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SPECTRUM LABORATORIES INC /CA
Form 10QSB
November 15, 2005

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

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 24, 2005

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 No
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Number of shares of Common Stock outstanding as of October 31, 2005: 5,312,468

TRANSITIONAL SMALL BUSINESS DISCLOSURE FORMAT

YES NO

Part I - FINANCIAL INFORMATION

Item 1. Financial Statements

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Consolidated Balance Sheet as of September 24, 2005
Consolidated Statements of Income for the Three and Nine Months Ended
September 24, 2005 and September 25, 2004
Consolidated Statements of Cash Flows for the Nine Months Ended September 24, 2005 and
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Signature

Exhibits Certifications - Chief Executive Officer and Chief Financial Officer

Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

SPECTRUM LABORATORIES, INC.
Consolidated Balance Sheet
AS OF SEPTEMBER 24, 2005
(DOLLARS IN THOUSANDS, EXCEPT SHARE DATA)
(UNAUDITED)

ASSETS

CURRENT ASSETS:

Cash and cash equivalents	\$ 7,107
Marketable securities available for sale	395
Accounts receivable, net of allowances of \$191	1,938
Inventories	2,817
Prepaid expenses	157
Deferred taxes	525

Total current assets	12,939
INVESTMENT IN MARKETABLE SECURITIES	689
EQUIPMENT AND LEASEHOLD IMPROVEMENTS, net of accumulated depreciation of \$6,623	1,001
GOODWILL	1,122
DEFERRED TAXES	1,188
PATENTS, subject to amortization, net of accumulated amortization of \$288	462
OTHER ASSETS - Principally Artwork of \$986	1,038

Total assets	\$18,439

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LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Current maturities of long-term debt	\$ 1,020
Accounts payable	552
Accrued expenses and other current liabilities	407

Total current liabilities	1,979
LONG-TERM DEBT, net of current maturities	4,300
PREFERRED STOCK of SUBSIDIARY - SLI ACQUISITION CORP	1,755
STOCKHOLDERS' EQUITY:	
Preferred stock, par value \$.01; 10,000,000 shares authorized; none issued and outstanding	--
Common stock, \$.01 par value, 25,000,000 shares authorized; 5,312,468 shares issued and outstanding	53
Additional paid-in capital	8,637
Accumulated other comprehensive income	413
Retained earnings	1,302

Total stockholders' equity	10,405

Total liabilities and stockholders' equity	\$18,439

The accompanying notes are an integral part of these consolidated financial statements.

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

	Three Months Ended		Ni
	September 24, 2005	September 25, 2004	
	-----	-----	-----
NET SALES	\$ 3,409	\$ 3,564	\$ 9,
COSTS AND EXPENSES			
Cost of sales	1,970	2,016	5,
Selling, general and administrative	1,069	1,005	3,
Research and development	246	221	
Unrealized (gain) loss on marketable securities	(55)	--	
Warrant related	--	130	
Other expense, primarily interest	51	19	

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	-----	-----	-----
Total costs and expenses	3,281	3,391	9,
	-----	-----	-----
Income before provision of income taxes	128	173	
Provision for income taxes	44	63	
	-----	-----	-----
Net income	\$ 84	\$ 110	\$
	=====	=====	=====
Earnings per share:			
Basic	\$ 0.02	\$ 0.02	\$ 0
	=====	=====	=====
Diluted	\$ 0.02	\$ 0.02	\$ 0
	=====	=====	=====
Weighted average shares outstanding:			
Basic	5,312	5,312	5,
	=====	=====	=====
Diluted	5,557	5,590	5,
	=====	=====	=====

The accompanying notes are an integral part of these consolidated financial statements.

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SPECTRUM LABORATORIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
NINE MONTHS ENDED SEPTEMBER 24, 2005 AND SEPTEMBER 25, 2004
(IN THOUSANDS)
(UNAUDITED)

	2005	2004
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 70	\$ 495
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	519	616
Noncash compensation and warrant related expense	4	139
Change in working capital components:		
(Increase) in accounts receivable	(285)	(477)
(Increase) in inventories	(1)	(215)
(Increase) Decrease in prepaid expenses	(71)	10
Increase (Decrease) in accounts payable	38	(126)
(Decrease) Increase in accrued expenses	(125)	299
(Increase) in Other Assets	(11)	--
	-----	-----
NET CASH PROVIDED BY OPERATING ACTIVITIES	138	741
	-----	-----

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CASH FLOWS (USED IN) PROVIDED BY INVESTING ACTIVITIES:		
Investment in marketable securities	(417)	--
Unrealized loss on investment in marketable securities	22	--
Acquisition of equipment and leasehold improvements	(75)	(272)
	-----	-----
NET CASH (USED IN) INVESTING ACTIVITIES	(470)	(272)
	-----	-----
CASH FLOWS (USED IN) FINANCING ACTIVITIES:		
Principal payments of long-term debt	(680)	(720)
	-----	-----
NET DECREASE IN CASH AND CASH EQUIVALENTS	(1,012)	(251)
CASH AND CASH EQUIVALENTS, beginning of period	8,119	3,837
	-----	-----
CASH AND CASH EQUIVALENTS, end of period	\$ 7,107	\$ 3,586
	=====	=====

The accompanying notes are an integral part of these consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

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.

Unaudited Interim Financial Statements - The unaudited consolidated financial statements and related notes have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted pursuant to such rules and regulations. The accompanying consolidated financial statements of the Company should be read in conjunction with the audited consolidated financial statements of the Company, and notes thereto, for the year ended December 25, 2004. The information furnished reflects, in the opinion of management, all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the results of the interim periods presented. Operating results of the interim period are not necessarily indicative of the amounts that will be reported for the year ending December 31, 2005.

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

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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 reserves are adequate and the amounts are 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 (in thousands except share data - refer to next page for table):

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

	Three Months Ended		Nine M
	September 24, 2005	September 25, 2004	September 24, 2005
Net income:			
As reported	\$ 84	\$ 110	\$ 70
Add total stock-based compensation expense determined under APB opinion 25, net of related tax effects	--	3	4
(Deduct) total stock-based employee			

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compensation expense determined under the fair value method based for all awards, net of related tax benefits	(18)	(15)	(62)
	-----	-----	-----
	\$ 66	\$ 98	\$ 12
	=====	=====	=====
Basic earnings per share:			
As reported	\$ 0.02	\$ 0.02	\$ 0.01
Pro forma	\$ 0.01	\$ 0.02	\$ 0.00
Diluted earnings per share:			
As reported	\$ 0.02	\$ 0.02	\$ 0.01
Pro forma	\$ 0.01	\$ 0.02	\$ 0.00
Weighted average shares outstanding:			
Basic	5,312	5,312	5,312
	=====	=====	=====
Diluted	5,557	5,590	5,470
	=====	=====	=====

The Company was not in compliance with one of its loan covenants as of September 24, 2005 relating to cash flow to debt coverage. The Company received a covenant violation waiver from its bank on November 14, 2005.

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	\$ 2,415
Work in process	180
Finished goods	828

	3,423
Less reserve for slow moving & obsolete items	(606)

	\$ 2,817
	=====

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 are a combined total of 918,674 options and warrants outstanding as of September 24, 2005, as disclosed in Note 6 - Option Plan. Diluted earnings per share reflect the potential dilution that could occur from common shares issuable through stock options and warrants (244,053 and 157,126 equivalent shares in the three and nine month periods ending September 24, 2005, respectively and 277,252 and 263,009 equivalent shares in the three and nine month periods ending September 25, 2004, respectively).

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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 25, 2004, the Company had approximately \$5.2 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 \$1.5 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 24, 2005	September 25, 2004	September 24, 2005	September 25, 2004
BioProcessing	\$ 2,934	\$ 3,142	8,423	8,916
OR	475	422	1,334	1,250
	\$ 3,409	\$ 3,564	\$ 9,757	\$ 10,166

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 24, 2005, there were 528,050 options outstanding under the 2000 Option Plan. There were no options granted and 46,000 options forfeited during the nine months ended September 24, 2005.

In addition to the 2000 Option Plan there are 265,624 non qualified stock options outstanding and 125,000 warrants.

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 nine month period ended September 24, 2005 was as follows (in thousands):

	Nine Months Ended September 24, 2005

Net income	\$ 70
Unrealized (loss) on investment in marketable securities	(272)
Tax benefit	108

Comprehensive (loss)	\$ (94)
	=====

The activity in accumulated OCI, net of taxes for the nine months ended September 24, 2005 was as follows (in thousands):

Unrealized gain on securities available for sale (net of tax effect of \$384 at the beginning of the year)	\$ 577
Change in unrealized gain on securities available for sale (net of tax effect of \$108)	(164)

Unrealized gain on securities available for sale as of September 24, 2005, (net of tax effect of \$276)	\$ 413
	=====

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 25, 2004 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 24, 2005 totaled \$3,409,000, a decrease of \$155,000 (4.3%), when compared to third quarter 2004. >From a product perspective sales for OR products during the third quarter

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increased \$53,000 (12.6%) while BioProcessing sales decreased by \$208,000 (6.6%). Sales on a year to date basis for 2005 were below prior year by \$409,000 (4.0%) with OR product sales being \$84,000 (6.7%) ahead of prior year while BioProcessing sales were \$493,000 (5.5%) below prior year. The underperformance in BioProcessing was attributable to one OEM customer, with sales in excess of \$750,000 in 2004 and no sales in 2005.

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Gross Margin

Gross margin for the third quarter of 2005 was \$1,439,000 (42.2%) versus prior year third quarter margin of \$1,548,000 (43.4%). Year to date gross margin for 2005 was \$4,144,000 (42.5%) versus prior year of \$4,434,000 (43.6%).

Selling, General & Administrative ("SG&A") and Research & Developmental Expenses ("R&D") During the third quarter of 2005 R&D expenses were \$246,000 while SG&A expenses were \$1,069,000 resulting in an increase in R&D expenses of \$25,000 (11.3%) while SG&A expenses increased \$64,000 (6.4%), when compared to third quarter of 2004. On a year to date bases R&D expenses total \$674,000, an increase of \$59,000 (9.6%) over 2004 while SG&A expenditures total \$3,149,000, an increase over 2004 of \$245,000 (8.4%) The increase in R&D expenses principally related to outside consultants and materials associated with the expansion of Spectrum's product line, partially offset by a specific consulting agreement with a university in 2004 that totaled approximately \$25,000.

The increase in SG&A was comprised of approximately \$50,000 associated with the going private process, \$67,000 related to translating its European subsidiary balance sheet and approximately \$115,000 in increased management expenses attributable to Spectrum's new President. The net of these increased expenses were partially offset by a reversal of a management accrual of approximately \$50,000 and other miscellaneous expenses totaling approximately \$63,000.

Net Income

Considering the above, net income for the third quarter was \$84,000 versus \$110,000 in the third quarter of 2004. On a year to date basis, net income was \$70,000 compared to 2004 year to date net income of \$495,000.

Liquidity and Capital Resources

Cash provided by operations for the first nine months of 2005 was \$138,000. Working capital components consumed cash of \$444,000 principally due to the increase in accounts receivable of \$285,000 and the decrease in accrued expenses of \$125,000. Cash flow was also impacted by financing activity relating to \$680,000 in bank loan payments, \$75,000 in investing activity associated with the acquisition of equipment and a current net investment in marketable securities of \$395,000. The net of this activity resulted in a net decrease in cash for the first nine months of 2005 of \$1,012,000 resulting in a cash balance at September 24, 2005 of \$7,107,000.

Spectrum was not in compliance with one of its loan covenants as of September 24, 2005 relating to cash flow to debt coverage. The Company received a covenant violation waiver from its bank on November 14, 2005.

In December of 2001 Spectrum entered into 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 is now listed on the OTC

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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. The amount of the Arbios investment was adjusted to \$961,000 as of December 25, 2004, per the listed trade quote of \$2.65. Based on Arbios most recent trade price of \$1.90, as of September 23, 2005, Spectrum reflected a decrease in fair market value during the first nine months of 2005 of \$272,000 to \$689,000 on its balance sheet as of September 24, 2005. 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 31, 2005 and the subsequent years ending December 31 are as follows: final quarter 2005 \$113,000 and \$106,000 year ending 2006 (total \$219,000).

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 and subsequently filed a number of amendments. A definitive Schedule 14C

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was filed on November 2, 2005. In addition the Company filed a Schedule 13E-3 Transaction Statement on October 13, 2004 with the latest amended Schedule 13E-3A being filed on October 25, 2005. The Company has recognized approximately \$115,000 in expense relating to going private, \$50,000 in the nine months of fiscal 2005 and \$65,000 in fiscal 2004. Spectrum currently estimates it will amend its Certificate of Incorporation in late November or early December of 2005 to effectuate the above discussed reverse stock split. Subsequently the Company will file Form 15 with the SEC, to effectuate being a private company.

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

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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

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 did not file a Form 8-K during the quarter ended September 24, 2005.

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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 November 14, 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