SCOLR INC
Form 10QSB
November 14, 2003

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2003

OR

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

FOR THE TRANSITION PERIOD FROM ______ TO ______

COMMISSION FILE NUMBER 000-24693

SCOLR, INC.

(EXACT NAME OF SMALL BUSINESS ISSUER AS SPECIFIED IN ITS CHARTER)

DELAWARE	**91-1689591**
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	**(I.R.S. EMPLOYER IDENTIFICATION NO.)**

8340 154TH AVENUE NORTHEAST
REDMOND, WASHINGTON 98052
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE)

(425) 883-9518
(ISSUER S TELEPHONE NUMBER, INCLUDING AREA CODE)

Number of shares of issuer s common stock outstanding as of November 9, 2003: **21,381,086**

Transitional Small Business Disclosure Format: Yes o No x

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

SCOLR, Inc.
BALANCE SHEETS

	September 30, 2003 (Unaudited)	December 31, 2002 (As Restated)
ASSETS		
CURRENT ASSETS		
Cash	$ 2,015,418	$ 257,382
Accounts receivable, less allowance for doubtful accounts of $0 and $12,524, respectively	774,818	486,417
Current portion of notes receivable	196,923	166,154
Inventories, net	953,489	493,541
Debt issuance costs	1,146,579	
Prepaid expenses	326,237	138,448
Total current assets	5,413,464	1,541,942
PROPERTY AND EQUIPMENT net	1,318,635	1,494,315
OTHER ASSETS		
Intangible assets net	735,633	818,371
Noncurrent portion of notes receivable		55,385
	$ 7,467,732	$ 3,910,013
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Line of credit	$ 97,139	$ 296,387
Current maturities of long-term obligations	78,792	168,870
Current maturities of capital lease obligations	196,596	215,347
Stockholder loan payable, less discount on debt of $165,501	834,499	
Accounts payable trade	236,883	782,385
Accrued liabilities	171,843	124,645
Deferred revenue	235,687	100,000
Total current liabilities	1,851,439	1,687,634
LONG-TERM OBLIGATIONS, less current maturities	10,806	56,650
CAPITAL LEASE OBLIGATIONS, less current maturities	160,770	327,273
STOCKHOLDER LOAN PAYABLE, less discount on debt of $289,627		710,373
CONVERTIBLE LOAN PAYABLE, less discount on debt of $3,331,429	1,968,571	
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Preferred stock, authorized 5,000,000 shares, $.01 par value, none issued or outstanding		
Common stock, authorized 50,000,000 shares, $.001 par value	21,381	21,199
Additional contributed capital	18,532,835	14,041,051
Accumulated deficit	(15,078,070)	(12,934,167)
Total stockholders equity	3,476,146	1,128,083

	$ 7,467,732	$ 3,910,013

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

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SCOLR, Inc.
STATEMENTS OF OPERATIONS
(Unaudited and As restated)

	Three months ended September 30,		Nine months ended September 30,	
	2003	2002	2003	2002
Net revenues	$ 1,595,267	$ 1,645,130	$ 5,420,882	$ 5,198,402
Cost of revenues	1,126,573	1,214,358	3,654,610	3,998,535
Gross profit	468,694	430,772	1,766,272	1,199,867
Operating expenses				
Marketing and selling	97,212	71,659	366,710	268,125
Research and development	101,860	236,558	267,062	440,401
General and administrative	934,681	592,169	2,339,009	1,894,290
	1,133,753	900,386	2,972,781	2,602,816
Operating loss	(665,059)	(469,614)	(1,206,509)	(1,402,949)
Other income (expense)				
Interest expense	(588,539)	(80,876)	(956,878)	(214,979)
Other	8,894	1,157	19,483	(72,648)
	(579,645)	(79,719)	(937,395)	(287,627)
NET LOSS	$ (1,244,704)	$ (549,333)	$ (2,143,904)	$ (1,690,576)
Net loss per share, basic and diluted	$ (0.06)	$ (0.03)	$ (0.10)	$ (0.09)

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

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SCOLR, Inc.
STATEMENTS OF CASH FLOWS
Nine Months ended September 30,
(Unaudited)

	2003	2002
		(as restated)
Increase (Decrease) in Cash		
Cash flows from operating activities:		
Net loss	$(2,143,904)	$(1,690,576)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	364,385	363,640
Loss on the sale of equipment		36,228
Allowance for uncollectible notes receivable		5,528
Amortization of discount on debt	520,646	
Gain on sale of intangible assets	(5,670)	
Amortization of debt issuance costs	148,984	
Warrants issued for services	29,123	
Impairment of available-for-sale security		36,190
Changes in assets and liabilities		
Accounts receivable	(288,401)	144,073
Notes receivable	24,616	138,618
Inventories	(461,967)	252,766
Prepaid expenses	(187,789)	(94,655)
Accounts payable	(545,502)	428,618
Accrued liabilities and deferred revenue	182,885	19,292
Net cash used in operating activities	(2,362,594)	(360,278)
Cash flows from investing activities:		
Proceeds from sale of intangible assets	130,000	
Purchase of equipment and furniture	(48,002)	(38,005)
Proceeds from sale of equipment		49,488
Patent and technology rights expenditures	(180,276)	(91,352)
Net cash used in investing activities	(98,278)	(79,869)
Cash flows from financing activities:		
Payments on long-term obligations and capital lease obligations	(363,452)	(429,568)
Payments on bridge note payable	(550,000)	
Proceeds from shareholder note payable & long-term obligations	42,276	1,124,940
Proceeds from convertible note payable, net of issuance costs	4,634,897	
Proceeds from bridge note payable	505,250	
Net borrowings on line of credit	(199,248)	(866,295)
Net proceeds from issuance of common stock, net of costs	149,185	1,516,346
Net cash provided by financing activities	4,218,908	1,345,423
Net increase in cash	1,758,036	905,276
Cash at beginning of period	257,382	93,082
Cash at end of period	$ 2,015,418	$ 998,358

Cash paid during the year for:		
Interest	$ 283,248	$ 214,979
Noncash investing and financing activities:		
Purchase of equipment under capital lease obligations	$	$ 87,842
Issuance of warrants for debt issuance costs	$ 585,710	$ 331,002
Issuance of warrants with debt and beneficial conversion feature	$ 3,727,949	$

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

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SCOLR, Inc.

NOTES TO FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 FINANCIAL STATEMENTS

The unaudited financial statements of SCOLR, Inc. (the Company) have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. 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 condensed or omitted pursuant to such rules and regulations. The results of operations for interim periods are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2003. The accompanying unaudited financial statements and related notes should be read in conjunction with the audited financial statements and the Form 10-KSB of the Company for its fiscal year ended December 31, 2002.

NOTE 2 INVENTORIES

Inventories are stated at the lower of cost or market; cost is determined by the first-in, first-out method. Inventories consist of the following:

	September 30, 2003	December 31, 2002
Raw materials	$311,272	$270,165
Work in progress	470,922	206,386
Finished goods	212,978	52,467
	995,172	529,018
Less allowance for obsolete and slow moving items	41,683	35,477
	$953,489	$493,541

NOTE 3 SEPARATION AGREEMENT

The Company entered into a separation agreement with its former Chief Scientific Officer and a separation agreement with its former Vice President of Administration, Secretary and Treasurer, both of which became fully binding on the parties on March 31, 2001 and effective as of January 15, 2001. For the nine months ended September 30, 2003 and 2002, the Company recorded severance costs totaling $157,448 and $159,152, respectively. These costs have been classified from Other Expense, as previously reported, to General and Administrative expense.

NOTE 4 SALE OF PRODUCT LINE AND RELATED INTANGIBLE ASSETS

In February 2003, the Company sold its feed additive product line for $230,000, net of certain royalties, to a third party for $130,000 cash payment and an executed purchase order of inventory for the remaining $100,000. The assets sold included inventories of $2,019 and related intellectual property of $122,311 resulting in a net gain of $5,670.

NOTE 5 STOCK OPTIONS

The Company has stock-based employee compensation plans. The Company applies APB Opinion 25, *Accounting for Stock Issued to Employees*, and related Interpretations in accounting for its plans. Because the exercise price of the Company s common stock options equals the market price of the underlying stock on the date of the grant, no corresponding compensation expense has been recognized.

The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of SFAS 123 to its stock-based awards for the periods ended September 30:

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	Three months ended September 30, 2003	2002	Nine Months ended September 30, 2003	2002
Net loss, as reported	$ (1,244,704)	$ (549,333)	$ (2,143,904)	$ (1,690,576)
Total stock-based compensation expense determined under fair-value-based method	$ (220,274)	$ (31,773)	$ (429,922)	$ (95,318)
Pro forma net loss	$ (1,464,978)	$ (581,106)	$ (2,573,826)	$ (1,785,894)
Basic and diluted loss per share: As reported	$ (0.06)	$ (0.03)	$ (0.10)	$ (0.09)
Pro forma net loss per share	$ (0.07)	$ (0.03)	$ (0.12)	$ (0.09)

NOTE 6 EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share is based on the weighted average number of shares outstanding during the quarter and income available to common shareholders. Earnings (loss) per share assuming dilution is based on the assumption that outstanding stock options and warrants were exercised. The weighted average shares for computing basic earnings (loss) per share were 21,336,198 and 20,775,608 for the three months ended September 30, 2003 and 2002, respectively and 21,256,621 and 20,062,652 for the nine months ended September 30, 2003 and 2002, respectively. At September 30, 2003, there were 9,144,833 shares of potentially issuable common stock. Because of the net loss for the three months and nine months ended September 30, 2003 and 2002, potentially issuable common stock was not included in the calculation of diluted loss per share as their inclusion would be anti-dilutive.

NOTE 7 FINANCING EVENTS

Convertible Notes Payable

On June 25, 2003 the Company completed a private placement and issued $5.3 million of Convertible Notes due June 25, 2006. The transaction provided the Company with approximately $4.7 million in net proceeds. Interest accrues on the notes at 6% and is payable quarterly. Of the $5.3 million of notes issued, $75,000 were issued to Herbert L. Lucas, a director of the Company. The principal balance is convertible into shares of the Company s common stock at a conversion price equal to $1.05 per share, subject to certain anti-dilution adjustments. The Company exercised its right to force conversion of all the notes into shares of the Company s common stock, because the common stock traded at $2.10 or higher for 20 trading days within a 30-consecutive day trading period. As of November 11, 2003, the common stock has traded at $2.10 or higher for the 20 trading days within a 30-consecutive day trading period. Accordingly, the Company will issue 5,047,559 shares upon conversion of the notes effective December 15, 2003.

In accordance with EITF 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios*, and EITF 00-27, *Application of Issue No. 98-5 to Certain Convertible Instruments*, an embedded beneficial conversion feature should be recognized and measured by allocating a portion of the proceeds of the note equal to the intrinsic value of that feature to additional paid-in capital. That amount should be calculated at the commitment date as the difference between the conversion price and the fair value of the common stock into which the note is convertible, multiplied by the number of shares into which the note is convertible (intrinsic value). The fair value of the Company s common stock on June 25, 2003 was $1.77, resulting in a beneficial conversion feature of $0.72 per share. As a result, the Company recorded a discount on the note for the beneficial conversion feature of approximately $3.6 million, which is being recognized as interest expense over the earlier of the term of the notes (3 years) or upon the conversion of the notes into the Company s common stock. The convertible notes payable totaled $5,300,000 less the discount of $3,331,429 or $1,968,571 at September 30, 2003.

In consideration of certain placement services, the Company paid Taglich Brothers, Inc. a cash fee of approximately $200,000, issued $300,000 of convertible notes and issued warrants to purchase up to 476,191 shares at $1.155 per share. Michael N. Taglich, an affiliate of Taglich Brothers, Inc. became a director of the Company on August 17, 2003. The fair value of the warrants was determined using the Black-Scholes option pricing model using the following assumptions: volatility of 72%, term of five years, risk-free interest rate of 3.36% and 0% dividend yield. The fair value of the warrants totaled approximately $586,000. The total debt issuance costs of

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$1,250,813 are being amortized as interest expense over the earlier of the term of the notes (3 years) or upon conversion of the notes into the Company s common stock. Conversion of the notes will be effective during the fourth quarter of 2003, at which time the debt issuance costs will be fully amortized.

The notes and warrants include registration rights requiring the Company to file a registration statement with the Securities and Exchange Commission (SEC) registering, for resale, the shares of common stock issuable upon conversion of the notes or exercise of the warrants. The registration statement was to be filed no later than 60 days after the final closing date (June 25, 2003) with an effective date no later than 150 days after the final closing date. The Company filed the registration statement on August 13, 2003, and it was declared effective by the SEC on November 6, 2003.

Short Term Notes Financing

Between April 30, 2003 and May 6, 2003 the Company issued $550,000 of subordinated notes to a group of accredited investors, including Herbert L. Lucas, a director of the Company, who purchased $75,000 of such subordinated notes. The transaction provided the Company with approximately $505,000 in net proceeds. In conjunction with the sale of these notes the Company granted warrants to purchase 235,722 shares of the Company s common stock (including 32,144 warrants granted to Mr. Lucas) at $1.11 per share exercisable for three years. The notes were unsecured and did not accrue interest. The notes were paid in full on June 25, 2003 with the proceeds received from the Convertible Note financing discussed above.

The loan was discounted for the relative fair value of the warrants totaling approximately $94,000, which was recognized as interest expense upon payment of the loan. The fair value of warrants was determined using the Black-Scholes option-pricing model with the following assumptions: volatility of 72%, risk-free interest rate of 2.25%, expected life of three years and 0% dividend yield.

For placement services associated with the financing, the Company paid Taglich Brothers, Inc. a fee of $23,750 and issued warrants to purchase up to 20,357 shares of the Company s common stock at $1.11 per share exercisable for three years. The fair value of the warrants was valued using the Black-Scholes option pricing model with the same assumptions as the bridge notes discussed above. The total debt issuance costs of approximately $44,750 were recognized as interest expense upon the payment of the notes.

The warrants include registration rights requiring the Company to register the underlying shares of common stock with the SEC. The Company filed an S-2 registration statement covering the underlying shares on August 13, 2003, and such registration statement was declared effective by the SEC on November 6, 2003.

NOTE 8 RESEARCH AND DEVELOPMENT AGREEMENT

The Company entered into a Letter of Intent with BioNutrics, Inc. during the quarter ended December 31, 2002 that states the Company will sub-license two separate products to BioNutrics and enter into a Research and Development Agreement covering use of the Company s CDT technology in conjunction with certain patented Active Pharmaceutical Ingredients or proprietary formulations owned by BioNutrics. The agreement called for a non-refundable up front fee of $200,000 in the form of a cash payment and note receivable. The cash payment of $100,000 was received in December 2002 and the note agreement was executed during the nine months ended September 30, 2003. The note is due nine months after the execution of a license, development and sales agreement. The $200,000 fee is included in deferred revenue and will be recognized when the Company has satisfied its obligations. The Company has not yet entered into the license, development and sales agreement.

NOTE 9 RESTATEMENT OF FINANCIAL INFORMATION

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During the three months ended March 31, 2003, the Company determined that certain costs that were incurred during 2002 and deferred as a prepaid expense at December 31, 2002, should have been expensed in the year ended December 31, 2002. These costs totaled approximately $104,000 and were incurred in conjunction with the anticipated sale of its Probiotics business. These costs have been recorded as a prior period adjustment in the period ended March 31, 2003.

During the nine months ended September 30, 2003, the Company determined that severance costs related to the separation agreement discussed in Note 3 that were classified as Other expense , should have been classified as General and Administrative expense on the Statement of Operations. These costs totaling $157,448 and $159,152 for the nine months ended September 30, 2003 and 2002, respectively have been reclassed in General and Administration expense in the accompanying Statement of Operations.

The following is a summary of the effects of such restatement on the Company s financial statements as of December 31, 2002 and for the year then ended:

	As Originally Reported	As Restated
Balance Sheet:		
Current assets	$1	