

PROLONG INTERNATIONAL CORP  
Form 10-Q  
May 12, 2003  
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**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended March 31, 2003

**OR**

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No 0-22803

**PROLONG INTERNATIONAL CORPORATION**

(Exact name of registrant as specified in its charter)

Nevada  
(State or other jurisdiction of  
incorporation or organization)

6 Thomas  
Irvine, CA 92618  
(Address of principal executive offices) (Zip  
Code)

74-2234246  
(IRS Employer Identification  
No.)

(949) 587-2700

(Registrant's telephone number,  
including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

(1) Yes  No

(2) Yes  No

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Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).

Yes  No

There were 29,789,598 shares of the registrant's common stock (\$0.001 par value) outstanding as of May 12, 2003.

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**Table of Contents****Item 1.****Financial Statements****PROLONG INTERNATIONAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED CONDENSED BALANCE SHEETS****ASSETS**

|   | <b>March 31,<br/>2003</b> | <b>December 31,<br/>2002</b> |
|---|---------------------------|------------------------------|
|   | <b>(Unaudited)</b>        |                              |
| <b>CURRENT ASSETS:</b>  |                           |                              |
| Cash and cash equivalents   | \$ 22,646                 | \$ 261,623                   |
| Accounts receivable, net of allowance for doubtful accounts of \$353,040 and \$351,361 at March 31, 2003 and at December 31, 2002, respectively | 1,958,400                 | 1,622,414                    |
| Inventories, net  | 587,785                   | 512,595                      |
| Prepaid expenses, net   | 302,872                   | 351,637                      |
| Advances to employees, current portion  | 46,943                    | 46,497                       |
| Deferred tax asset  | 168,850                   | 168,850                      |
| Total current assets  | 3,087,496                 | 2,963,616                    |
| Property and equipment, net (Note 4)  | 311,033                   | 329,985                      |
| Patents, net  | 408,536                   | 426,829                      |
| Intangible assets, net  | 6,058,007                 | 6,058,007                    |
| Deferred tax asset, noncurrent  | 1,376,279                 | 1,376,279                    |
| Investment in affiliate   | 349,992                   | 324,993                      |
| Other assets  | 169,893                   | 169,975                      |
| <b>TOTAL ASSETS</b>   | <b>\$ 11,761,236</b>      | <b>\$ 11,649,684</b>         |

**LIABILITIES AND STOCKHOLDERS EQUITY****CURRENT LIABILITIES:**

|                                    |            |            |
|------------------------------------|------------|------------|
| Accounts payable                   | \$ 872,793 | \$ 981,388 |
| Accrued expenses                   | 556,602    | 409,163    |
| Line of credit (Note 5)            | 1,183,712  | 863,592    |
| Notes payable, current (Note 6)    | 334,365    | 291,577    |
| Total current liabilities          | 2,947,472  | 2,545,720  |
| Notes payable, noncurrent (Note 6) | 544,639    | 592,481    |
| Total liabilities                  | 3,492,111  | 3,138,201  |

**COMMITMENTS AND CONTINGENCIES (Notes 1, 5, 6 and 7)****STOCKHOLDERS EQUITY**

Preferred stock, \$0.001 par value; 50,000,000 shares authorized;

no shares issued or outstanding

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|  |                      |                      |
|--|----------------------|----------------------|
| Common stock, \$0.001 par value; 150,000,000 shares authorized; 29,789,598 shares issued and outstanding in 2003 and 2002 respectively | 29,789               | 29,789               |
| Additional paid-in capital   | 15,387,562           | 15,387,562           |
| Accumulated deficit  | (7,148,226 )         | (6,905,868 )         |
|  | <hr/>                | <hr/>                |
| Total stockholders' equity   | 8,269,125            | 8,511,483            |
|  | <hr/>                | <hr/>                |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>  | <b>\$ 11,761,236</b> | <b>\$ 11,649,684</b> |
|  | <hr/>                | <hr/>                |

See notes to consolidated condensed financial statements

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

|   | <b>Three Months Ended<br/>March 31,</b> |              |
|---|---|--------------|
|   | <b>2003</b>                             | <b>2002</b>  |
| NET REVENUES  | \$ 2,188,061                            | \$ 2,885,925 |
| COST OF GOODS SOLD  | 751,867                                 | 992,873      |
| GROSS PROFIT  | 1,436,194                               | 1,893,052    |
| OPERATING EXPENSES:   |   |              |
| Selling and marketing   | 856,603                                 | 1,025,144    |
| General and administrative  | 741,309                                 | 758,407      |
| Total operating expenses  | 1,597,912                               | 1,783,551    |
| OPERATING (LOSS) INCOME   | (161,718 )                              | 109,501      |
| OTHER INCOME (EXPENSE), net:  |   |              |
| Interest expense  | (113,683 )                              | (101,031 )   |
| Interest income   | 19                                      | 1,483        |
| Other income  | 33,024                                  | 53,601       |
| Total other income (expense)  | (80,640 )                               | (45,947 )    |
| (LOSS) INCOME BEFORE EXTRAORDINARY ITEM AND PROVISION FOR INCOME TAXES            |   |              |
| TAXES   | (242,358 )                              | 63,554       |
| EXTRAORDINARY ITEM gain from forgiveness of debt, net of income taxes of \$68,400 |   | 94,924       |
| (LOSS) INCOME BEFORE PROVISION FOR INCOME TAXES                                   | (242,358 )                              | 158,478      |
| PROVISION FOR INCOME TAXES  |   | 26,600       |
| NET (LOSS) INCOME   | \$ (242,358 )                           | \$ 131,878   |
| NET (LOSS) INCOME PER SHARE:  |   |              |
| Basic and Diluted:  |   |              |
| (Loss) income per share before extraordinary item                                 | (\$0.01 )                               | \$ 0.00      |
| Extraordinary item  |   | 0.00         |
| Net (loss) income   | (\$0.01 )                               | \$ 0.00      |
| WEIGHTED AVERAGE COMMON SHARES:   |   |              |
| Basic and Diluted:  | 29,789,598                              | 29,789,598   |

See notes to consolidated condensed financial statements

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

|  | <b>Three Months Ended March 31,</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2003</b>                         | <b>2002</b> |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                                     |             |
| Net (loss) income  | \$ (242,358 )                       | \$ 131,878  |
| Adjustments to reconcile net (loss) income to net cash used in operating activities: |                                     |             |
| Gain from forgiveness of debt  |                                     | (163,324 )  |
| Sublease income from affiliate   | (24,999 )                           | (24,999 )   |
| Depreciation and amortization  | 46,424                              | 77,719      |
| Provision for doubtful accounts  | 1,679                               | 3,071       |
| Deferred taxes   |                                     | 95,000      |
| Reserve for inventory obsolescence   | 15,933                              |             |
| Amortization of debt discount related to warrants issued to sub debt creditors       | 32,585                              |             |
| Changes in assets and liabilities:   |                                     |             |
| Accounts receivable  | (337,665 )                          | (413,351 )  |
| Inventories  | (91,123 )                           | 54,590      |
| Prepaid expenses   | 48,765                              | 2,517       |
| Other assets   | 82                                  | 14          |
| Accounts payable   | (108,595 )                          | (345,131 )  |
| Accrued expenses   | 147,439                             | 137,451     |
| Net cash used in operating activities  | (511,833 )                          | (444,565 )  |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                                     |             |
| Purchases of property and equipment  | (9,179 )                            | (7,091 )    |
| Employee advances  | (446 )                              | 5,468       |
| Net cash used in investing activities  | (9,625 )                            | (1,623 )    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                                     |             |
| Payments on notes payable  | (37,639 )                           | (13,602 )   |
| Net proceeds from line of credit   | 320,120                             | 73,415      |
| Deposits under sales contract  |                                     | (52,646 )   |
| Net cash provided by financing activities  | 282,481                             | 7,167       |
| NET DECREASE IN CASH AND CASH EQUIVALENTS  | (238,977 )                          | (439,021 )  |
| CASH AND CASH EQUIVALENTS, beginning of period                                       | 261,623                             | 466,453     |
| CASH AND CASH EQUIVALENTS, end of period   | \$ 22,646                           | \$ 27,432   |
| <b>SUPPLEMENTAL CASH FLOW DISCLOSURES:</b>   |                                     |             |
| Income taxes paid  | \$                                  | \$          |
| Interest paid  | \$ 81,098                           | \$ 101,031  |



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SUPPLEMENTAL NONCASH INVESTING AND FINANCING ACTIVITIES:

During the quarters ended March 31, 2003 and 2002, the Company provided an affiliate with office space and recorded increases in other income and investment in affiliate of \$24,999.

See notes to consolidated condensed financial statements

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

1.

**BUSINESS**

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

*Management's Plans Regarding Financial Results and Liquidity* At March 31, 2003, the Company had a net working capital of approximately \$140,000 and, an accumulated deficit of approximately \$7,148,000. The Company initiated vigorous expense-reduction strategies during the years 2001 and 2002. During 2001 and 2002, the Company reduced personnel, discontinued certain of its endorsement and sponsorship contracts and aggressively reduced selling and general and administrative expenses. Additionally, the Company improved its credit and collections function and worked with its vendors to improve payment terms. Although the Company used cash in operations during the first quarter of 2003, the Company's business plan for fiscal year 2003 provides for positive cash generation from operations. The Company initiated an Accounts Payable Discounted Debt Restructure Program, which was successfully executed and the program reduced the accounts payable balance by approximately \$1,300,000 and recognized debt forgiveness income of \$677,000 (before taxes), during the year ended December 31, 2002. The Company also recognized a one-time gain of \$983,400 on the sale of its corporate headquarters during the year ended December 31, 2002. During 2002, the Company raised additional working capital of \$1,125,000 through a private placement offering of subordinated secured promissory notes to accredited investors. If these measures are not adequate, the Company will pursue additional expense reductions during 2003. The Company is continuing to seek financing on favorable terms, including senior secured debt, subordinated debt and/or equity placements. There can be no assurance that such financing will be available on favorable terms, or at all. If additional funds are raised by issuing equity securities, dilution to existing stockholders is likely to result. The Company owns shares of common stock in Oryxe Energy International, Inc. Management believes that some or all of which could be sold to provide additional working capital. Management believes that the aforementioned plans, if successfully executed, will provide adequate financial resources to sustain the Company's operations and enable the Company to continue as a going concern.

2.

**BASIS OF PRESENTATION**

The accompanying unaudited consolidated condensed financial statements include the accounts of PIC and its wholly-owned subsidiaries, PSL, Prolong International Holdings Ltd. and its wholly-owned subsidiary, Prolong International Ltd. (collectively, the

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Company or Prolong). All intercompany accounts have been eliminated in consolidation. These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments, including normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. For further information, refer to the Form 10-K for the year ended December 31, 2002 filed by the Company with the Securities and Exchange Commission.

3.

**INVENTORIES**

Inventories consist of the following:

|                      | <b>March 31,<br/>2003</b>   | <b>December 31,<br/>2002</b> |
|----------------------|-----------------------------|------------------------------|
|                      | <u>                    </u> | <u>                    </u>  |
|                      | (Unaudited)                 |                              |
| Raw materials        | \$ 307,804                  | \$ 307,218                   |
| Finished goods       | 366,352                     | 275,815                      |
| Obsolescence reserve | (86,371 )                   | (70,438 )                    |
|                      | <u>\$587,785</u>            | <u>\$ 512,595</u>            |

4.

**PROPERTY AND EQUIPMENT**

Property and equipment consist of the following:

|                               | <b>March 31,<br/>2003</b>   | <b>December 31,<br/>2002</b> |
|-------------------------------|-----------------------------|------------------------------|
|                               | <u>                    </u> | <u>                    </u>  |
|                               | (Unaudited)                 |                              |
| Computer equipment            | \$ 293,879                  | \$ 284,700                   |
| Office equipment              | 55,753                      | 55,753                       |
| Furniture and fixtures        | 585,168                     | 585,168                      |
| Automotive equipment          | 35,925                      | 35,925                       |
| Exhibit equipment             | 130,482                     | 130,482                      |
| Machinery and equipment       | 17,953                      | 17,953                       |
| Molds and dies                | 233,117                     | 233,117                      |
|                               | <u>1,352,277</u>            | <u>1,343,098</u>             |
| Less accumulated depreciation | (1,041,244 )                | (1,013,113 )                 |
|                               | <u>\$ 311,033</u>           | <u>\$ 329,985</u>            |



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5.

## LINES OF CREDIT

Until February 26, 2003, the Company had a \$5,000,000 credit facility with a financial institution. Such facility was collateralized by eligible accounts receivable and inventories. Interest was payable monthly at the default rate of the financial institution's prime rate which was 4.25% at March 31, 2003, plus 7.00%, subject to a minimum interest charge of \$50,000 per quarter. The credit facility contained certain defined net income and tangible net worth financial covenants. During the three month period ended March 31, 2003, the Company was in default with certain financial covenants under the credit agreement. The credit facility was terminated on February 26, 2003 and the outstanding loan balance and termination fees were paid in full.

Effective February 26, 2003, the Company entered into a new \$1,500,000 credit facility with a financial institution, that, unless terminated earlier by its terms, has an initial term through February 26, 2005 with automatic renewals for successive one-year periods thereafter. The credit facility provides for advances of funds up to 75% of the gross face value of eligible trade accounts receivable based on agreed terms. Such facility is collateralized by accounts receivable, inventory, equipment and other assets. Interest is payable monthly at the financial institution's base index which was 4.75% at March 31, 2003, plus 2.25%. Additionally, the Company is obligated to pay the lender (i) a monthly purchasing fee of 0.25% of the total monthly average advances outstanding and (ii) an annual facility fee of 0.75% of the purchasing limit (which limit is currently \$1,500,000). As of March 31, 2003, \$1,183,712 was outstanding under the credit facility.

6.

## NOTES PAYABLE

Notes payable consist of the following as of March 31, 2003:

|   |              |
|---|--------------|
| a) Various subordinated secured promissory notes payable to accredited investors bearing interest at 15% per annum to be repaid under various terms in monthly principal and interest payments through June 30, 2005. | \$ 1,034,793 |
| Less current maturities   | (334,365 )   |
|   | <hr/>        |
|   | 700,428      |
| Less unamortized debt discount relating to the relative estimated fair value of warrants issued   | (155,789 )   |
|   | <hr/>        |
|   | \$ 544,639   |
|   | <hr/>        |

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The following are the annual minimum principal payments due under the subordinated secured promissory notes:

**Year ending December 31,**

|            |              |
|------------|--------------|
| 2003       | \$253,938    |
| 2004       | 708,544      |
| 2005       | 72,311       |
| 2006       |              |
| Thereafter |              |
|            | \$ 1,034,793 |

In connection with the Company's issuance of the subordinated secured promissory notes payable listed above, the Company issued 2,250,000 common stock purchase warrants to related note holders and 247,000 common stock purchase warrants as broker commissions. Each warrant allows the holder to purchase one share of the Company's common stock at \$0.09 per share for a period of five years. In accordance with APB No. 14, the Company has presented the relative estimated fair value of the warrants issued to note holders of \$209,000 as a debt discount and such amount is being amortized over the expected terms of the promissory notes.

7.

**CONTINGENCIES**

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

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

8.

**INVESTMENT IN AFFILIATE**

On March 31, 2001 the Company entered into an Organization Agreement with Prolong Environmental Energy Corporation (PEEC), a California corporation, whereby the Company agreed to contribute up to \$150,000 to PEEC as required to meet the operating working capital obligations for PEEC. The Company also provided administrative and facilities services support in the amount of \$199,992 during the period April 1, 2001 through March 31, 2003. The Company contribution, and the services provided (total investment of \$349,992), has been considered a capital contribution for PEEC in return for approximately 10% of the issued and outstanding common stock of PEEC. In December 2001, PEEC was merged into ORYXE Energy International, Inc. The Company also has a warrant to purchase additional shares of ORYXE, which if exercised would vest the Company with ownership of approximately 16% of ORYXE, based upon ORYXE's current capitalization.

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**INTANGIBLE ASSETS**

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

Accounting for the Impairment or Disposal of Long-Lived Assets. In conjunction with the implementation of SFAS No. 142, the Company has completed a goodwill impairment review as of the beginning of 2002 and 2003 with the assistance of an independent valuation company. Management has determined that no impairment existed.

Upon adoption of the new rules described above, the Company separately identified the estimated fair value of its patents and such amount has been presented on a separate line item, net of related accumulated amortization of \$91,464, in the accompanying consolidated condensed balance sheets. Patents are amortized over their estimated useful lives of 15 years. Intangible assets are comprised of goodwill and trademarks and are not being amortized in accordance with the provisions of SFAS No. 142.

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10.

**STOCK OPTIONS**

SFAS No. 123 and No. 148 require the determination and disclosure of compensation costs implicit in stock option grants or other stock rights. The Company has adopted certain required provisions of this standard for nonemployee transactions. Under the employee transaction provisions, companies are encouraged, but not required, to adopt the fair value of accounting for employee stock-based transactions. Companies are also permitted to continue to account for such transactions under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. The following table illustrates the effect on net income if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation.

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2003</b>               | <b>2002</b> |
| Net (loss) income, as reported   | \$(242,358)               | \$(380,436) |
| Total stock-based employee compensation determined under fair value based method, net of related tax effects | (20,700 )                 | (82,956 )   |
| Net (loss) income, pro forma   | \$(263,058)               | \$(463,392) |
| Earnings (loss) per share:   |                           |             |
| Basic as reported  | \$(0.01 )                 | \$(0.01 )   |
| Basic pro forma  | \$(0.01 )                 | \$(0.02 )   |
| Diluted as reported  | \$(0.01 )                 | \$(0.01 )   |
| Diluted pro forma  | \$(0.01 )                 | \$(0.02 )   |

Effective June 4, 1997, the Company adopted the Prolong International Corporation 1997 Stock Incentive Plan (the Plan). Under the Plan, the Company may grant nonqualified or incentive stock options for the benefit of qualified employees, officers, directors, consultants and other service providers. On June 26, 2002, the Company's stockholders approved an increase of 1,500,000 shares of common stock issuable under the Plan, bringing the total number of authorized shares to 4,000,000. The term of the option is fixed by the administrator of the Plan, but no option may be exercisable more than 10 years after the date of grant.

Stock option activity is as follows:

|                                | <b>Shares</b> | <b>Weighted<br/>average<br/>under<br/>exercise price<br/>option<br/>per share</b> |
|--------------------------------|---------------|---|
| OUTSTANDING, December 31, 2001 | 913,500       | \$0.51  |
| Granted                        | 1,482,500     | \$0.10  |
| Canceled                       | (329,500 )    | \$0.70  |
| Exercised                      | 0             |   |
| OUTSTANDING, December 31, 2002 | 2,066,500     | \$0.19  |
| Granted                        | 0             | \$0.10  |
| Canceled                       | (10,000 )     | \$0.70  |



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|                             |                  |        |
|-----------------------------|------------------|--------|
| Exercised                   | <u>0</u>         |        |
| OUTSTANDING, March 31, 2003 | <u>2,066,500</u> | \$0.19 |

Outstanding options vest over periods ranging from one to five years. During the three months ended, there were no options issued by the Company to either outside consultants or employees.

As of March 31, 2003, options to purchase 495,500 shares of common stock were exercisable.

The fair value of options granted is estimated on the date of grant using the Black-Scholes option-pricing model that considers various weighted average assumptions, including dividend yields, expected volatility of Company stock, risk-free interest rates, and expected option life.

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**ITEM 2:**

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

**RISK FACTORS AND FORWARD LOOKING STATEMENTS**

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

Actual results are uncertain and may be impacted by the factors discussed in more detail in the Company's Annual Report on Form 10-K for the year ended December 31, 2002 and other periodic reports filed with the Securities and Exchange Commission. In particular, there are certain risks and uncertainties that may impact the accuracy of the forward looking statements with respect to revenues, expenses and operating results including without limitation, the risks set forth in the risk factors section of the Annual Report on Form 10-K for the year ended December 31, 2002, which risk factors are hereby incorporated into this report by this reference. As a result, the actual results may differ materially from those projected in the forward looking statements.

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

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the

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reported amounts of net revenue and expenses during the reporting period. The Company regularly evaluates its estimates and assumptions related to allowances for doubtful accounts, sales returns and allowances, inventory reserves, goodwill and purchased intangible asset valuations, deferred income tax asset valuation allowances, warranty reserves, litigation and other contingencies. The Company bases its estimates and assumptions on historical experience, forecasted operating results and expected trends, and on various other factors that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. To the extent there are material differences between the Company's estimates and the actual results, its future results of operations will be affected. The Company believes the following critical accounting policies require it to make significant judgments and estimates in the preparation of its consolidated financial statements:

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

*Goodwill and Purchased Intangible Assets* - The purchase method of accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired. Goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to at least annual impairment tests. Management obtains an annual independent, third party valuation of the Company to assist it in the performance of annual impairment tests. The amounts and useful lives assigned to intangible assets impact future amortization.

*Deferred Taxes* - If the Company determines that it is more likely than not that it will not realize all or part of its net deferred tax assets in the future, it will record a valuation allowance against the deferred tax assets, which allowance will be charged to income tax expense in the period of such determination. Management considers the scheduled reversal of deferred tax liabilities, tax planning strategies and future taxable income in assessing the realizability of deferred tax assets. Management also considers the weight of both positive and negative evidence in determining whether a valuation allowance is needed.

**Table of Contents****RESULTS OF OPERATIONS**

|  | <b>Percentage of Net<br/>Revenues<br/>Three Months Ended<br/>March 31,</b> |             |
|--|--|-------------|
|  | <b>2003</b>  | <b>2002</b> |
| Net revenues   | 100.0  | 100.0       |
| Cost of goods sold   | 34.4   | 34.4        |
| Gross profit   | 65.6   | 65.6        |
| Selling and marketing expenses   | 39.1   | 35.5        |
| General and administrative expenses                                    | 33.9   | 26.3        |
| Operating (loss) income  | (7.4 )   | 3.8         |
| Other (expense) income   | (3.7 )   | (1.6 )      |
| (Loss) income before extraordinary item and provision for income taxes | (11.1 )  | 2.2         |
| Extraordinary item gain from forgiveness of debt, net of income taxes  |  | 3.3         |
| (Loss) income before income taxes                                      | (11.1 )  | 5.5         |
| Provision for income taxes   |  | 0.9         |
| Net (loss) income  | (11.1 )  | 4.6         |

**Three Months Ended March 31, 2003 vs. Three Months Ended March 31, 2002**

Net revenues for the three months ended March 31, 2003 were approximately \$2,188,000 as compared to approximately \$2,886,000 for the comparable period of the prior year, a decrease of \$698,000 or 24.2%. Revenues for the three-month period ended March 31, 2003 were derived from retail sales of \$1,935,000 and international and other sales of \$253,000. Revenues for the three-month period ended March 31, 2002 were derived from retail sales of \$2,583,000 and international and other sales of \$303,000.

During the first quarter of 2003, retail sales were 88.4% of total revenues while international and other sales comprised 11.6% of total revenues. During the first quarter of 2002, retail sales were 89.5% of total revenues while international and other sales comprised 10.5% of total revenues. The lower retail sales for the period ended March 31, 2003 versus the same period a year ago are attributable to a decrease in lubricant sales of approximately \$648,000. The lubricant retail sales decline is attributable to a soft market for specialty lubricants, competitive pressures, reduced advertising expenditures, and general economic factors.

Cost of goods sold for the three months ended March 31, 2003 was approximately \$752,000 as compared to \$993,000 for the comparable period of the prior year, a decrease of \$241,000 or 24.3%. As a percentage of net revenues, cost of goods sold remained at 34.4% for the three months ended March 31, 2003 and the three months ended March 31, 2002. The decrease in costs of goods sold was a result of overall decreased sales.

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Selling and marketing expenses of \$857,000 for the three months ended March 31, 2003 represented a decrease of \$168,000 over the comparable period of the prior year. This 16.4% decrease was primarily the result of decreased expenses for endorsement and sponsorship payments, advertising and salaries (decreased headcount). Selling and marketing expenses as a percentage of net revenues were 39.1% for the three months ended March 31, 2003 versus 35.5% for the comparable period of the previous year. Even though the aggregate expenses declined during the period, the ratio of expenses as a percentage of net revenues increased due to the decrease in sales during the period.

General and administrative expenses for the three months ended March 31, 2003 were approximately \$741,000 as compared to \$758,000 for the three months ended March 31, 2002, a decrease of \$17,000 or 2.2%. As a percentage of net revenues, general and administrative expenses increased from 26.3% in 2002 to 33.9% in 2003. Even though the aggregate expenses declined during the period, the ratio of expenses as a percentage of net revenues increased due to the decrease in sales during the period.

Net interest expense of \$114,000 for the three months ended March 31, 2003 represented an increase of \$14,000 over the comparable period in 2002. The increase is attributable to a noncash charge of \$33,000 for the unamortized debt discount on the subordinated secured promissory notes, which was partially offset by decreases in the interest rate relating to the credit facilities. Other income for the three months ended March 31, 2003 was \$33,000 as compared to \$54,000 for the three months ended March 31, 2002, a decrease of \$21,000. This decrease was the result of reduced income from the subletting of a portion of our facilities.

Extraordinary item gain from forgiveness of debt, net of income taxes for the three months ended March 31, 2003 was none as compared to \$94,900 for the three months ended March 31, 2002. The gain in the prior period resulted from the executed settlements during the period of the Company's Accounts Payable Discounted Debt Restructure Program.

Net loss for the three-month period ended March 31, 2003 was approximately \$(242,000) as compared to a net income of approximately \$132,000 for the comparable period in the prior year, a decrease of \$374,000. The decrease is a result of the factors discussed above.

## **LIQUIDITY AND CAPITAL RESOURCES**

At March 31, 2003, the Company had a net working capital of approximately \$140,000 as compared to \$418,000 at December 31, 2002, representing a decrease of \$278,000. Cash used in operating activities during the three month period ended March 31, 2003, was \$512,000, primarily consisting of a decrease in accounts payable, and an increase in accounts receivable, and inventories which was partially offset by an increase in accrued expenses. Additionally, the Company used \$9,600 in investing activities and provided \$282,000 from financing activities which were primarily net reductions in outstanding subordinated secured promissory notes offset by proceeds from the credit facility entered into on February 26, 2003.

Until February 26, 2003, the Company had a \$5,000,000 credit facility with a financial institution. Such facility was collateralized by eligible accounts receivable and inventories. Interest was payable monthly at the default rate of the financial institution's prime rate which was 4.25% at March 31, 2003, plus 7.00%, subject to a minimum interest charge of \$50,000 per

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quarter. The credit facility contained certain defined net income and tangible net worth financial covenants. During the three month period ended March 31, 2003, the Company was in default with certain financial covenants under the credit agreement. The credit facility was terminated on February 26, 2003 and the outstanding loan balance and termination fees were paid in full.

Effective February 26, 2003, the Company entered into a new \$1,500,000 credit facility with a financial institution, that, unless terminated earlier by its terms, has an initial term through February 26, 2005 with automatic renewals for successive one-year periods thereafter. The credit facility provides for advances of funds up to 75% of the gross face value of eligible trade accounts receivable based on agreed terms. Such facility is collateralized by accounts receivable, inventory, equipment and other assets. Interest is payable monthly at the financial institution's base index which was 4.75% at March 31, 2003, plus 2.25%. Additionally, the Company is obligated to pay the lender (i) a monthly purchasing fee of 0.25% of the total monthly average advances outstanding and (ii) an annual facility fee of 0.75% of the purchasing limit (which limit is currently \$1,500,000). As of March 31, 2003, \$1,183,712 was outstanding under the credit facility.

At March 31, 2003, the Company had a net working capital of approximately \$140,000 and, an accumulated deficit of approximately \$7,046,000. The Company initiated vigorous expense-reduction strategies during the years 2001 and 2002. During 2001 and 2002, the Company reduced personnel, discontinued certain of its endorsement and sponsorship contracts and aggressively reduced selling and general and administrative expenses. Additionally, the Company improved its credit and collections function and worked with its vendors to improve payment terms. Although the Company used cash in operations during the first quarter of 2003, the Company's business plan for fiscal year 2003 provides for positive cash generation from operations. The Company initiated an Accounts Payable Discounted Debt Restructure Program which was successfully executed and the program reduced the accounts payable balance by approximately \$1,300,000 and recognized debt forgiveness income of \$677,000 (before taxes), during the year ended December 31, 2002. The Company also recognized a one-time gain of \$983,400 on the sale of its corporate headquarters during the year ended December 31, 2002. During 2002, the Company raised additional working capital of \$1,125,000 through a private placement offering of subordinated secured promissory notes to accredited investors. If the aforementioned measures are not adequate, the Company will pursue additional expense reductions during 2003. The Company cannot guarantee that the timing of further reductions in operating expenses will be adequate to return to profitability for 2003 and beyond. The Company is continuing to seek financing on favorable terms, including senior secured debt, subordinated debt and/or equity placements. The Company owns shares of common stock in Oryxe Energy International, Inc. Management believes that some or all of which could be sold to provide additional working capital. There can be no assurance that such financing will be available on favorable terms, or at all. If additional funds are raised by issuing equity securities, dilution to existing stockholders is likely to result. Management believes that the aforementioned plans, if successfully executed, will provide adequate financial resources to sustain the Company's operations and enable the Company to continue as a going concern.

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**ITEM 3:**

**QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

PIC's financial instruments include cash and long-term debt. At March 31, 2003 and December 31, 2002, respectively the carrying values of PIC's financial instruments approximated their fair values based on current market prices and rates. It is PIC's policy not to enter into derivative financial instruments. PIC does not currently have any significant foreign currency exposure since it does not transact business in foreign currencies. Due to this, PIC did not have significant overall currency exposure at March 31, 2003 and December 31, 2002, respectively.

The Company is exposed to market risk from changes in interest rates on borrowings under our credit facility entered into on February 26, 2003, which bears interest at the financial institution's base index, which was 4.75% at March 31, 2003, plus 2.25%.

**ITEM 4:**

**CONTROLS AND PROCEDURES**

We maintain a system of internal controls and procedures designed to provide reasonable assurance as to the reliability of our published financial statements and other disclosures included in this report. Within the 90-day period prior to the date of this report, under the supervision and with the participation of the Company's management, including the Chief Executive Officer (the CEO) and the Chief Financial Officer (the CFO), we evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-14 of the Securities Exchange Act of 1934 (the 1934 Act). Based upon that evaluation, our CEO and our CFO concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic filings under the 1934 Act.

There have been no significant changes in our internal controls or in other factors, which could significantly affect internal controls subsequent to the date that we carried out our evaluation.

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**PROLONG INTERNATIONAL CORPORATION**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

Reference is made to Note 7 of the notes to consolidated condensed financial statements.

**Item 3. Defaults upon Senior Securities**

Until February 26, 2003, the Company had a \$5,000,000 credit facility with a financial institution. Such facility was collateralized by eligible accounts receivable and inventories. Interest was payable monthly at the default rate of the financial institution's prime rate which was 4.25% at March 31, 2003, plus 7.00%, subject to a minimum interest charge of \$50,000 per quarter. The credit facility contained certain defined net income and tangible net worth financial covenants. During the three month period ended March 31, 2003, the Company was in default with certain financial covenants under the credit agreement. The credit facility was terminated on February 26, 2003 and the outstanding loan balance and termination fees were paid in full.

**Item 6. Exhibits and Reports on Form 8-K**

(a)

Exhibits

99.1

Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

99.2

Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b)

Reports on Form 8-K

On March 6, 2003, the Company filed a Form 8-K relating to the appointment of Richard E. Solomon to the Board of Directors.

On March 11, 2003, the Company filed a Form 8-K relating to entering into a new \$1.5 million credit facility.

**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 thereunto duly authorized.

Date: May 12, 2003

PROLONG INTERNATIONAL CORPORATION

/s/ NICHOLAS ROSIER

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**Nicholas Rosier**  
**Chief Financial Officer**  
**(Principal Financial Officer)**





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**CERTIFICATIONS PURSUANT TO SECTION 302  
OF THE SARBANES-OXLEY ACT OF 2002**

I, Elton Alderman, certify that:

1.

I have reviewed this quarterly report on Form 10Q of Prolong International Corporation;

2.

Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statement made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3.

Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4.

The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Rules 13a-14 and 15d-14 of the Exchange Act) for the registrant and we have:

a)

designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b)

evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of the quarterly report (the Evaluation Date); and

c)

presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5.

The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:

a)

all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b)

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any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6.

The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 12, 2003

/s/ ELTON ALDERMAN

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**Elton Alderman**  
**President & CEO**

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**CERTIFICATIONS PURSUANT TO SECTION 302  
OF THE SARBANES-OXLEY ACT OF 2002**

I, Nicholas Rosier, certify that:

1.

I have reviewed this quarterly report on Form 10Q of Prolong International Corporation;

2.

Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statement made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3.

Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4.

The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Rules 13a-14 and 15d-14 of the Exchange Act) for the registrant and we have:

a)

designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b)

evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of the quarterly report (the Evaluation Date); and

c)

presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5.

The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:

a)

all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b)

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any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls;  
and

6.

The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 12, 2003

/s/ NICHOLAS ROSIER

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**Nicholas Rosier**  
**Chief Financial Officer/(Principal Financial Officer)**

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