PROLONG INTERNATIONAL CORP
Form 10-Q
November 12, 2002
Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2002

OR

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

For the transition period from ____________________to______________________

Commission File No. 0-22803

PROLONG INTERNATIONAL CORPORATION

(Exact name of registrant as specified in its charter)

Nevada	**6 Thomas Irvine, CA 92618**	**74-2234246**
(State or other jurisdiction of incorporation or organization)	**(Address of principal executive offices) (Zip Code)**	**(IRS Employer Identification No.)**

(949) 587-2700
(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.

(1) Yes x No o

(2) Yes x No o

There were 29,789,598 shares of the registrant s common stock ($0.001 par value) outstanding as of November 8, 2002.

Page 1 of 23 pages
Exhibit Index on Sequentially Numbered Page 19

Table of Contents

PROLONG INTERNATIONAL CORPORATION
FORM 10-Q
TABLE OF CONTENTS

Table of Contents

Item 1. Financial Statements

PROLONG INTERNATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS

	September 30, 2002 (Unaudited)	December 31, 2001
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 82,164	$ 466,453
Accounts receivable, net of allowance for doubtful accounts of $327,760 and $461,731 in 2002 and 2001, respectively	2,104,430	2,485,191
Inventories, net	519,246	691,921
Prepaid expenses, net	337,174	145,107
Advances to employees, current portion	11,568	31,578
Deferred tax asset	877,455	877,455
Total current assets	3,932,037	4,697,705
Property and equipment, net (Note 4)	336,958	2,879,094
Patents, net	445,122	
Intangible assets, net	6,058,007	6,558,007
Deferred tax asset, noncurrent	1,412,601	2,349,552
Investment in affiliate	299,994	224,997
Other assets, net	204,531	232,042
TOTAL ASSETS	$ 12,689,250	$ 16,941,397
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 1,010,475	$ 2,647,266
Accrued expenses	530,718	416,203
Line of credit	1,107,209	1,728,868
Notes payable, current	60,739	53,974
Total current liabilities	2,709,141	4,846,311
Deposits under building sales contract (Note 7)		1,223,265
Notes payable, noncurrent	277,491	2,230,359
Total liabilities	2,986,632	8,299,935
COMMITMENTS AND CONTINGENCIES (Note 7 & 8)		
STOCKHOLDERS EQUITY:		
Preferred stock, $0.001 par value; 50,000,000 shares authorized; no shares issued or outstanding		
Common stock, $0.001 par value; 150,000,000 shares authorized; 29,789,598 shares issued and outstanding in 2002 and 2001, respectively	29,789	29,789
Additional paid-in capital	15,137,105	15,137,105
Accumulated deficit	(5,464,276)	(6,525,432)
Total stockholders equity	9,702,618	8,641,462
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 12,689,250	$ 16,941,397

See notes to consolidated condensed financial statements

Table of Contents

PROLONG INTERNATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	**2001**	**2002**	**2001**
NET REVENUES	$ 2,627,994	$ 2,858,222	$ 8,001,231	$ 10,939,283
COST OF GOODS SOLD	933,626	929,751	2,722,030	3,401,632
GROSS PROFIT	1,694,368	1,928,471	5,279,201	7,537,651
OPERATING EXPENSES:				
Selling and marketing	974,343	1,397,081	2,982,209	4,726,728
General and administrative	638,521	908,713	2,070,059	2,799,902
Total operating expenses	1,612,864	2,305,794	5,052,268	7,526,630
OPERATING INCOME (LOSS)	81,504	(377,323)	226,933	11,021
OTHER (EXPENSE) INCOME, net:				
Interest (expense)	(71,213)	(147,656)	(270,329)	(417,039)
Interest income	341	(1,509)	1,865	7,976
Other income	39,939		148,810	
Gain on sale of building			983,401	
Total other (expense) income, net	(30,933)	(149,165)	863,747	(409,063)
INCOME (LOSS) BEFORE EXTRAORDINARY ITEM AND PROVISION OF INCOME TAXES	50,571	(526,488)	1,090,680	(398,042)
EXTRAORDINARY ITEM gain from forgiveness of debt, net of income taxes of $0 and $270,985 for the three and nine month period ended September 30, 2002 (Note 1)			406,476	
INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES	50,571	(526,488)	1,497,156	(398,042)
PROVISION (BENEFIT) FOR INCOME TAXES	20,000	(106,392)	436,000	(2,936)
NET INCOME (LOSS)	$ 30,571	$ (420,096)	$ 1,061,156	$ (395,106)
NET INCOME (LOSS) PER SHARE				
Basic	$ 0.00	$ (0.01)	$ 0.03	$ (0.01)
Diluted	$ 0.00	$ (0.01)	$ 0.03	$ (0.01)
WEIGHTED AVERAGE COMMON SHARES				
Basic	29,789,598	28,438,903	29,789,598	28,438,903
Diluted options outstanding	0	0	0	0
Diluted	29,789,598	28,438,903	29,789,598	28,438,903

See notes to consolidated condensed financial statements

Table of Contents

PROLONG INTERNATIONAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30,	
	2002	**2001**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 1,061,156	$ (395,106)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Gain from forgiveness of debt	(677,461)	
Gain from sale of building	(983,401)	
Sublease income from affiliate	(74,997)	
Depreciation and amortization	195,747	635,995
Provision for doubtful accounts		62,078
Deferred taxes	936,951	(8,684)
Reserve for inventory obsolescence	2,838	
Compensation costs related to options		
Amortization of warrants issued to lender		126,279
Loss on exchange of common stock for accounts receivable		
Changes in assets and liabilities:		
Accounts receivable	380,761	(644,006)
Inventories	169,837	235,865
Prepaid expenses	(161,567)	(5,336)
Income taxes receivable		75,002
Prepaid television time	(30,500)	5,583
Other assets	27,511	88,254
Accounts payable	(959,330)	369,882
Accrued expenses	114,516	(334,514)
Income taxes payable	(1)	
Net cash provided by operating activities	2,060	211,292
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(12,574)	(12,153)
Employee advances	20,010	13,660
Investment in affiliate		(150,000)
Net cash provided by (used in) investing activities	7,436	(148,493)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from notes payable sub-debt	338,230	
Payments on notes payable	(24,491)	(37,759)
Net payments on line of credit from bank	(621,659)	(118,165)
Deposits under sales contracts	(85,865)	
Net cash used in financing activities	(393,785)	(155,924)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(384,289)	(93,125)
CASH AND CASH EQUIVALENTS, beginning of period	466,453	126,917
CASH AND CASH EQUIVALENTS, end of period	$ 82,164	$ 33,792
SUPPLEMENTAL CASH FLOW DISCLOSURES:		
Income taxes paid	$	$ 13,600

Interest paid	$ 270,329	$ 417,039

SUPPLEMENTAL NONCASH INVESTING AND FINANCING ACTIVITIES

During the nine months ended September 30, 2002, the Company completed the following transactions:

Provided an affiliate with office space, and recorded increases in other income and investment in affiliate of $74,997. Completed the sale of its corporate headquarters at a one time-gain of $983,400. The transaction resulted in a net decrease in property and equipment (land, building & improvements) of approximately $2,414,000 and a reduction in long-term liabilities, (notes payable & deposits under sales contracts) of approximately $3,398,000.

See notes to consolidated condensed financial statements

PROLONG INTERNATIONAL CORPORATION
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(UNAUDITED)

1. BUSINESS

Prolong International Corporation (PIC) is a Nevada corporation originally organized on August 24, 1981. In September 1995, PIC acquired 100% of the outstanding stock of Prolong Super Lubricants, Inc. (PSL), a Nevada corporation. In 1997, Prolong Foreign Sales Corporation was formed as a wholly-owned subsidiary of PIC. In 1998, Prolong International Holdings Ltd., was formed as a wholly-owned subsidiary of PIC. At the same time, Prolong International Ltd., was formed as a wholly-owned subsidiary of Prolong International Holdings Ltd. PIC, through its subsidiaries, is engaged in the manufacture, sale and worldwide distribution of a patented complete line of high-performance and high-quality lubricants and appearance products.

Management s Plans Regarding Financial Results and Liquidity - At September 30, 2002, the Company had a net working capital of approximately $1,223,000 and, an accumulated deficit of approximately $5,464,000. The Company initiated vigorous expense-reduction strategies during the years 2000 and 2001. During 2001 and 2002, the Company reduced personnel, discontinued certain of its endorsement and sponsorship contracts and aggressively reduced selling and general and administrative expenses. The Company anticipates realizing the full impact of these expense reductions in the remainder of 2002 and beyond. Additionally, the Company improved its credit and collections function and worked with its vendors to improve payment terms. The Company s business plan for 2002 provides for positive cash generation from operations. The Company initiated an Accounts Payable Discounted Debt Restructure Program , which was successfully executed and the program reduced the accounts payable balance by approximately $1,300,000 and recognized debt forgiveness income of $677,000 (before taxes), during the nine month period ended September 30, 2002. The Company also recognized a one-time gain of $983,400 on the sale of its corporate headquarters during the nine month period ended September 30, 2002. The Company is currently seeking additional working capital through a private placement offering of subordinated secured promissory notes to accredited investors. As of September 30, 2002, the Company raised $375,000 through this private placement. If these measures are not adequate, the Company will pursue additional expense reductions. The Company is continuing to seek financing on favorable terms, including senior secured debt, subordinated debt and/or equity placements. There can be no assurance that such financing will be available on favorable terms, or at all. If additional funds are raised by issuing equity securities, dilution to existing stockholders is likely to result. Management believes that the aforementioned plans, if successfully executed, will provide adequate financial resources to sustain the Company s operations and enable the Company to continue as a going concern.

2. BASIS OF PRESENTATION

The accompanying unaudited consolidated condensed financial statements include the accounts of PIC and its wholly-owned subsidiaries, PSL, Prolong Foreign Sales Corporation, Prolong International Holdings Ltd. and its wholly-owned subsidiary, Prolong International Ltd. (collectively, the Company or Prolong). All intercompany accounts have been

Table of Contents

eliminated in consolidation. These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments, including normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. For further information, refer to the Form 10-K for the year ended December 31, 2001 filed by the Company with the Securities and Exchange Commission.

3. INVENTORIES

Inventories consist of the following:

	September 30, 2002	December 31, 2001
	(Unaudited)	
Raw materials	$ 333,726	$ 353,065
Finished goods	273,066	423,564
Obsolescence reserve	(87,546)	(84,708)
	$ 519,246	$ 691,921

4. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	September 30, 2002	December 31, 2001
	(Unaudited)	
Building and improvements (Note 7)	$	$ 2,280,783
Computer equipment	278,537	265,964
Office equipment	55,753	55,753
Furniture and fixtures	585,168	585,168
Automotive equipment	35,925	35,925
Exhibit equipment	115,143	115,143
Machinery and equipment	17,953	17,953
Molds and dies	233,117	233,117
	1,321,596	3,589,806
Less accumulated depreciation	(984,638)	(1,248,712)
	336,958	2,341,094
Land (Note 7)		538,000
	$ 336,958	$ 2,879,094

Table of Contents

5. LINE OF CREDIT

The Company has a $5,000,000 credit facility with a financial institution, expiring in May 2003. Such facility is collateralized by eligible accounts receivable and inventories. Interest is currently payable monthly at the default rate of the financial institution s prime rate (4.75% at September 30, 2002), plus 7.00% subject to a minimum interest charge of $50,000 per quarter. The credit facility contains certain defined net income and tangible net worth financial covenants. At September 30, 2002 the Company was in default with certain financial covenants under the credit agreement. The Company is currently discussing remedies with the lender and is also actively pursuing a replacement senior secured lender. There can be no assurance that the Company will successfully secure a replacement senior secured lender on favorable terms, or at all. As of September 30, 2002, $1,107,209 was outstanding and approximately $136,000 was available under the terms of the line of credit.

6. NOTES PAYABLE

Notes payable consist of the following as of September 30, 2002:

Various subordinated secured promissory notes payable to accredited investors bearing interest at 15% per annum to be repaid under various terms in monthly principal and interest through June 30, 2005.	$ 338,230
Less current maturities	60,739
	$ 277,491

The following are annual minimal principal payments due under notes payable:

Year ending December 31,	
2002	$ 4,839
2003	93,103
2004	163,510
2005	76,778
	$ 338,230

7. DEPOSITS UNDER BUILDING SALES CONTRACT

On December 31, 2001, Prolong Super Lubricants, Inc. (PSL) sold its 6 Thomas, Irvine, CA headquarters building to an investment group for $3,675,000. The buyers made a cash down payment of approximately $1,138,667, took subject to the existing 1st trust deed in favor of Bank of America, FSB in the amount of $1,609,057, took subject to the 2nd trust deed in favor of CDC Small Business Finance in the amount of $675,276, and legally assumed the

3rd trust deed loan in favor of ABQ Dolphin LP in the amount of approximately $252,000. From the cash down payment received by PSL, $423,000 was applied as a principal payment on the ABQ Dolphin LP 3rd trust deed loan. On June 28, 2002 the buyer secured a new loan by a first deed of trust, paying off the three existing loans of record. Because the Company s contractual obligations under these loans have been satisfied, the gain on the sale of the building in the amount of approximately $983,400 was recognized during the quarter ended June 30, 2002.

8. CONTINGENCIES

Legal Proceedings - In February 1999, PSL entered into a negotiated Consent Order with the FTC concerning the standards for adequate substantiation of engine treatment advertising claims, among others items. As a follow on to the FTC matter, four separate lawsuits were filed by individuals purporting to act as class representatives for consumers seeking redress based on various allegations of false advertising, unfair competition, violation of various state consumer laws, fraud, deceit, negligent misrepresentation, breach of warranty and seeking equitable relief. All four of the suits have been settled with court approval; namely Fernandes et al v PSL, Bowland et al v PSL, Mata et al v PSL, and Kachold et al v PSL, and the period for appeal has expired. In settlement, the Company will offer a discount cash rebate on certain of its products through four major distributors by means of an in-store coupon for a period of six months, with the coupons expiring eighteen months from the date of settlement. In addition, the Company will reimburse plaintiff s legal counsel as a group in an amount not to exceed $66,000. Settlement of these suits has no material adverse affect on the Company s financial position or results of operation, as the Company has fully accrued for the settlements.

On April 8, 1997, a lawsuit was filed by Francis Helman et al v EPL and PIC et al in the Court of Common Pleas, Columbiana County, Ohio as a purported class action alleging breach of fiduciary duty, breach of oral and written contract, and fraud, in thirteen original causes of action related to a claim of right to become a shareholder of PIC. Management believes that there is no merit to the plaintiffs complaint, is vigorously defending against the claims, and does not believe the outcome will have a material adverse affect on the Company s financial position or results of operations.

PIC and its subsidiaries are subject to other legal proceedings, claims, and litigation arising in the ordinary course of business. PIC s management does not expect that the ultimate costs to resolve these matters will have a material adverse affect on PIC s consolidated financial position, results of operations or cash flows.

9. INVESTMENT IN AFFILIATE

On March 31, 2001 the Company entered into an Organization Agreement with Prolong Environmental Energy Corporation (PEEC), a California Corporation, whereby the Company agreed to contribute up to $150,000 to PEEC as required to meet the operating working capital obligations for PEEC. The Company also provided administrative and facilities services support in the amount of $149,994 during the period April 1, 2001 through September 30, 2002. The Company contribution, and the services provided (total investment of $299,994), shall be considered a capital contribution for PEEC in return for approximately 10% of the issued and outstanding common stock of PEEC. In December 2001, PEEC was merged into ORYXE Energy International, Inc. The Company also has a warrant to purchase additional shares of ORYXE, which if exercised would vest the Company with ownership of approximately 16% of ORYXE, based upon ORYXE s current capitalization.

10. INTANGIBLE ASSETS

Effective the beginning of the first quarter of 2002, the Company completed the adoption of Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting. As required by SFAS No. 142, the Company discontinued amortizing the remaining balances of goodwill as of the beginning of fiscal 2002. All remaining and future acquired goodwill will be subject to impairment tests annually, or earlier if indicators of potential impairment exist, using a fair-value-based approach. All other intangible assets will continue to be amortized over their estimated useful lives and assessed for impairment under SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. In conjunction with the implementation of SFAS No. 142, the Company has completed a goodwill impairment review as of the beginning of 2002 and found no impairment.

Upon adoption of the new rules described above, the Company separately identified the estimated fair value of its patents and such amount has been presented on a separate line item, net of related accumulated amortization of $18,293, in the accompanying consolidated balance sheets. Patents are amortized over their estimated useful lives of 15 years. Intangible assets are comprised of goodwill and trademarks and are not being amortized in accordance with the provisions of SFAS No. 142.

Table of Contents

ITEM 2:

PROLONG INTERNATIONAL CORPORATION
MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RISK FACTORS AND FORWARD LOOKING STATEMENTS

This report contains certain forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that involve risks and uncertainties. In addition, the Company may from time to time make oral forward looking statements. The words estimate, project, potential, intended, expect, anticipate, believe and similar expressions or words are intended to identify forward looking statements. The forward looking statements included herein are based on current expectations, which involve a number of risks and uncertainties and assumptions regarding the Company s business and technology. These assumptions involve judgments with respect to, among other things, future economic and competitive conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the control of the Company. Although the Company believes that the assumptions underlying the forward looking statements are reasonable, any of the assumptions could prove inaccurate and, therefore, there can be no assurance that the results contemplated in forward looking statements will be realized and actual results may differ materially. In light of the significant uncertainties inherent in the forward looking information included herein, the inclusion of such information should not be regarded as a representation by the Company or any other person that the objectives or plans of the Company will be achieved. The Company undertakes no obligation to publicly release the result of any revisions to these forward looking statements that may be made to reflect events or circumstances after the date hereof, or to reflect the occurrence of unanticipated events.

Actual results are uncertain and may be impacted by the factors discussed in more detail in the Company s Annual Report on Form 10-K for the year ended December 31, 2001 and other periodic reports filed with the Securities and Exchange Commission. In particular, there are certain risks and uncertainties that may impact the accuracy of the forward looking statements with respect to revenues, expenses and operating results including without limitation, the risks set forth in the risk factors section of the Annual Report on Form 10-K for the year ended December 31, 2001, which risk factors are hereby incorporated into this report by this reference. As a result, the actual results may differ materially from those projected in the forward looking statements.

Because of these and other factors that may affect the Company s operating results, past financial performance should not be considered an indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of net revenue and expenses during the reporting period. We regularly evaluate our estimates and assumptions related to allowances for doubtful accounts, sales returns and allowances, inventory reserves, goodwill and purchased intangible asset valuations, deferred income tax asset valuation allowances, warranty reserves, litigation and other contingencies. We base our estimates and assumptions on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. To the extent there are material differences between our estimates and the actual results, our future results of operations will be affected. We believe the following critical accounting policies require us to make significant judgments and estimates in the preparation of our unaudited condensed consolidated financial statements:

Revenue, Receivables and Inventory - We recognize product revenue upon concluding that all of the fundamental criteria for revenue recognition have been met. The criteria are usually met at the time of product shipment. In addition, we record reductions to revenue for estimated product returns and allowances such as competitive pricing programs. Should actual product returns or pricing adjustments exceed our estimates, additional reductions to revenue would result. We provide reserves for estimated product warranty costs at the time revenue is recognized. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances could be required. We write down our inventory for estimated obsolescence. If actual market conditions are less favorable than those projected by management, additional inventory write-downs could be required.

Goodwill and Purchased Intangible Assets - The purchase method of accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired. Goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests. The amounts and useful lives assigned to intangible assets impact future amortization.

Deferred Taxes - If we determine that we will not realize all or part of our net deferred tax assets in the future, we will make an adjustment to the deferred tax assets, which adjustment will be charged to income tax expense in the period of such determination.

Table of Contents

RESULTS OF OPERATIONS

	Percentage of Net Revenues			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net revenues	100.0	100.0	100.0	100.0
Cost of goods sold	35.5	32.5	34.0	31.1
Gross profit	64.5	67.5	66.0	68.9
Selling and marketing expenses	37.1	48.9	37.3	43.2
General and administrative expenses	24.3	31.8	25.9	25.6
Operating income (loss)	3.1	(13.2)	2.8	0.1
Other (expense) income	(1.2)	(5.2)	10.8	(3.7)
Income (loss) before extraordinary item and provision for income taxes	1.9	(18.4)	13.6	(3.6)
Extraordinary item gain from forgiveness of debt, net of income taxes			5.1	
Income (loss) before provision income taxes	1.9	(18.4)	18.7	(3.6)
Provision (benefit) for income taxes	0.8	(3.7)	5.4	