SPECTRUM LABORATORIES INC /CA
Form 10QSB
January 31, 2005

SECURITES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-QSB

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 25, 2004

OR

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

COMMISSION FILE NUMBER 0-9478

SPECTRUM LABORATORIES, INC.
(Exact name of small business registrant as specified in its charter)

DELAWARE	95-4718363
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

18617 BROADWICK STREET, RANCHO DOMINGUEZ, CALIFORNIA 90220
(Address of principal executive offices) (zip code)

Registrant's telephone number, including area code: (310) 885-4600

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

Number of shares of Common Stock outstanding as of October 29, 2004: 5,312,468

TRANSITIONAL SMALL BUSINESS DISCLOSURE FORMAT

YES [ ] NO [X]

Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

SPECTRUM LABORATORIES, INC.
Consolidated Balance Sheet
AS OF SEPTEMBER 25, 2004
(DOLLARS IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	$ 3,586
Accounts receivable	2,140
Inventories	2,877
Prepaid expenses	208
Deferred taxes	579
Total current assets	9,390
INVESTMENT IN MARKETABLE SECURITIES	1,723
EQUIPMENT AND LEASEHOLD IMPROVEMENTS	2,439
GOODWILL	1,122
DEFERRED TAXES	801
PATENTS, subject to amortization, net of accumulated amortization of $227	523
OTHER ASSETS	33
Total assets	$16,031

LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Current maturities of long-term debt	$ 960
Accounts payable	496
Accrued expenses and other current liabilities	713
Total current liabilities	2,169
LONG-TERM DEBT, net of current maturities	1,065
MINORITY INTEREST	1,755
STOCKHOLDERS' EQUITY:	
Common stock, $.01 par value, 25,000,000 shares authorized; 5,312,468 shares issued and outstanding	53
Preferred stock, par value $.01; 10,000,000 shares authorized; none issued and outstanding	--
Additional paid-in capital	8,630
Accumulated other comprehensive income	1,034
Retained earnings	1,325
Total stockholders' equity	11,042
Total liabilities and stockholders' equity	$16,031

See Notes to Consolidated Financial Statements.

3

SPECTRUM LABORATORIES, INC.
CONSOLIDATED STATEMENTS OF INCOME
(IN THOUSANDS, EXCEPT FOR PER SHARE AMOUNTS)
(UNAUDITED)

	Three Months Ended		Nine Mon
	September 25, 2004	September 27, 2003	September 25, 2004
NET SALES	$ 3,564	$ 2,653	$10,166
COSTS AND EXPENSES			
Cost of sales	2,016	1,697	5,732
Selling, general and administrative	1,005	1,096	2,904
Research and development	221	215	615
Warrant related	130	--	130
Other expense, primarily interest	19	22	62
Total costs and expenses	3,391	3,030	9,443

Income (loss) before provision of income taxes	173	(377)	723
Provision (benefit) for income taxes	63	(108)	228
Net income (loss)	$ 110	$ (269)	$ 495
Earnings (loss) per share:			
Basic	$ 0.02	($ 0.05)	$ 0.09
Diluted	$ 0.02	($ 0.05)	$ 0.09
Weighted average shares outstanding:			
Basic	5,312	5,312	5,312
Diluted	5,590	5,312	5,575

See Notes to Consolidated Financial Statements.

SPECTRUM LABORATORIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
NINE MONTHS ENDED SEPTEMBER 25, 2004 AND SEPTEMBER 27, 2003
(IN THOUSANDS)
(UNAUDITED)

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 495	$ 15
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	616	56
Noncash compensation and warrant related expense	139	
Change in working capital components:		
(Increase) Decrease in accounts receivable	(477)	18
(Increase) in inventories	(215)	(57
Decrease (Increase) in prepaid expenses & deferred financing	10	(4
(Decrease) Increase in accounts payable	(126)	30
Increase (Decrease) in accrued expenses	299	(8
NET CASH PROVIDED BY OPERATING ACTIVITIES	741	50
CASH FLOWS (USED IN) INVESTING ACTIVITIES:		
Acquisition of equipment and leasehold improvements	(272)	(44

CASH FLOWS (USED IN) FINANCING ACTIVITIES:		
Principal payments of long-term debt	(720)	(70
NET DECREASE IN CASH AND CASH EQUIVALENTS	(251)	(64
CASH AND CASH EQUIVALENTS, beginning of period	3,837	5,10
CASH AND CASH EQUIVALENTS, end of period	$ 3,586	$ 4,46

See Notes to Consolidated Financial Statements.

5

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1

Basis of Presentation - The accompanying unaudited financial statements consolidate the accounts of Spectrum Laboratories, Inc. and its subsidiaries, SLI Acquisition Corp., Spectrum Europe B.V. and Spectrum Chromatography (collectively, the Company). All significant intercompany transactions have been eliminated in consolidation. In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the financial position of the Company as of September 25, 2004 and the results of its operations and its cash flows for the nine months ended September 25, 2004 and September 27, 2003. Certain information and footnote disclosures normally included in the financial statements have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission.

Determining Impairment on Long-lived Assets - The Company recognizes impairment losses for long-lived assets used in operations when indicators of impairment are present and the future undiscounted cash flows are not sufficient to recover the assets' carrying amount. Management believes there has been no impairment of the value of such assets. The analysis of indicators of impairment and future cash flows are estimates made by management.

Patents - The Company has acquired patents utilized within the various manufacturing processes. These patents are amortized over their respective lives, typically 17 years. Management believes there has been no impairment in the value of these patents.

Estimates & Reserves - The Company's principal reserves relate to accounts receivable and inventory. A detailed review of these reserves is done annually with a general review quarterly. The Company believes these reserve are adequate and the amounts consistent with prior year's level. A significant estimate is made in the annual impairment testing of goodwill. Changes in management's estimate of fair value of the Company could result in future impairment charges.

Accounting for Stock-based Compensation - The Company accounts for stock-based employee compensation under the requirements of Accounting Principles Board (APB) Opinion No. 25, which does not require compensation to be recorded if the consideration to be received is at least equal to fair value at the measurement date. Nonemployee stock-based transactions are accounted for under the requirements of the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards (SFAS) No. 123, ACCOUNTING FOR STOCK-BASED

COMPENSATION, which requires compensation to be recorded based on the fair value of the securities issued or the services received, whichever is more reliably measurable.

SFAS No. 123 requires the disclosure of pro forma net income and earnings per share had the Company adopted the fair value method. Under SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of option-pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options with vesting restrictions which significantly differ from the Company's stock option awards. These models also require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated value.

The calculations are based on a single-option valuation approach and forfeitures are recognized as they occur. The following table illustrates the effect on net income and earnings per share had compensation cost for stock-based compensation been determined based on the grant date fair values of awards (refer to next page for table):

Note 1 Accounting for Stock-Based Compensation (Continued):

	Three Months Ended		Nine
	September 25, 2004	September 27, 2003	September 25, 2004
Net income:			
As reported	$ 110,000	$ (269,000)	$ 495,000
Add total stock-based compensation expense determined under APB opinion 25, net of related tax effects	3,000	3,000	9,000
(Deduct) total stock-based employee compensation expense determined under the fair value method based for all awards, net of related tax benefits	(15,000)	(16,000)	(44,000
	$ 98,000	$ (282,000)	$ 460,000
Basic earnings (loss) per share:			
As reported	$ 0.02	$ (0.05)	$ 0.09
Pro forma	$ 0.02	$ (0.05)	$ 0.09
Diluted earnings (loss) per share:			
As reported	$ 0.02	$ (0.05)	$ 0.09
Pro forma	$ 0.02	$ (0.05)	$ 0.08
Weighted average shares outstanding:			
Basic	5,312,000	5,312,000	5,312,000
Diluted	5,590,000	5,312,000	5,575,000

Note 2 - Inventories

Inventories are stated at the lower of cost or market , determined using the first-in, first-out method, or net realizable value and are composed of the following (in thousands):

Raw materials	$2,422
Work in process	305
Finished goods	769
	3,496
Less reserve for slow moving & obsolete items	(619)
	$2,877

Note 3 - Earnings per Share

Basic earnings per share is computed by dividing the net income attributable to the common stockholders by the weighted average number of common shares outstanding during the period. There is no adjustment in the net income attributable to common stockholders. Diluted earnings per share reflect the potential dilution that could occur from common shares issuable through stock options and warrants (277,252 and 263,009 equivalent shares in the fiscal year 2004 three and nine month periods respectively and 0 and 143,743 shares in fiscal year 2003 three and nine month periods, respectively).

Note 4 - Income Taxes

In assessing the realizability of deferred tax assets, management has estimated that it is likely that approximately $1,500,000 will not be realized. This valuation allowance represents a portion of net operating loss carryforwards attained through a prior business acquisition. As further discussed below, tax law limits the use of an acquired entity's net operating loss carryforwards to subsequent taxable income of the consolidated entity. Management will continue to evaluate the realizability of the deferred tax assets by assessing the need for and amount of a valuation allowance.

At December 27, 2003, the Company had approximately $6.1 million in net operating loss carryforwards for federal income tax purposes available to offset future taxable income. Certain of these loss carryforwards are limited to approximately $298,000 annually. Any unused net operating loss is carried forward. As a result of the limitation discussed above, it is probable that approximately $4.5 million of the Company's net operating loss will expire without utilization.

Note 5 - Product Group Information

While management has determined the Company operates as a single reportable segment, the Company's product groups are based on specific product characteristics and are grouped into bioprocessing products ("BioProcessing"), formerly referred to as laboratory products, and disposable operating room products ("OR"). BioProcessing products consist primarily of membranes and modules used to filter, extract, concentrate, separate and purify. These products are sold primarily to laboratories, research institutions, biotech and pharmaceutical companies. OR products consist primarily of sterile surgical drapes and bandages that are sold primarily to hospitals and their suppliers.

Revenue by product group is as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 25, 2004	September 27, 2003	September 25, 2004	September 27, 2003
BioProcessing	3,142	2,282	8,916	8,224
OR	422	371	1,250	1,214
	$ 3,564	$ 2,653	$10,166	$ 9,438

Note 6 - Option Plan

The Company has an option plan referred to as the 2000 Option Plan (the "2000 Option Plan" or "Plan") with 600,000 shares of common stock reserved for option grants to key employees, directors and consultants. Exercise prices for the stock options will not be less than 100% of the fair market value of the stock on the date of grant. Options under the Plan expire not more than ten years from date of grant. Options under the Plan become exercisable over a 5 year period (20% per year). As of September 25, 2004, there were 575,050 options outstanding under the 2000 Option Plan. In addition to the 2000 Option Plan there are 265,624 non qualified stock options outstanding. There were 25,000 options granted to one key employee during the nine months ended September 25, 2004 while 8,050 options were forfeited.

Note 7- Comprehensive Income

Comprehensive income is comprised of net income and Other Comprehensive Income ("OCI"). OCI includes certain changes in stockholders' equity that are excluded from net income. Specifically, the Company includes in OCI changes in the fair value of unrealized gains and losses on Spectrum's available for sale securities. The activity in comprehensive income during the three and nine month periods ended September 25, 2004 was as follows (in thousands):

	Three Months Ended September 25, 2004	Nine Months Ended September 25, 2004
Net Income	$ 110	$ 495
Unrealized gain on investment in marketable securities	526	816
Tax expense	(210)	(326)
Comprehensive income	$ 426	$ 985

The activity in accumulated OCI, net of taxes for the nine months ended September 25, 2004 was as follows (in thousands):

Unrealized gain on securities available for sale (net of tax effect of $363 at the beginning of the year)	$ 544
Change in unrealized gain on securities available for sale	

(net of tax effect of $326)	490

Unrealized gain on securities available for sale as of September 25, 2004, (net of tax effect of $689)	$1,034
	======

Spectrum did not have any securities available for sale during the nine months ended September 27, 2003.

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

The following discussion should be read in conjunction with the Consolidated Financial Statements of Spectrum Laboratories, Inc. and Notes thereto contained elsewhere within this Report on Form 10-QSB. Except for the historical information contained herein, the following discussion may contain forward-looking statements that involve risks and uncertainties. The actual future results of the Company could differ materially from those discussed here. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this report and those factors discussed in the Company's Form 10-KSB for the year ended December 27, 2003 as filed with the Securities and Exchange Commission and, from time to time, in the Company's other reports on file with the Commission.

Results of Operations

Sales

Total sales for the third quarter ended September 25, 2004 totaled $3,564,000, an increase of $911,000 (34.3%), when compared to the same period in 2003, although third quarter sales in 2003 were significantly lower than normal. As noted in Spectrum's 2003 third quarter 10QSB quarterly sales were down from the same quarter in 2002 by $523,000 (16.5%) principally due to order timing from certain large customers.

Sales on a year to date basis for 2004 were $10,166,000, an increase of $728,000 (7.7%) as compared to 2003. From a product perspective sales for both BioProcessing and OR products are above prior year by $692,000 (8.4%) and $36,000 (3.0%), respectively.

Gross Margin

Gross margin for the second quarter of 2004 was $1,548,000 (43.4%) versus prior year second quarter margin of $956,000 (36.0%). Prior year quarterly margin was negatively impacted by significantly lower sales and unfavorable overhead absorption. On a year to date ("YTD") basis gross margin for 2004 was $4,434,000 (43.6%) versus $4,175,000 (44.2%) for 2003 an increase of $259,000 (6.2%) although gross margin percentage declined slightly from 44.2% YTD in 2003 to 43.6% YTD in 2004. The decline in gross margin percentage, as noted in Spectrum's prior 10QSBs issued in 2004, was principally attributable to one Spectrum product being specifically built for one customer that had a lower than normal gross margin. The large order associated with this customer has know been fully shipped.

Selling, General & Administrative ("SG&A") and Research & Developmental Expenses ("R&D")

During the third quarter of 2004 R&D expenses were $221,000 while SG&A expenses were $1,005,000 resulting in a slight increase in R&D expenses of $6,000 (2.8%) while SG&A expenses decreased $91,000 (8.3%), when compared to 2003. The decline in SG&A expenditures were principally related to reduced advertising related expenditures partially offset by accrued expenses concerning Spectrum going private. Refer to Subsequent Event below.

On a year to date basis R&D expenditures totaled $615,000, a decrease of $18,000 (2.8%) versus prior year. YTD SG&A expenses totaled $2,904,000 a reduction of $330,000 (10.2%) compared to 2003, principally associated with lower advertising related expenditures although reduced salary & related expenditures were also a contributing factor

Warrant Related

During the first quarter of 2004 the Company issued warrants to a third party (the Warrant Holder) to purchase 125,000 shares of common stock at $1.70 per share through February 4, 2010. The Warrant Holder is entitled to purchase an additional 125,000 shares of common stock at $1.70 upon having assisted Spectrum in raising at least $2.5 million in gross proceeds from one or more private or public equity financings originated or facilitated by the Warrant Holder through February 3, 2010.

Spectrum's estimate of the fair value of the first 125,000 warrants granted were made using the Black-Scholes warrant-pricing model with the following weighted average assumptions: expected life of three years; stock volatility of 66%; risk-free interest rate 2.5%; and no dividends during the expected term. Based on the Black-Scholes warrant-pricing model Spectrum and the Board of Directors decision not to actively pursue either private or public equity financing at this time Spectrum has recorded $130,000 in warrant related expense in the third quarter associated with the 125,000 warrants issued during the first quarter. If Spectrum is successful in the future, in raising the required $2.5 million, with the Warrant Holder's assistance, the additional 125,000 warrants will vest immediately upon issuance and the Company will measure the warrants using the Black-Scholes warrant pricing model and the fair value of the warrants will be charged against the proceeds at that time.

Net Income

Considering the above, net income for the quarter was $110,000 versus a net loss of $269,000 in the third quarter of 2003. On a YTD basis net income for 2004 was $495,000 compared to $150,000 in 2003.

Liquidity and Capital Resources

Cash provided by operations for the first nine months of 2004 was $741,000. Working capital components consumed cash of $509,000 principally due to the increase in accounts receivable of $477,000. The increase in receivables relates to timing, principally relating to a sales perspective although timing of collections was a contributing factor. The Company believes there are no material collection issues and its current reserves are adequate.

The above discussion of cash provided by operating activities was also impacted by financing activity relating to $720,000 in bank loan payments and $272,000 in investing activity associated with the acquisition of equipment. This resulted in a net decrease in cash for the YTD period of approximately $251,000 to a cash balance at September 25, 2004 of $3,586,000.

In December of 2001 Spectrum entered into a specific research, licensing, manufacturing and supply agreements (the "Agreements") with an unrelated company, now known as Arbios Systems, Inc. ("Arbios"). These Agreements, among other aspects, resulted in Spectrum being granted 362,669 shares of Arbios.

Arbios became a public company on October 30, 2003 and originally traded on the Pink Sheets electronic trading system under the symbol of ABOS.PK. Arbios is now listed on the OTC Bulleting Board under the symbol of ABOS.OB. Arbios is an early-stage biomedical device company engaged in the discovery, acquisition and

development of proprietary liver assist devices and new technologies useful in the diagnosis and treatment of acute liver failure. In compliance with SFAS No. 115 based on the listed trade price of $2.50 per share Spectrum allocated $907,000 as the fair market value reflecting this amount as accumulated other comprehensive income on its balance sheet as of December 27, 2003. Based on Arbios most recent trade price of $4.75, as of September 25, 2004, Spectrum reflected an increase in fair market value of $816,000 to $1,723,000 on its balance sheet as of September 25, 2004. Spectrum has classified this amount as a non current asset as it realizes there have been limited trades in Arbios and the potential to sell the stock may be limited. In addition, due to Arbios being an early stage developmental company, this investment may be subject to significant adjustments.

The Company is obligated under the terms of various operating lease agreements for manufacturing, warehouse and office facilities. Certain of these leases provide for rent escalation adjustments. Minimum future rental payments under these operating lease agreements for the final quarter ending December 28, 2004 and the subsequent years ending December 31 are as follows: final quarter 2004 $123,000; years ending 2005 $336,000; and 2006 $106,000 (total $565,000).

Subsequent Events

The Board of Directors of Spectrum elected on October 6, 2004 to amend its Certificate of Incorporation to effect a 1 for 25,000 reverse stock split. Stockholders, subsequent to the reverse stock split, holding fractional shares, would be paid $2.56 per share for each pre reverse stock split share. The Board of Directors then elected to effectuate a going private transaction as subsequent to the reverse stock split the Company anticipates it will only have 3 shareholders.

To effectuate the above transactions Spectrum filed a Schedule 14C Information Statement with the Securities and Exchange Commission ("SEC") on October 12, 2004. In addition the Company filed a Schedule 13E-3 Transaction Statement on October 13, 2004 with a subsequent amended Schedule 13E-3A being filed on October 19, 2004. It is anticipated this process will be finalized prior to December 25, 2004, Spectrum's fiscal 2004 year end. The Company has recognized $35,000 in expense as of September 25, 2004 relating to going private.

The Company hired a new President during the third quarter of 2004. Spectrum's former President has assumed the position of Senior Vice President and Chief Scientific Officer.

Considering the timing of the filing of this 10QSB, Spectrum has performed its annual year end physical inventory and is currently analyzing its year end financial information. The Company anticipates it will incur an approximate physical inventory adjustment of $185,000. Considering fourth quarter sales will approximate $3.1 million, the above noted inventory loss and an anticipated increase in SG&A expenses from the average of the prior three quarters of approximately $75,000, Spectrum currently estimates a fourth quarter pre tax loss of approximately $150,000. This will result in an anticipated annual pre tax income for 2004 of approximately $575,000.

Item 3. Controls and Procedures

As of the end of the period covered by this report, the Company conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")). Based on this evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. There was no change in the Company's internal control over financial reporting during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings
None

Item 2. Change in Securities and Use of Proceeds
None

11

Item 3. Defaults Upon Senior Securities
None

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

Item 5. Other Information
None

Item 6. Exhibits and Reports on Form 8-K
(a) Exhibits

31 (a) & (b) Rule 13a-14(a)/15d-14(a) Certifications

32 (a) & (b) 18 U.S.C. Section 1350 Certifications

(b) The Company filed no reports on Form 8-K during the quarter ended September 25, 2004.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on January 31, 2005.

SPECTRUM LABORATORIES, INC.
(Registrant)

/S/ Roy T. Eddleman

Signature

Roy T. Eddleman

Chief Executive Officer

/S/ Brian A. Watts

Signature

Brian A. Watts
Chief Financial Officer/Vice President of Finance