INTERNATIONAL ISOTOPES INC
Form 10QSB
November 04, 2004

FORM 10-QSB

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

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

For the quarterly period ended
September 30, 2004

Commission file number:
0-22923

INTERNATIONAL ISOTOPES INC.
(Exact name of registrant as specified in its charter)

Texas	74-2763837
(State of incorporation)	(IRS Employer Identification Number)

4137 Commerce Circle, Idaho Falls, Idaho	83401
(Address of principal executive offices)	(zip code)

208-524-5300
(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 [X] NO [ ]

As of November 3, 2004 the number of shares of Common Stock, $.01 par value, outstanding was 159,066,260.

INTERNATIONAL ISOTOPES INC.

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Part I. Financial Statements

Item 1. Financial Statements

INTERNATIONAL ISOTOPES INC. AND SUBSIDIARIES
Unaudited Condensed Consolidated Balance Sheets

Assets	September 30, 2004	December 31, 2003
Current assets:		
Cash and cash equivalents	$ 667,459	$ 160,216
Accounts receivable	502,153	203,152
Inventories	2,218,160	2,283,752
Prepaids and other current assets	67,605	190,979
Total current assets	3,455,377	2,838,099
Long-term assets		

Restricted certificate of deposit	152,239	150,573
Property, plant and equipment, net	844,790	617,287
Capitalized lease disposal costs, net of accumulated amortization of $44,505 and $35,604 respectively	104,827	113,728
Patents, net of accumulated amortization	97,125	--
Total long-term assets	1,198,981	881,588
Total assets	$ 4,654,358	$ 3,719,687
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 301,031	$ 320,554
Accrued liabilities	211,549	150,475
Current installments of notes payable	28,000	756,725
Total current liabilites	540,580	1,227,754
Long-term liabilities		
Obligation for lease disposal costs	149,332	149,332
Notes payable, excluding current installments	2,260,467	898,664
Mandatorily redeemable preferred stock, $0.01 par value; 850 shares outstanding	850,000	850,000
Total long-term liabilities	3,259,799	1,897,996
Stockholders' equity		
Common stock, $0.01 par value; 250,000,000 shares authorized; 159,064,660 and 139,363,046 shares issued and outstanding, respectively	1,590,646	1,393,630
Additional paid-in capital	87,773,531	87,168,957
Accumulated deficit	(88,510,198)	(87,968,650)
Total stockholders' equity	853,979	593,937
Total liabilities and stockholders' equity	$ 4,654,358	$ 3,719,687

See accompanying notes to condensed consolidated financial statements.

INTERNATIONAL ISOTOPES INC. AND SUBSIDIARIES
Unaudited Condensed Consolidated Statements of Operations

	Three Months ended September 30,		Nine Months
	2004	2003	2004
Sale of product	$ 985,072	$ 552,020	$ 2,195,7
Cost of product	582,418	320,761	1,351,1

Gross profit	402,654	231,259	844,6
Operating costs and expenses:			
Salaries and contract labor	175,735	129,196	494,4
General, administrative and consulting	215,055	172,464	744,0
Research and development	13,313	18,913	40,2
Total operating expenses	404,103	320,573	1,278,7
Operating loss	(1,449)	(89,314)	(434,1
Other income (expense):			
Other income (expense)	1,684	(1,986)	10,4
Interest income	493	548	1,8
Interest expense	(40,591)	(32,512)	(119,6
Total other expense	(38,414)	(33,950)	(107,4
Net Loss	$ (39,863)	$ (123,264)	$ (541,5
Net loss per common share - basic and diluted	$ --	$ --	$ --
Weighted common shares outstanding - basic and diluted	159,064,660	102,871,252	147,936,8

See accompanying notes to condensed consolidated financial statements.

INTERNATIONAL ISOTOPES INC. AND SUBSIDIARIES
Unaudited Condensed Consolidated Statements of Cash Flows

	Nine Months ended September	
	2004	2003
Cash flows from operating activities:		
Net loss	$ (541,548)	$ (456
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	130,315	69
Loss on disposal of property, plant and equipment	380	
Changes in operating assets and liabilities:		
Accrued interest on restricted certificate of deposit	(1,666)	
Accounts receivable	(299,001)	(71
Prepaids and other assets	123,374	(76
Inventories	65,592	69
Accounts payable and accrued liabilities	87,601	91

Net cash used in operating activities	(434,953)	(374
Cash flows from investing activities:		
Purchase of patents	(105,000)	
Purchase of property, plant and equipment	(341,422)	(244
Proceeds from sale of assets held for sale	--	262
Net cash provided by (used in) investing activites	(446,422)	17
Cash flows from financing activities:		
Proceeds from exercise of warrants	801,590	
Offering costs	--	(112
Proceeds from issuance of debt	603,950	760
Principal payments on notes payable	(16,922)	(308
Net cash provided by financing activities	1,388,618	338
Net change in cash and cash equivalents	507,243	(18
Cash and cash equivalents at beginning of period	160,216	441
Cash and cash equivalents at end of period	$ 667,459	$ 423
Supplemental disclosure of cash flow activities:		
Cash paid for interest, net of amounts capitalized	$ 60,893	$ 84
Supplemental disclosure of noncash transactions:		
Note payable converted from interest payable	$ 46,050	$
Renewal/renogiation of note payable	733,595	
Acquisition of equipment for note payable	--	17
Sale of assets held for sale through assumption of debt	--	345
Conversion of debt and accrued interest to rights offering	--	906
Common stock issued in rights offering for note receivable	--	406

See accompanying notes to condensed consolidated financial statements

INTERNATIONAL ISOTOPES INC. AND SUBSIDIARIES
Notes to Unaudited Condensed Consolidated Financial Statements

(1) The Company and Basis of Presentation

International Isotopes Inc (the Company) was incorporated in Texas in November 1995. The Company owns 100% of the outstanding common shares of International Isotopes Idaho, Inc. (I4) and Gazelle Realty Inc. Gazelle Realty Inc. was dissolved in December 2003.

Nature of Operations - The Company is a manufacturer of calibration and reference standards for nuclear medicine, offers a selection of radioisotopes (lutetium-177 and iodine-131) and radiochemicals for various applications such as clinical research, supplies bulk cobalt-60 isotope for use in various devices, recycles certain expended cobalt sources, and provides general radiological measurement capability for processed gemstones. With the exception of cobalt-60, the Company's normal operating cycle is considered to be one year. Due to the time required to produce high specific activity (HSA) cobalt-60, the Company's operating cycle for the cobalt-60 is considered to be three years. All assets expected to be realized in cash or sold during the normal operating cycle of business are classified as current assets. As of September 30, 2004, the Company had 14 full time employees.

Principles of Consolidation - The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary International Isotopes Idaho, Inc. All significant intercompany accounts and transactions have been eliminated in consolidation.

Information About Major Customers - The Company has two major customers which respectively represent approximately 35% and 47% of revenues.

Interim Financial Information - The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation have been included and are of a normal recurring nature. Operating results for the nine-month period ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. The accompanying financial statements should be read in conjunction with the Company's annual financial statements included in its annual report on form 10KSB as of December 31, 2003.

Stock-based Compensation Plans - The Company accounts for stock options issued to directors, officers and employees under Accounting Principles Board Opinion No. 25 and related interpretations ("APB 25"). The Company accounts for options and warrants issued to non-employees at their fair value in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123").

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No compensation cost has been recognized for its stock options in the accompanying consolidated financial statements. Had the Company determined compensation cost based on the fair value at the grant date for its stock options under SFAS No. 123, the Company's net loss applicable to common shareholders would have been increased to the pro forma amounts indicated below for the three and nine months ended September 30, 2004 and 2003:

	For the Three Months Ended		For
	September 30, 2004	September 30, 2003	September
Net loss as reported	$ (39,86)	$ (123,264)	$
Deduct: Total stock-based employee			

compensation expense determined under fair value based method for all awards, net of related tax effects	$ (89,987)	$ (20,291)	$
Pro forma net loss	$ (129,850)	$ (143,555)	$
Loss per share, basic and diluted:			
As reported	$ --	$ --	$
Pro forma	$ --	$ --	$

(2) Current Developments and Liquidity

Business Condition - Since inception, the Company has suffered substantial losses. During the three and nine-month periods ended September 30, 2004 the Company had a loss of $39,863 and $541,548 respectively compared to a loss of $123,264 and $456,842 during the same periods ended September 30, 2003. During the nine-month period ended September 30, 2004, the Company's operations used cash of $434,953. During the period ended September 30, 2003, the Company's operations used cash of $374,460. The Company has taken steps to further improve financial performance and diversify their customer base. In the Company's main production facility the construction of additional hot cells and new production contracts for isotope sales, source recycling, and cobalt source fabrication will all lead to increased revenue and improved cash flow. In addition, the Company's Fluorine Products Division is developing manufacturing capability for high purity fluorine gases which will begin to contribute to Company revenue in early 2005. Therefore, management expects to generate sufficient cash flows to meet operational needs during the remainder of 2004 through increased sales, financing, and operating capital; however, there is no assurance that adequate cash flow will occur to continue operations for a reasonable period of time.

(3) Net Loss Per Common Share - Basic and Diluted

As of September 30, 2004 there were 67,878,692 warrants and 17,500,000 options outstanding respectively, and 850 shares of Series B redeemable convertible preferred stock that were not included in the computation of diluted net loss per common share as their effect would have been anti-dilutive, thereby decreasing the net loss per common share.

(4) Inventories

Inventories consist of the following at September 30, 2004 and December 31, 2003:

	September 30, 2004	December 31, 2003
Raw materials	$ 268,265	$ 268,265
Work in progress	1,946,897	2,007,066
Finished goods	2,998	8,421
	$ 2,218,160	$ 2,283,752

(5) Acquisition of license rights

During the nine months ended September 30, 2004, the Company completed the purchase of certain assets, patents and intellectual property related to the fluorine extraction process. The patents were acquired for $105,000 and the equipment for $10,000. The patents and equipment will be amortized/depreciated over their estimated useful lives, which are 10 years for the patents and 5 years for the equipment.

(6) Notes Payable

The Company completed an unsecured note purchase agreement on January 21, 2004 with certain of the Company's principal shareholders and Directors totaling $650,000. This is an unsecured note accruing interest at 6% per year with a maturity date of December 31, 2005. Interest is to be paid on this note on a semi-annual basis and the Company has the option to prepay the principal balance at any time prior to maturity. The principal of the note and any accrued interest is convertible into shares of the Company's common stock at any time at the option of the holder prior to maturity. The conversion price for this conversion option is $0.18 per share, which was the market value of the common stock on the date the note was issued.

In July 2004, the Company renewed the terms of a note with a bank. The new terms extend the due date of the note to February 1, 2006 and set the interest rate at 7.5% through July 1, 2005 and then at a variable rate through maturity. At June 30, 2004 the balance outstanding that was renewed was $733,595. The Company also renewed with the same bank its $250,000 revolving line of credit changing the due date to July 1, 2005 and fixing the interest rate at the bank's prime rate plus 1% ($0 outstanding at September 30, 2004). The loans are secured with accounts receivables, inventory and equipment.

(7) Stockholders' Equity and Warrants

For the nine-months ended September 30, 2004, 19,701,614 warrants were exercised and exchanged for 19,701,614 shares of the Company's common stock. The Company received $801,590 for the exercise of these warrants.

During August 2004, the Company granted 1,500,000 options to a new employee to purchase shares of common stock with an exercise price of $0.17 per share, which was equal to the closing market price of the common stock on the date of grant. These options vest through August 2007 in increments of 25% per year.

(8) Commitments and Contingencies

Litigation

During February 2004, a lawsuit was filed by Iso-Science Laboratories, Inc. dba Isotope Products Laboratories in the Superior Court of the State of California for the County of Los Angeles against the Company, the Company's President and CEO, a significant customer of the Company and certain officers of this significant customer. The lawsuit contains numerous allegations against the defendants relating to the manufacture and sale of calibration and reference standards for nuclear medicine. The lawsuit alleges the defendants are using information and equipment that the plaintiff acquired from a previous employer of one of the defendants. The lawsuit also alleges unfair trade practices, interference with prospective business relationships, and conspiracy. The plaintiff seeks an injunction to restrain the Company from manufacturing, marketing, or selling any of the products in question; a 55% royalty of the price of all related products sold by the Company; the return of all equipment and information in question; disgorgement of profits received for the manufacture and sale of the products in question; and general and punitive damages in an amount to be shown at the time of trial. In March 2004, the Company filed a response to the lawsuit in which the Company denied all of the allegations made in the suit. In addition, the Company has filed a counterclaim against Isotopes Products Laboratories on the basis that Isotopes Products Laboratories filed the suit against the Company with the knowledge that it has no basis in law or fact and the lawsuit was calculated to interfere with the Company's contractual arrangements and prospective business between the Company and its customers. On July 29, 2004 the court granted the Company's motion to dismiss all charges against the Company's President and CEO, Steve T. Laflin. On October 25, 2004 the court established an anticipated trial start date of December 5, 2005. The Company will continue to vigorously defend itself in the lawsuit; however, an outcome favorable to the Company is not determinable at this time. Should this lawsuit be settled in a manner unfavorable to the Company, the Company could lose its major line of revenues and could be required to make substantial payments to the plaintiff. The Company has a manufacturing agreement in place with this significant customer, which indemnifies the Company and its officers from any loss arising from this suit. However, there is no guarantee that this significant customer can bear the financial burden arising from defending and possible settlement of this lawsuit.

Dependence on Third Parties

The production of HSA Cobalt is dependent upon the Department of Energy, and its prime-operating contractor, who controls the reactor and laboratory operations. Revenue associated with the sale of HSA Cobalt and nuclear medicine calibration and reference standards are largely dependent on two major customers. A loss of any of these customers or vendors could adversely affect operating results by causing a delay in production or a possible loss of sales.

Contingencies

The Company conducts its operations under an operating license from the Nuclear Regulatory Commission ("NRC"). The details of this license determine the scope of permitted operations and amendments are required to either increase the amount of material permitted or change the types of activities conducted within the facility. The Company is required to maintain a funding reserve adequate to address future decommissioning of the facility. An irrevocable, automatically renewable letter of credit against a $152,239 Certificate of Deposit at Texas State Bank has been used to provide this financial assurance.

(9) Subsequent Events

In October 2004, the Company aquired all the intellectual property associated with detailed design of a Type B transportation container.

In October 2004, the Company submitted an application for sealed source registration to the Nuclear Regulatory Commission for a wide range of cobalt teletherapy source capsules. These are generic sealed sources compatible with a wide range of commercially available teletherapy units.

During October 2004, 1,600 warrants were exercised and exchanged for 1,600 shares of the Company's common stock. The Company received $72 for the exercise of these warrants.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Except for historical information contained herein, the following contains forward-looking information that is subject to certain risks and uncertainties. The Company's actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors including those set forth in the "Risk Factors" section included in the Company's Form 10-KSB, filed with the Securities Exchange Commission (SEC) on March 24, 2004 ("Form 10-KSB"). The following discussion should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the Form 10-KSB.

RESULTS OF OPERATIONS

Three and nine-month periods ended September 30, 2004 and 2003. The Company's losses from operations for the three and nine-month periods ended September 30, 2004 were $39,863 and $541,548 respectively, as compared to loss from operations of $123,264 and $456,842 for the comparable periods of 2003. The decrease in net loss for the three-month period was attributable to increased revenue from sales during the period. The increase in net loss for the nine months is attributable to increased cost of goods sold and operational expense for new products, such as the Fluorine Extraction Process (FEP) production operation that was being developed during the period.

Revenue for the three and nine-month periods ended September 30, 2004 were $985,072 and $2,195,756 respectively, as compared to $552,020 and $1,696,703 for the same periods in 2003. These represent an increase of $433,052 (or 78%) and $499,053 (or 29%) respectively. The increase in revenue for both periods was attributable to increased sale of HSA cobalt and new revenues resulting from the sale of newly developed products such as radiochemicals and cobalt source recycling. Gross profit for the three and nine-month periods ended September 30, 2004 was $402,654 and $844,603 respectively, as compared to $231,259 and $734,291 for the same periods in 2003 representing increases of 74% and 15% respectively. However, gross profit, as a percentage of revenues, declined by 1% and 5% respectively for the three and nine-month periods ended September 30, 2004 compared to the same periods for 2003. This slight decline in gross profit percentage was attributable to slightly higher cost of goods sold for new products.

Operating expenses were $404,103 and $1,278,751 respectively for the three and nine-month periods ended September 30, 2004 compared to $320,573 and $1,110,888 for the same periods of 2003. Salaries and contract labor expenses for the three and nine-month periods ended September 30, 2004 were $175,735 and $494,425 respectively, as compared to $129,196 and $342,948for the same periods of 2003, an increase of $45,539 and $151,477 respectively. General, administrative and consulting expenses totaled $215,055 and $744,034 respectively for the three and nine-month periods ended September 30, 2004 as compared to $172,464 and $726,314 for the same periods of 2003, an increase of $42,591 and $17,720 respectively. The overall increase in operating expense was largely attributable to increased expenditures, such as wages and marketing consultants, associated with development of new products and start-up of the Company's new FEP product division.

Interest expense for the three and nine-month period ended September 30, 2004 was $40,591 and $119,646 as compared to $32,512 and $114,712 for the comparable periods in 2003, an increase of $8,079 and $4,934 respectively.

Liquidity and Capital Resources

On September 30, 2004 the Company had cash and cash equivalents of $667,459 compared to $160,216 at December 31, 2003. For the nine months ended September 30, 2004, operating activities used cash of $434,953, investing activities used cash of $446,422 and financing activities provided cash of $1,388,618. Cash from financing activities consisted primarily of notes provided by several principals and directors and the conversion of warrants to common stock.

The Company has financed its operations since inception primarily by bank loans, sales of accelerator components and excess equipment, its initial public offering, sales of shares of common and preferred stock in private placements to investors, and loans from stockholders and directors.

The Company's future liquidity and capital funding requirements will depend on numerous factors, including, but not limited to, contract manufacturing agreements, commercial relationships, technological developments, and certain market factors. The Company still has a significant amount of Series A and B warrants that remain outstanding from the Company's Rights Offering conducted in 2003. Funds from the additional conversion of those warrants should be adequate to pay down certain of the Company's long-term liabilities and to generate additional cash for the acquisition of assets and continued development of the Fluorine Extraction Process (FEP). This should continue to improve the Company's financial strength, debt ratio, and attractiveness to investors or lending institutions.

Although there can be no assurances, the Company expects that revenues will continue to increase. These increased revenues will provide sufficient funds for operations and capital expenditures. The Company has made significant investments into assets necessary to carry out new revenue-producing operations and to manufacture new products. These include radiochemical sales and the installation of a large cobalt-60 processing hot cell that will support a wide range of cobalt products such as cobalt source recycling services and teletherapy source manufacturing. The Company expects these new business areas to make a significant contribution towards further growth in revenue and our customer base in 2005. In addition, the Company continues to make significant investments in and advancement towards, the start of fluorine producing operations utilizing the patented FEP process. The first of the Company FEP products is expected to be launched by the second quarter of 2005.

ITEM 3. CONTROLS AND PROCEDURES

(a) The Company maintains controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Based upon their evaluation of those controls and procedures performed within 90 days of the filing date of this report, the chief executive officer and the principal financial officer of the Company concluded that the Company's disclosure controls and procedures were adequate.

(b) Changes in internal controls. The Company made no significant changes in its internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation of those controls by the chief executive officer and principal financial officer.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

During February 2004, a lawsuit was filed by Iso-Science Laboratories, Inc. dba Isotope Products Laboratories in the Superior Court of the State of California for the County of Los Angeles against the Company, the Company's President and CEO, a significant customer of the Company and certain officers of this significant customer. The lawsuit also alleges unfair trade practices, interference with prospective business relationships, and conspiracy. The plaintiff seeks an injunction to restrain the Company from manufacturing, marketing, or selling any of the products in question; a 55% royalty of the price of all related products sold by the Company; the return of all equipment and information in question; disgorgement of profits received for the manufacture and sale of the products in question; and general and punitive damages in an amount to be shown at the time of trial. In March 2004, the Company filed a response to the lawsuit in which the Company denied all of the allegations made in the suit. In addition, the Company has filed a counterclaim against Isotopes Products Laboratories on the basis that Isotopes Products Laboratories filed the suit against the Company with the knowledge that it has no basis in law or fact and the lawsuit was calculated to interfere with the Company's contractual arrangements and prospective business between the Company and its customers. On July 29, 2004 the court granted the Company's motion to dismiss all charges against the Company's President and CEO, Steve T. Laflin. On October 25, 2004 the court established an anticipated trial start date of December 5, 2005. The Company will continue to vigorously defend itself in the lawsuit; however, an outcome favorable to the Company is not determinable at this time.

Item 5. Other Information

None

Item 6. Exhibits

Exhibits:

31 Certification by the Chief Executive and Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Certification by the Chief Executive and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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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 hereunto duly authorized.

International Isotopes Inc.
(Registrant)

By: /s/ Steve T. Laflin

Steve T. Laflin
President and Chief Executive Officer

Date: November 3, 2004

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ise for the remainder of 2001 as the Company plans to aggressively promote the features of its recent and expected software product releases as well as the Tools4Mfg.com web site. During the three months ended September 30, 2001 and 2000, the Company devoted significant time and resources to finalizing the release of its new products. During the three months ended September 30, 2001 and 2000, the Company invested over 32% and 35%, respectively, of net sales or $404,000 and $469,000, respectively, in the forms of capitalized software development costs and research and development activities. The capitalized software development investment has declined in dollars as well as a percentage of net sales from 2000 levels due to the completion and release of the CAMWorks and Machine Shop Estimating upgrades during the three months ended June 30, 2001 whereas the Company was working on these development projects as well as the ProCAM II upgrade in 2000. Total research and development costs expensed during the three months ended September 30, 2001 and 2000, were $71,000 and $115,000, respectively. Total costs capitalized as software development costs were $333,000 and $354,000 for the three months ended September 30, 2001 and 2000, respectively. Management expects capitalized software and research and development costs to remain steady for the remainder of 2001. Goodwill and other intangible amortization expenses were $335,000 and $303,000 for the three months ended September 30, 2001 and 2000, respectively. The increase is related to the TekSoft acquisition on January 31, 2000. Goodwill amortization was $296,000 and $264,000 for the three months ended September 30, 2001 and 2000, respectively. Other intangible amortization was comprised of amortization of the assembled workforce, trade names and distribution network intangible assets acquired as part of the TekSoft acquisition. Goodwill and other intangible amortization expenses are expected to remain constant for the remainder of 2001. General and administrative expenses decreased to $519,000 or 41% of net sales for the three months ended September 30, 2001 as compared to the $637,000 or 47% of net sales for the three months ended September 30, 2000. The decrease in general and administrative expenses from the three months ended September 30, 2000 is largely related to lower accounting fees and reduced amortization of a professional services contract for consulting services. The Company issued 300,000 shares of common stock for these services at a value of $2.00 per share on May 19, 2000. This contract was subsequently extended to February 19, 2002, for no additional consideration, which reduced the monthly expense from $50,000 to $14,000 per month starting in February 2001. The amortization of this professional services contract resulted in general and administrative expense of $42,000 and $150,000 for the three months ended September 30, 2001 and 2000, respectively. Management expects some increase in general and administrative costs associated with new business initiatives as well as the normal increase in administrative resources required to support ongoing growth. Interest expense increased to $37,000 for the three months ended September 30, 2001 from $29,000 for the same period in 2000. This increase is attributed to additional debt incurred by the Company that was used to finance the development of the Company's computer-aided-manufacturing and computer-aided-engineering software products. However, lower interest rates on its line of credit facility as well as a reduced interest rate on its term debt helped interest expense to increase at a lower rate than the increase in bank debt. Management expects interest expense to increase during the remainder of 2001, as the company will incur additional debt that will be used to promote its enhanced software products and the Tools4Mfg.com web site and to compensate for the lower sales volumes. After interest expense, the Company had a pre-tax loss of $762,000 for the three months ended September 30, 2001 as compared to the $824,000 pre-tax loss for the same period in 2000. The net loss after tax benefits was $584,000 and $629,000 for the three months ended September 30, 2001 and 2000, respectively. NINE MONTHS ENDED SEPTEMBER 30, 2001 AND 2000 The Company's net sales increased from $3,737,000 for the nine months ended September 30, 2000 to $3,997,000 for the same period in 2001 for a 7% increase. The increase is partially related to the Company having nine months of TekSoft net sales in 2001 compared to only eight months of net sales for the same period in 2000. Management believes that sales for the nine months ended September 30, 2001, which were below expectations, reflects the general concerns and conservative outlook that the metal working industry has taken given the many negative domestic and global economic indicators reported prior to and during the nine-month period ended September 30, 2001. Strong sales growth in the Company's computer-aided-design/computer-aided-manufacturing (CAD/CAM) software products and the introduction of Tools4Mfg.com helped to offset a decline in computer-aided-estimating (CAE) software sales. Cost of goods sold was $1,374,000 or 34% of net sales for the nine months ended September 30, 2001 as compared to the $1,250,000 or 33% of net sales for the nine months ended September 30, 2000. The gross margin percentage for the nine months ended September 30, 2001 declined from the same period in 2000 largely due to sales increases that were at a lower rate than the increase in the capitalized software amortization expense for the Machine Shop Estimating and CAMWorks software products which were released in April 2001 and May 2001, respectively, and other cost of goods sold components. Selling expenses decreased 6% to $1,725,000 for the nine months ended September 30, 2001 as compared to $1,841,000 for the same period in 2000. Selling expenses as a percentage of net sales were 43% and 49% for the nine months ended September 30, 2001 and 2000, respectively. Lower advertising and other general selling expenses accounted for the decrease. During the nine months ended September 30, 2001 and 2000, the Company devoted significant time and resources to finalizing the release of its new products. During the nine months ended September 30, 2001 and 2000, the Company invested over 30% and 38%, respectively, of net sales or $1,212,000 and $1,412,000, respectively, in the forms of capitalized software development costs, internal research and development activities and purchased in-process research and development related to the TekSoft acquisition. Total research and development costs expensed during the nine months ended September 30, 2001 and 2000, were $232,000 and $219,000, respectively. Total purchased in-process research and development costs expensed during the nine months ended September 30, 2001 and 2000, were $0 and $270,000, respectively. Total costs capitalized as software development costs were $979,000 and $923,000 for the nine months ended September 30, 2001 and 2000, respectively. Goodwill and other intangible amortization expenses were $1,007,000 and $790,000 for the nine months ended September 30, 2001 and 2000, respectively. The increase is largely related to the TekSoft acquisition in which nine months of amortization occurred in 2001 as compared to only eight months in 2000. Goodwill amortization was $891,000 and $687,000 for the nine months ended September 30, 2001 and 2000, respectively. Other intangible amortization was comprised of amortization of the assembled workforce, trade names and distribution network intangible assets acquired as part of the TekSoft acquisition. General and administrative expenses increased to $1,646,000 or 41% of net sales for the nine months ended September 30, 2001 as compared to the $1,467,000 or 39% of net sales for the nine months ended September 30, 2000. The increase from the nine months ended September 30, 2000 is largely related to the professional and legal expenses incurred in 2001 associated with the Company's initial 10-SB and various other SEC filings. A lesser portion of the expenses related to SEC filings were incurred during the nine months ended September 30, 2000 since the Company didn't obtain full reporting status until December 2000. In addition, some of the professional and legal expenses incurred during the nine months ended September 30, 2000 were offset against equity in conjunction with the Company's equity fund raising efforts. Interest expense increased to $94,000 for the nine months ended September 30, 2001 from $72,000 for the same period in 2000. This increase is attributed to additional debt incurred by the Company that was used to finance the development of the Company's computer-aided-manufacturing and computer-aided-engineering software products. After interest expenses, the Company had a pre-tax loss of $2,081,000 for the nine months ended September 30, 2001 as compared to the $2,165,000 pre-tax loss for the same period in 2000. The net loss after tax benefits was $1,684,000 and $1,760,000 for the nine months ended September 30, 2001 and 2000, respectively. LIQUIDITY AND CAPITAL RESOURCES OnCourse has incurred losses over the last two years and has negative working capital. Based upon its current plans, the Company believes it has sufficient funds and borrowing availability to meet its operating expenses and capital requirements through fiscal year 2001 and into fiscal year 2002. However, the Company intends to seek such additional funding from equity offerings to existing shareholders or other third parties during 2001. There is no assurance that such additional funds will be available on acceptable terms, if at all. Should the plans contemplated by management not be consummated, the Company may have to seek alternative sources of capital, affect borrowing under its line of credit or reevaluate its operating plans. The Company's cash position as of September 30, 2001 was approximately $107,000 as compared to $200,000 as of December 31, 2000. During the nine months ended September 30, 2001, net cash provided by operating activities was $227,000 versus $665,000 for the nine months ended September 30, 2000. Cash flows used in investing activities were $1,069,000 and $1,071,000 for the nine months ended September 30, 2001 and 2000, respectively. The Company invested $979,000 in capitalized software development costs for the nine months ended September 30, 2001 compared to $923,000 for the same period in 2000. The Company had positive cash flows from financing activities of $749,000 and $434,000 for the nine months ended September 30, 2001 and 2000, respectively. The financing activities for the nine months ending September 30, 2001 were primarily comprised of $419,000 of net proceeds from term debt and issuance of preferred stock and common stock of $192,000 and $107,000, respectively. The Company's working capital as of September 30, 2001 was a negative $1,148,000 as compared to the negative working capital of $971,000 as of December 31, 2000. This represents a decrease of $177,000 in working capital over the December 31, 2000 balance. Working capital, excluding deferred revenue, was $482,000 at September 30, 2001 as compared to $653,000 as of December 31, 2000. The Company had total interest bearing debt of $1,848,000 and $1,395,000 as of September 30, 2001 and December 31, 2000, respectively, consisting of current and long-term portions of a line of credit, term debt, capital leases and notes payable to shareholders. This represents an increase of $452,000 during the nine months ended September 30, 2001, which was largely made up of a $419,000 net increase in the Company's term debt. The Company's $1,100,000 long-term line of credit facility had outstanding borrowings of $830,000 as of September 30, 2001. Shareholder's Equity decreased from $10,742,000 as of December 31, 2000 to $9,622,000 as of September 30, 2001. The decrease in Shareholder's Equity since December 31, 2000 is largely attributed to the $1,684,000 net loss incurred during the nine months ended September 30, 2001. Offsetting the net loss was $192,000 of preferred stock issued for cash, $197,000 of additional common stock issued for cash, services and compensation, $56,000 of stock options granted for services, $120,000 of additional common stock issued for contingent shares earned by former shareholders of TekSoft and Cimtronics according to their respective purchase agreements and accrued dividends of $1,000. The Company invested $979,000 in capitalized software for the nine months ended September 30, 2001. This compares to $923,000 for the same period in 2000. The significant investment during the nine months ended September 30, 2001 was mostly attributed to feature enhancements to TekSoft's computer-aided- manufacturing software. The Company released its new versions of its Machine Shop Estimating computer-aided-engineering software and CAMWorks' computer- aided-manufacturing software in April 2001 and May 2001, respectively. The Company is currently in beta testing of its ProCAM II computer-aided- manufacturing software with a release date scheduled for towards the end of November 2001. The Company is also in beta testing of the raw materials procurement capabilities of its Tools4Mfg.com web site with a release date scheduled for November 2001. The Company intends on financing future expenditures for property and equipment, capitalized software and sales growth using internally generated cash flows from operations. The Company has approximately $270,000 available as of September 30, 2001 under its long-term revolving line of credit facility. Additional sales of common stock, if any, through private placement activities will help supplement internally generated cash flows in meeting the Company's operating and growth needs. PART II - OTHER INFORMATION ITEM 1. LEGAL PROCEEDINGS Neither the Company nor any of its subsidiaries are involved in any legal proceedings the resolution of which would have a material adverse effect on the business or financial condition of the Company. ITEM 2. CHANGES IN SECURITIES During the three months ended September 30, 2001, the Company entered into a stock purchase agreement with a third-party vendor ("Purchaser"). The agreement provided for the sale of up to 275 shares of non-voting 3% Series A Cumulative Convertible Preferred Stock of the Company without par value. The Purchaser agreed to purchase the shares in blocks of 192 and 83 shares at a stated value of $1,000 per share. During the three months ended September 30, 2001, 192 shares were purchased for a total of $192,000. The Purchaser is obligated over a two-year period to purchase the remaining 83 shares at a price of $1,000 per share upon the Company satisfactorily completing the conditions spelled out in the agreement. The conditions include the Company opening offices and or distribution channels in three specified geographic locations and maintaining an aged trade payable balance that is less than 90 days past due. The agreement entitles holders of the Series A Preferred Stock cumulative annual dividends at an annual rate of 3% of the stated value in cash for each share held. In the event that the two-year period lapses without the Company fulfilling the conditions stated in the agreement, the Purchaser no longer has an obligation to purchase the remaining 83 shares and the dividend rate on the 192 shares purchased shall increase to an annual rate of 7%. Under the agreement, the Series A Preferred Stock shall rank senior to the Common Stock and all other equity securities of the Company issued and outstanding on or after the first issuance date of any of the Series A Preferred Stock as to distributions and upon liquidation, dissolution or winding up. The holders, at their election, have the right at any time to convert Series A Preferred Stock into shares of Common Stock by converting the stated value at $.60 per share. Each common stock share resulting from the conversion will be entitled to receive one Class A Warrant and one Class B warrant of the Company. Each Class A warrant will be exercisable at a price of $1.25 per share at any time within three years of the warrant issuance date. Each Class B warrant will be exercisable at a price of $1.25 per share at any time within five years of the warrant issuance date. In addition, the purchaser is entitled to elect one member to the Board of Directors of the Company for so long as any shares of Series A Preferred stock are outstanding. During the three months ended September 30, 2001, the Company accrued dividends of $1,278 under this agreement. On September 30, 1999, the Company acquired Cimtronics for 153,846 shares to the former shareholders of Cimtronics. In addition, under the terms specified in the purchase agreement, the former shareholders of Cimtronics may receive up to 153,846 additional shares over the next five years if net profits, as defined in the agreement, increases. For the twelve months ended September 30, 2001, the net profit increase resulted in an additional 93,719 shares issued to the former shareholders of Cimtronics at a value of approximately $.17 per share. An additional $15,585 was allocated to goodwill, which will be amortized over its remaining useful life. During the three months ended September 30, 2001, the Company offered and issued 14,232 shares of Company common stock, 14,232 Class A stock purchase warrants and 14,232 Class B stock purchase warrants as payment of $10,673 in professional services to a vendor. The warrants were issued with initial estimated values (based on Black-Scholes valuation model) ranging from $.12 to $1.36 for each Class A warrant and $.14 to $1.45 for each Class B warrant and expire in 2004 and 2006, respectively. Each warrant represents the right to purchase one share of the Company's common stock at an exercise price of $1.00. During the three months ended September 30, 2001, the Company offered and issued 11,538 shares of Company common stock as payment of $7,500 to a vendor for customer relationship software. During the three months ended June 30, 2001, the Company granted 140,000 options to an independent contractor at an exercise price of $0.65, and which vest over a 12-month period ending May 3, 2002. The options expire May 3, 2007. During the three months ended September 30, 2001, an additional 18,000 options became vested bringing the total to 94,000 vested options. In connection with these options, the Company recorded legal and professional expenses of $7,176 for the three months ended September 30, 2001. ITEM 3. DEFAULTS UPON SENIOR SECURITIES The Company was not in default with regards to its debt facilities. ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS There were no matters submitted during the three months ended September 30, 2001 covered by this report to a vote of security holders, through the solicitation of proxies or otherwise. ITEM 5. OTHER INFORMATION On November 1, 2001, the Company passed a board of director resolution restricting any shareholder presently owning one percent or more of the common stock of the Company from directly or indirectly selling, offering to sell, granting any option for the sale of, assigning, transferring, pledging or otherwise encumbering or disposing of any shares of common stock or securities convertible into, exercisable or exchangeable for or evidencing any right to purchase or subscribe for any share of common stock of the Company (either pursuant to Rule 144 and the regulations under the Securities Act of 1933 or otherwise) or disposing of any beneficial interest therein. This resolution was adopted to protect the interests of the Corporation and its stockholders and as a prerequisite to the willingness of certain investment banking and corporate economic image firms to assist the Company in implementing its growth strategies. In connection with such willingness of certain investment banking and corporate economic image firms, the Company is in the process of negotiating agreements with various entities to implement the Company's growth strategies. The restriction shall be effective immediately and shall continue for the lesser of two and one half years from the date of resolution, or two years from the date of retention to a corporate economic image firm. ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K (a) EXHIBITS REQUIRED BY ITEM 601 OF REGULATION S-B None required for the three months ended September 30, 2001. (b) REPORTS ON FORM 8-K None filed by the Company in the three months ended September 30, 2001. 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. OnCourse Technologies, Inc. a Nevada Corporation By: /s/Bernard A. Woods III Date: November 14, 2001 --------------------------- Bernard A. Woods III, CEO By: /s/Charles W. Beyer Date: November 14, 2001 --------------------------- Charles W. Beyer, President By: /s/William C. Brown Date: November 14, 2001 --------------------------- William C. Brown, CFO