxies were mailed to the holders of 4,161,277 shares.

Following is a brief description of the matter voted on at the meeting and the number of votes cast for or withheld:

	Vote	
Matter	**For**	**Withhold Authority**
Election of Directors:		
Edward R. Cameron	3,280,657	29,422
Duane S. Carlson	3,202,883	107,196
Harry W. Spell	3,202,883	107,196

ITEM 5 - OTHER INFORMATION - None

ITEM 6 - EXHIBITS

Exhibit 31.1 – Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 31.2 – Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 32 – Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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.

Appliance Recycling Centers of America, Inc.
Registrant

Date: August 12, 2005

/s/Edward R. Cameron
Edward R. Cameron
President

Date: August 12, 2005

/s/Linda A. Koenig
Linda A. Koenig
Chief Financial Officer

FORM 10-Q CEO CERTIFICATION

CERTIFICATIONS:

I, Edward R. Cameron, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Appliance Recycling Centers of America, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements are made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the consolidated financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:

   (a) designed such disclosure controls and procedures or caused such disclosure controls and procedures to be designed under our supervision to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

   (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual repot) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting that are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 12, 2005

By: /s/ Edward R. Cameron
Edward R. Cameron, President

Exhibit 31.2

FORM 10-Q CFO CERTIFICATION

CERTIFICATIONS:

I, Linda A. Koenig, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Appliance Recycling Centers of America, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements are made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the consolidated financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:

   (a) designed such disclosure controls and procedures or caused such disclosure controls and procedures to be designed under our supervision to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by this report based on such evaluation; and

   (c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual repot) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   (a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting that are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date:	August 12, 2005	By:	/s/ Linda A. Koenig
			Linda A. Koenig, Chief Financial Officer

Exhibit 32

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to 18 U.S.C. §1350 (as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002), the undersigned Chief Executive Officer and Chief Financial Officer of Appliance Recycling Centers of America, Inc. (the "Company"), hereby certify that the Quarterly Report on Form 10-Q of the Company for the quarterly period ended July 2, 2005 (the "Report") fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Very truly yours,

Edward R. Cameron

/s/Edward R. Cameron
President

Linda A. Koenig

/s/Linda A.Koenig
Chief Financial Officer

Date August 12, 2005

* A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.