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SLS INTERNATIONAL INC
Form 10QSB/A
May 21, 2003

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB/A
AMENDMENT NO. 1

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of
The Securities Exchange Act of 1934

For the Quarterly Period Ended September 30, 2002

or

Transition Report Pursuant to Section 13 or 15(d) of
The Securities Exchange Act of 1934

For the Transition Period from _____ to _____

Commission File Number: 333-43770

SLS INTERNATIONAL, INC.

(Exact Name of Small Business Issuer as Specified in its Charter)

Delaware

52-2258371

(State of Incorporation)

(IRS Employer Identification No.)

3119 South Scenic

Springfield, Missouri

65807

(Address of Principal Executive Offices)

(Zip Code)

Issuer's Telephone Number, Including Area Code: (417) 883-4549

N/A

(Former Name, Former Address and Former Fiscal Year,
if Changed Since Last Report)

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING
THE PRECEDING FIVE YEARS

Check whether the registrant filed all documents and reports required to be
filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of
securities under a plan confirmed by a court. N/A
Yes No

On May 5, 2003, 23,196,528 shares of SLS International, Inc. common
stock were outstanding.

Transitional Small Business Disclosure Format (check one):
Yes _____ No x

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SLS INTERNATIONAL, INC.

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INTRODUCTORY NOTE

This amendment to SLS International, Inc.'s Quarterly Report on Form 10-QSB initially filed with the Securities and Exchange Commission on November 14, 2002, is being filed to reflect the restatement of our unaudited condensed financial statements for the quarter and nine months ended September 30, 2002. Certain items were also reclassified within the financial statements. The restatements and reclassifications in the nine-month period ended September 30, 2002 include adjustments for:

- o RESTATEMENTS - (a) Consulting Agreements. Consulting agreements entered into in the nine months ended September 30, 2002 are reflected in the restatements, recognizing the issuance of (or the obligation to issue) 1,595,000 shares of common stock and the grant of options to purchase 100,000 shares of Class A preferred stock at an exercise price of \$2.50 per share (each such share of preferred stock converts into 10 shares of common stock) under such agreements. In addition, a consulting agreement entered into in August 2001 is now reflected in the restated financial statements, recognizing an obligation to issue 100,000 shares of common stock under such agreement. We determined that the failure to include such consulting agreement in prior periods is not material to the prior periods' financial statements and would not require a restatement of the financial statements for such periods.

The total non-cash cost under such agreements is \$1,073,172, \$635,352 of which is now reflected as amortized expenses in the nine-month period and

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the remainder of which is to be amortized in subsequent periods over the respective terms of such agreements. The non-cash cost under the consulting agreement entered into in August 2001 is being amortized over a 12-month period beginning in January 2002. The restated financial statements also recorded \$3,000 of cash and \$27,000 of notes receivable received from such consultants. The notes receivable were then written off as bad debt expense in the quarter ended March 31, 2002.

(b) Bad Debt Expense. Bad debt expense was increased by \$169,305 (which includes the write-off of \$27,000 of notes receivable discussed in (a) above) and is reflected in the Consolidated Statement of Operations under general and administrative expenses.

(c) Accounts Payable. (i) Accounts payable were increased by \$49,492 and the related expenses are reflected in the Consolidated Statement of Operations under general and administrative expenses. (ii) Accounts payable were decreased by \$36,000, reflecting the entry fee for tradeshows that the Company entered but later canceled.

(d) Cost of Sales. Cost of sales was increased by \$114,300 and is reflected in the Consolidated Statement of Operations under cost of sales.

- o RECLASSIFICATIONS - (a) Notes Payable. The balance sheet now reflects an additional \$5,000 note payable that was previously classified as an account payable.

(b) Stock Issuances. The balance sheet now reflects the obligation to issue 2,000 shares of common stock that were sold in the first nine months of 2002 but were not yet issued. These shares were previously reflected as issued on September 30, 2002.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

SLS International, Inc.
Condensed Balance Sheet

| | September 30, 2002 | December 31, 2001 |
|---|-----------------------|----------------------|
| | ----- (unaudited) | ----- (audited) |
| Assets | | |
| Current assets: | | |
| Cash | \$ 7,761 | \$ 48,390 |
| Accounts receivable, less allowance for doubtful accounts of \$97,870 for September 30, 2002 and \$0 for December 31, 2001 | 34,927 | 69,185 |
| Inventory | 325,001 | 250,998 |
| Prepaid expenses and other current assets | 1,570 | 2,081 |
| Total current assets | ----- 369,259 | ----- 370,654 |
| | ----- | ----- |

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| | | |
|--|-------------|-------------|
| Fixed assets: | | |
| Vehicles | 47,376 | 47,376 |
| Equipment | 53,427 | 50,731 |
| Leasehold improvements | 3,376 | 3,376 |
| | ----- | ----- |
| | 104,179 | 101,483 |
| Less accumulated depreciation | 75,733 | 64,594 |
| | ----- | ----- |
| Net fixed assets | 28,446 | 36,889 |
| | ----- | ----- |
| | \$ 397,705 | \$ 407,543 |
| | ===== | ===== |
| Liabilities and Shareholders' Deficit | | |
| Current liabilities: | | |
| Current maturities of long-term debt and notes payable | \$ 419,815 | \$ 371,640 |
| Accounts payable | 359,352 | 196,833 |
| Due to shareholders | 29,886 | 31,886 |
| Accrued liabilities | 88,276 | 67,029 |
| | ----- | ----- |
| Total current liabilities | 897,328 | 667,388 |
| | ----- | ----- |
| Long-term debt, less current maturities | -- | 2,321 |
| | ----- | ----- |
| Commitments and contingencies: | | |
| Shareholders' deficit: | | |
| Preferred stock not issued but owed to buyers, \$.001 par, 5,000,000 shares authorized; 328,000 and 102,000 shares | | |
| at September 30, 2002 and December 31, 2001 | 328 | 102 |
| Discount on preferred stock | (330,776) | (166,694) |
| Contributed capital - preferred | 1,561,272 | 446,298 |
| Common stock, \$.001 par; 75,000,000 shares authorized; 20,403,528 shares and 19,019,528 shares issued at September 30, 2002 and December 31, 2001 | 20,404 | 19,020 |
| Common stock not issued but owed to buyers; 452,000 shares and 40,000 shares at September 30, 2002 and December 31, 2001 | 452 | 40 |
| Contributed capital - common | 2,862,301 | 1,710,425 |
| Unamortized cost of stock issued for services | (437,820) | -- |
| Retained deficit | (4,175,784) | (2,271,357) |
| | ----- | ----- |
| Total shareholders' deficit | (499,624) | (262,166) |
| | ----- | ----- |
| | \$ 397,705 | \$ 407,543 |
| | ===== | ===== |

See notes to the condensed financial statements.

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SLS International, Inc.
Condensed Statement Of Operations

For The Nine Months Ended
September 30,

| | |
|-------------|-------|
| ----- | ----- |
| 2002 | 2001 |
| ----- | ----- |
| (unaudited) | |

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| | | |
|--|----------------|--------------|
| Revenue | \$ 486,204 | \$ 284,306 |
| Cost of sales | 318,631 | 182,512 |
| | ----- | ----- |
| Gross profit | 167,573 | 101,794 |
| General and administrative expenses | 1,667,850 | 792,686 |
| | ----- | ----- |
| Loss from operations | (1,500,277) | (690,892) |
| Other income (expense): | | |
| Interest expense | (18,330) | (35,033) |
| Interest and miscellaneous, net | 298 | 2,092 |
| | ----- | ----- |
| | (18,032) | (32,941) |
| | ----- | ----- |
| Loss before income tax | (1,518,309) | (723,833) |
| Income tax provision | -- | -- |
| | ----- | ----- |
| Net loss | (1,518,309) | (723,833) |
| Deemed dividend associated with beneficial conversion feature of preferred stock | (386,118) | (52,000) |
| | ----- | ----- |
| Net loss available to common shareholders | \$ (1,904,427) | \$ (775,833) |
| | ===== | ===== |
| Basic and diluted earnings per share | \$ (0.09) | \$ (0.05) |
| | ===== | ===== |
| Weighted average shares outstanding | 20,095,306 | 16,716,528 |
| | ===== | ===== |

See notes to the condensed financial statements.

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SLS International, Inc.
Condensed Statement Of Operations

| | For The Three Months Ended September 30, | |
|-------------------------------------|---|------------|
| | 2002 | 2001 |
| | ----- | |
| | (unaudited) | |
| | ----- | ----- |
| Revenue | \$ 161,688 | \$ 173,783 |
| Cost of sales | 123,952 | 112,629 |
| | ----- | ----- |
| Gross profit | 37,736 | 61,154 |
| General and administrative expenses | 605,885 | 280,571 |
| | ----- | ----- |
| Loss from operations | (568,149) | (219,417) |
| Other income (expense): | | |
| Interest expense | (5,067) | (7,734) |
| Interest and miscellaneous, net | 259 | 544 |
| | ----- | ----- |

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| | | |
|--|--------------|--------------|
| | (4,808) | (7,190) |
| | ----- | ----- |
| Loss before income tax | (572,957) | (226,607) |
| Income tax provision | -- | -- |
| | ----- | ----- |
| Net loss | (572,957) | (226,607) |
| Deemed dividend associated with beneficial conversion feature of preferred stock | (180,892) | (52,000) |
| | ----- | ----- |
| Net loss available to common shareholders | \$ (753,849) | \$ (278,607) |
| | ===== | ===== |
| Basic and diluted earnings per share | \$ (0.04) | \$ (0.01) |
| | ===== | ===== |
| Weighted average shares outstanding | 20,647,195 | 18,792,125 |
| | ===== | ===== |

See notes to the condensed financial statements.

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SLS International, Inc.
Condensed Statement Of Cash Flows

| | For The Nine Months End September 30, | |
|--|--|--------------|
| | 2002 | 2001 |
| | ----- (unaudited) | |
| Operating activities: | | |
| Net loss | \$(1,518,309) | \$ (723,000) |
| Adjustments to reconcile net income to cash flows from operating activities: | | |
| Depreciation and amortization | 11,139 | 11,139 |
| Amortization of cost of stock issued for services | 635,352 | 635,352 |
| Change in assets and liabilities- | | |
| Accounts receivable, less allowance for doubtful accounts | 34,258 | (86,000) |
| Inventory | (74,003) | (17,000) |
| Prepaid expenses and other current assets | 511 | 79,000 |
| Accounts payable | 162,519 | (123,000) |
| Deferred revenue | -- | (70,000) |
| Due to shareholders | (2,000) | 4,000 |
| Accrued liabilities | 21,247 | 18,000 |
| | ----- | ----- |
| Cash used in operating activities | (729,286) | (907,000) |
| | ----- | ----- |

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| | | |
|---|--------------|-------|
| Investing activities: | | |
| Additions to fixed assets | (2,697) | (11) |
| | ----- | ----- |
| Cash used in investing activities | (2,697) | (11) |
| | ----- | ----- |
| Financing activities: | | |
| Sale of common stock | 80,500 | 1,214 |
| Sale of preferred stock | 565,000 | 50 |
| Borrowing of notes payable | 55,000 | 135 |
| Repayments of notes payable | (9,146) | (478) |
| | ----- | ----- |
| Cash provided by financing activities | 691,354 | 920 |
| | ----- | ----- |
| (Decrease) increase in cash | (40,629) | 1 |
| Cash, beginning of period | 48,390 | 17 |
| | ----- | ----- |
| Cash, end of period | \$ 7,761 | \$ 19 |
| | ===== | ===== |
| Supplemental cash flow information: | | |
| Interest paid | \$ -- | \$ |
| Income taxes paid (refunded) | -- | -- |
| Noncash investing activities: | | |
| Stock issued and options granted for services | \$ 1,073,172 | \$ |

See notes to the condensed financial statements.

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SLS INTERNATIONAL, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS

NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited condensed financial statements at September 30, 2002 have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-QSB and reflect all adjustments which, in the opinion of management, are necessary for a fair presentation of financial positions as of September 30, 2002 and results of operations and cash flows for the nine months ended September 30, 2002. All such adjustments are of a normal recurring nature. The results of operations for the interim period are not necessarily indicative of the results expected for a full year. Certain amounts in the 2001 financial statements have been reclassified to conform to the 2002 presentations. The statements should be read in conjunction with the financial statements and footnotes thereto included in the Company's Form 10-KSB for the year ended December 31, 2001.

NOTE 2 - COMMITMENTS AND CONTINGENCIES

Going Concern

The accompanying unaudited condensed financial statements at September 30, 2002 have been prepared in conformity with generally accepted accounting principles which contemplate the continuance of the Company as a going concern. The Company has suffered losses from operations during the nine months ended September 30, 2002 and the years ended

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December 31, 2001, 2000, and 1999. The Company's cash position may be inadequate to pay all of the costs associated with the introduction of its new loudspeakers. Management intends to use borrowings and security sales to mitigate the effects of its cash position, however no assurance can be given that debt or equity financing, if and when required, will be available. The unaudited condensed financial statements do not include any adjustments relating to the recoverability and classification of recorded assets and classification of liabilities that might be necessary should the Company be unable to continue in existence.

NOTE 3 - NOTES PAYABLE

The interest rate on the current notes are 7% and the maturity date is six months from the date of each note.

NOTE 4 - STOCK TRANSACTIONS

In May, 2001, the Company completed a public offering. The number of shares sold was 4,000,000. Included with the purchase of the shares was a Class A warrant and a Class B warrant. The Class A warrants expire on August 4, 2003 and are exercisable at a price of \$.50 per share. The Class B warrant has a term of 2 years and are exercisable at a price of \$3.00 per

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share. The warrants are detachable from the common stock but are not separable from each other until the Class A warrant is exercised.

From January 1, 2002 to September 30, 2002, 101,000 Class A warrants were exercised for 101,000 shares of common stock for a total of \$50,500. As of September 30, 2002, 2,000 shares of common stock had not been issued and therefore are shown on the balance sheet as common stock not issued but owed to buyers. 3,111,000 Class A warrants are outstanding as of September 30, 2002. No Class B warrants have been exercised as of September 30, 2002.

In the nine months ended September 30, 2002, the Company issued 226,000 shares of preferred stock for \$565,000. This preferred stock contained beneficial conversion features. The features allows the holder to convert the preferred to 10 shares of common stock after a one year period. A discount on preferred shares of \$550,200 relating to the beneficial conversion feature was recorded on these sales which will be amortized over a one year period beginning with the date the shareholders purchased their shares. \$386,118 was amortized to retained earnings in the nine months ended September 30, 2002. At September 30, 2002, the unamortized beneficial conversion on preferred shares was \$330,776.

In January of 2002, an agreement was signed with Office Radio Network for consulting services to be performed from January 5, 2002 to January 5, 2003. As compensation for consulting services, the Company gave Office Radio Network \$15,000 and issued 150,000 shares of common stock. As of September 30, 2002 the shares had not been issued and are therefore show as common stock not issued but owed to buyers in these financial statements. The shares of common stock were issued on November 19, 2002. Using the market value on the date the agreement was signed, the shares were valued at \$111,000 and recorded as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. The expense will be amortized over the one year period of the agreement. Consulting expense relating to this agreement was \$81,862 for the nine months ended September 30, 2002. On September

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30, 2002, there was \$29,138 remaining in unamortized cost of stock issued for services on the balance sheet.

In January of 2002, three agreements were signed for consulting services to be performed. The agreements paid 300,000 shares to the consultants in exchange for \$3,000, an executed note receivable for \$27,000, and services to be rendered. As of September 30, 2002 the shares had not been issued and are therefore recorded as common stock not issued but owed to buyers on these financial statements. 100,000 of the common shares were issued on November 19, 2002. The remaining 200,000 shares have not been issued as of December 31, 2002. Using the market value on

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the date the agreements were signed, the shares were valued at \$237,000. Value of the shares over consideration given is \$207,000 and is recorded as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. The expense will be amortized over a one year period. Consulting expense relating to these agreements was \$142,065 for the nine months ended September 30, 2002. On September 30, 2002 there was \$64,935 remaining in unamortized cost of stock issued for services on the balance sheet. A valuation allowance of \$27,000 has been used to offset the resulting note receivable from the transaction and therefore \$0 is reflected in the asset section of the balance sheet for the note receivables.

In April of 2002, an agreement was signed with The Equitable Group, LLC for consulting services to be performed from March 26, 2002 to September 26, 2002. As compensation for consulting services, the Company agreed to issue 600,000 shares of common stock, of which 100,000 were nonrefundable, to the consultant. The Company issued 100,000 shares on April 9, 2002. Using the market value on the date the agreement was signed, the shares were valued at \$51,000 and recorded as a debit in the equity section of the balance sheet as unamortized cost of stock given for services. On May 2, 2002, the Company terminated the agreement. Upon termination of the agreement all unamortized costs were amortized as consulting expense. Consulting expense relating to this agreement was \$51,000 for the nine months ended September 30, 2002. On September 30, 2002, there was \$0 remaining in unamortized cost of stock issued for services on the balance sheet.

In April of 2002, an agreement was signed with Muir, Crane, & Co. for consulting services to be performed April 2, 2002 to April 2, 2003. As compensation for consulting services the Company agreed to pay a retainer of \$4,000 per month and issue 200,000 shares of common stock. 100,000 shares were issued on April 9, 2002 and 100,000 shares were issued on July 18, 2002. Using the market value on the date the agreement was signed, the shares were valued at \$95,000 and recorded as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. At December 31, 2002, the consulting agreement had been terminated and all costs were amortized. Consulting expense relating to this agreement was \$34,740 for the nine months ended September 30, 2002. On September 30, 2002, there was \$60,260 remaining in unamortized cost of stock issued for services on the balance sheet.

In April of 2002, an agreement was signed with Sam Hamra for consulting services to be performed April 18, 2002 to April 18, 2003. As compensation for consulting services the Company agreed to issue 70,000 shares of common stock. 70,000 shares of common stock were issued on

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April 18, 2002. Using the market value on the date the agreement was signed, the

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shares were valued at \$39,200 and recorded as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. As compensation, Mr. Hamra was also issued options to purchase 100,000 shares of preferred stock at a strike price of \$2.50 per share. This preferred stock was convertible into 1,000,000 shares of common stock after a period of one year. The options expire when the preferred stock offering closes. The closing date has been extended to July 31, 2003. Using the Black-Scholes pricing model, the options were valued at \$311,222 and shown as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. At December 31, 2002, the consulting agreement had been terminated and all costs were amortized. Consulting expense relating to this agreement was \$157,798 for the nine months ended September 30, 2002. On September 30, 2002, there was \$192,624 remaining in unamortized cost of stock issued for services on the balance sheet.

In June of 2002, an agreement was signed with Liquid Solutions Corp. for consulting services to be performed June 10, 2002 to September 10, 2002. As compensation for consulting services the Company agreed to issue 500,000 shares of common stock. 500,000 shares of common stock were issued on June 19, 2002. Using the market value on the date the agreement was signed, the shares were valued at \$155,000 and recorded as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. The expense will be amortized over the three months of the agreement. Consulting expense relating to this agreement was \$155,000 for the nine months ended September 30, 2002. On September 30, 2002, there was \$0 remaining in unamortized cost of stock issued for services on the balance sheet.

In August of 2002, an agreement was signed with Atlantic Services, Ltd., a foreign corporation based in Costa Rica, for consulting services to be performed August 15, 2002 to August 15, 2003. As compensation for consulting services the Company agreed to issue 125,000 shares of common stock. 125,000 shares of common stock were issued on August 15, 2002. Using the market value on the date the agreement was signed, the shares were valued at \$43,750 and recorded as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. The expense will be amortized over the one year period of the agreement. Consulting expense relating to this agreement was \$5,687 for the nine months ended September 30, 2002. On September 30, 2002, there was \$38,063 remaining in unamortized cost of stock issued for services on the balance sheet.

In September of 2002, an agreement was signed with Art Malone, Jr. for consulting services to be performed September 10, 2002 to March 10,

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2003. As compensation for consulting services the Company agreed to issue 250,000 shares of common stock upon signing of the agreement and another 250,000 shares upon the consummation or signing of a celebrity brought directly or indirectly by Mr. Malone as an endorser. 250,000 shares of common stock were issued on September 17, 2002. As of December 31, 2002 no other shares have been issued in regards to this agreement. Using the market value on the date the agreement was signed,

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the shares were valued at \$60,000 and recorded as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. The expense will be amortized over the six month period of the agreement. Consulting expense relating to this agreement was \$7,200 for the nine months ended September 30, 2002. On September 30, 2002, there was \$52,800 remaining in unamortized cost of stock issued for services on the balance sheet.

NOTE 5 - SUBSEQUENT EVENTS

From October to December of 2002, the Company issued 89,000 shares of preferred stock for \$222,500.

In February and March of 2003, the Company issued 32,940 shares of preferred stock for \$82,350.

In October of 2002, an agreement was signed with Patrick Armstrong of Titan Entertainment Group for consulting services to be performed November 5, 2002 to November 5, 2003. As compensation for consulting services the Company agreed to issue 100,000 shares of common stock and 250,000 options for 250,000 shares of common stock. The options have a strike price of \$.30 and expire ten years from date of issuance. 100,000 shares of common stock were issued on November 5, 2002. Using the market value on the date the agreement was signed, the shares were valued at \$39,000 and recorded as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. Using the Black-Scholes pricing model, the options were valued at \$57,471 and shown as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. All costs will be amortized over the one year period of the agreement.

In October of 2002, an agreement was signed with Larry Stessel of Titan Entertainment Group for consulting services to be performed November 5, 2002 to November 5, 2003. As compensation for consulting services the Company agreed to issue 100,000 shares of common stock and 250,000 options for 250,000 shares of common stock. The options have a strike price of \$.30 and expire ten years from date of issuance. 100,000 shares of common stock were issued on November 5, 2002. Using the market value on the date the agreement was signed, the shares were valued at \$39,000 and recorded as a debit in the equity section of the balance sheet as

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unamortized cost of stock issued for services. Using the Black-Scholes pricing model, the options were valued at \$57,471 and shown as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. All costs will be amortized over the one year period of the agreement.

In December of 2002, an agreement was signed with Atlantic Services, Ltd., a foreign corporation based in Costa Rica, for consulting services to be performed December 2, 2002 to June 2, 2003. As compensation for consulting services the Company agreed to issue 300,000 shares of common stock and the president of the Company agreed to issue 300,000 options to purchase 300,000 shares of common stock owned by him personally. The options have a strike price of \$.05 and expire 30 days after the current lock-up period ends on the president's shares. 300,000 shares of common stock were issued on December 9, 2002. Using the market value on the date the agreement was signed, the shares were valued at \$114,000 and recorded as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services.

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Using the Black-Scholes pricing model, the options were valued at \$99,099 and shown as a credit to additional paid in capital - common stock and a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. The cost will be amortized over the six month period of the agreement.

In December 2002, an agreement was signed with Worldwide Financial Marketing, Inc. for consulting services to be performed December 15, 2002 to December 15, 2003. As compensation for consulting services the Company agreed to issue 300,000 shares of common stock. 300,000 shares of common stock were issued on December 13, 2002. Using the market value of the date the agreement was signed, the shares were valued at \$120,000 and recorded as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. The cost will be amortized over the one year period of the agreement.

In February of 2003, the Company signed a consulting agreement with Tom Puccio for a period of six months. On February 25, 2003, the Company issued 300,000 shares of common stock in fulfillment of this agreement. Using the market value on the date the agreement was signed the stock was valued at \$93,000.

In October, November, and December of 2002, 102,000 shares of preferred stock were converted into 1,020,000 shares of common stock. The shares were issued in February of 2003.

In February of 2003, 42,000 shares of preferred stock were converted into 420,000 shares of common stock.

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On April 19, 2003, the board of directors approved and ratified all the consulting agreements detailed in Note 4 and Note 5.

NOTE 6 - UNAMORTIZED COST OF STOCK ISSUED FOR SERVICES

As detailed in Note 4, the Company issued or agreed to issue 1,695,000 shares of common stock and 1,000,000 options as part of consulting agreements. The value of stock issued and options granted totaled \$1,073,172 for the nine months ended September 30, 2002. This cost is shown as a debit in the equity section of the balance sheet as unamortized cost of stock issued for services. The balance will be amortized into consulting expense over the lives of the various consulting agreements. For the nine months ended September 30, 2002, \$635,352 was amortized into consulting expense. Unamortized cost of stock issued for Services was \$437,820 as of September 30, 2002.

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

OVERVIEW

We manufacture premium-quality loudspeakers and sell them through our dealer networks. The speakers use our proprietary ribbon-driver technology and are generally recognized in the industry as high-quality systems. We sell a Professional Line of loudspeakers, a Commercial Line of loudspeakers, and Home

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Theatre systems.

From the early 1970's through 1999 we derived substantially all of our revenue from marketing, renting, selling and installing sound and lighting systems. In June 1999, due to the favorable customer acceptance of our custom-designed loudspeaker systems, we ceased these historical operations and began focusing all efforts towards becoming a loudspeaker manufacturer and selling to dealers and contractors on a wholesale basis. As a result, we have been essentially in a development stage, as we are bringing to market products that we introduced in 2000 and 2001 and designing and bringing to market additional products.

In June 2000, we asked dealers and distributors to sell our Professional Line of products. These dealers and distributors started to form our current network of approximately 50 dealers and 7 foreign distributors and we began shipping to them. However, most of the Professional Line required new ribbon drivers that we completed and implemented into the product line in early 2001.

In September 2000, we introduced our Home Theatre systems, and sales for those systems began immediately. From September through December 2000, we added 20 new Home Theatre dealers in the US and began marketing efforts to establish distributors and dealers outside the US.

In June 2001, we introduced a Commercial Line of loudspeakers that use our PRD500 Ribbon Driver and, in September 2001, we finished the development of our PRD1000 Ribbon Driver and began implementing it into our Professional Line. Our PRD drivers upgraded the previous drivers that we purchased from third-party manufacturers and the cost to us is approximately one-sixth of the price that we had been paying for the previous drivers.

SLS International, Inc. was formed on July 25, 2000 and had no previous operations. On the same date, this corporation merged with Sound and Lighting Specialist Inc., its sole shareholder. All of the financial and other information reported for periods prior to the merger are the results of operations of Sound and Lighting Specialist, Inc. All of the operating activity reported for periods after the merger are the results of operations of SLS International, Inc. After effectiveness of the merger, Sound and Lighting Specialist, Inc. ceased to exist as a separate corporate entity. The information in this section should be read together with the financial statements, the accompanying notes to the financial statements and other sections included in this report.

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RESULTS OF OPERATIONS

Quarter ended September 30, 2002 as compared to the quarter ended September 30, 2001. For the quarter ended September 30, 2002, revenue decreased to \$161,688 from \$173,783 in 2001, a 7% decrease. The decrease resulted primarily from approximately \$70,000 in orders that were originally scheduled for shipment in September being delayed until October. Our gross profit percentage decreased to approximately 23% in the 2002 period from approximately 35% in the 2001 period, as discussed below. Primarily as a result of an increase in general and administrative expenses discussed below, our net loss increased to \$572,957 in the third quarter of 2002 as compared to a net loss of \$226,607 in the comparable quarter of 2001.

Gross profit percentage worsened compared to the prior-year period, primarily due to discounted introductory sales that gave us favorable publicity, and the sale at discounted prices of models that had been used for trade show

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demonstrations. We expect to continue to make sales at discounted prices as similar special circumstances arise, but we expect such sales to constitute a smaller portion of our sales in most future periods, thereby having less of an impact on our gross profit percentage.

General and administrative expenses for the 2002 third quarter increased to \$605,885 from \$280,571 in the 2001 third quarter, primarily as a result of \$24,953 of bad debt expense (compared to \$0 in the 2001 quarter) and \$321,333 of non-cash cost amortized in the quarter reflecting a portion of the fair value of stock issued under consulting agreements entered into during the quarter and in prior periods, as well as additional trade shows and travel expense in the 2002 quarter. During the 2002 third quarter, we also increased the size of our leased facility, thereby increasing our monthly lease costs, which will increase our capacity to satisfy the expected growth in revenue.

Interest expense decreased to \$5,067 in the 2002 third quarter as compared to \$7,734 in the 2001 third quarter, due to the repayment of loans resulting in decreased borrowings.

Nine months ended September 30, 2002 as compared to the nine months ended September 30, 2001. For the first nine months of 2002, revenue increased to \$486,204 from \$284,306 in the 2001 period, a 71% increase, resulting primarily from the expansion of our loudspeaker product line and the growth in sales of our loudspeakers. Our gross profit percentage decreased to approximately 34% in the 2002 period from approximately 36% in the 2001 period, primarily as a result of discounted introductory sales and the sale of demonstration models, as discussed above, partially offset by our conversion to in-house manufacturing of our ribbon drivers from our previous outsourcing of such components. As a result of the increase in general and administrative expenses, our net loss increased to \$1,518,309 in the first nine months of 2002 as compared to a net loss of \$723,833 in the first nine months of 2001.

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General and administrative expenses for the first nine months of 2002 increased to \$1,667,850 from \$792,686 in 2001, primarily as a result of \$169,305 of bad debt expense (compared to \$0 in the 2001 period); \$635,352 of non-cash cost amortized in the nine-month period reflecting a portion of the fair value of stock issued under consulting agreements entered into during the period and in prior periods; the hiring of a sales manager; and consulting expenses incurred for investor relations and public relations.

Interest expense decreased to \$18,330 in the 2002 period as compared to \$35,033 in the 2001 period, due to the repayment of loans resulting in decreased borrowings.

FINANCIAL CONDITION

On September 30, 2002, our current liabilities exceeded current assets by \$528,069, compared to \$296,734 on December 31, 2001. Total liabilities exceeded total assets by \$499,623, compared to \$262,166 on December 31, 2001. The increased working capital deficit was due primarily to increases in accounts payable and other increased liabilities incurred from our expanding operations, and decreases in cash and accounts receivable. These factors were partially offset by an increase in inventory, funded in large part by the sales of equity described below, as well as increases in accounts payable and accrued liabilities.

We have experienced operating losses and negative cash flows from operating activities in all recent years. The losses have been incurred due to the development time and costs in bringing our products through engineering and

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to the marketplace. In addition we have not paid notes payable and accounts payable on due dates. The report of our accountants contains an explanatory paragraph indicating that these factors raise substantial doubt about our ability to continue as a going concern.

We are experiencing significant cash shortages; we had \$7,761 in cash on September 30, 2002. However, in October 2002, we raised \$100,000 through the sale of 40,000 shares of preferred stock. In order to continue operations, we have been dependent on raising additional funds and have continued to sell preferred stock in 2002 to raise capital. In the first nine months of 2002 we sold 226,000 shares of preferred stock for \$565,000. In addition, we have outstanding warrants, which, upon exercise, have provided additional funding of \$50,500 during the first nine months of 2002.

In the first nine months of 2002, we entered into consulting agreements that required us to issue an aggregate of 1,595,000 shares of common stock and options to purchase 100,000 shares of Class A preferred stock at an exercise price of \$2.50 per share (each such share of preferred stock converts into 10 shares of common stock). In addition, a consulting agreement entered into in August 2001 is now reflected in the restated financial statements, recognizing an obligation to issue 100,000 shares of common stock under such agreement. Total non-cash cost under such agreements is \$1,073,172, \$635,352 of which is reflected as amortized expenses in the first nine months of 2002 and the remainder of which are to be amortized in subsequent periods over the respective terms of such agreements. The difference between such total cost and the

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amount amortized is reflected as unamortized cost of stock issued for services on the balance sheet. The restated financial statements also recorded \$3,000 of cash and \$27,000 of notes receivable received from such consultants. The notes receivable were then written off as bad debt expense in the quarter ended March 31, 2002.

Notes payable increased slightly to \$419,815 on September 30, 2002. One note totaling \$7,181 is secured with equipment; and the remaining borrowings are from individuals, are unsecured and matured in the first quarter of 2002. However, these notes are payable to existing shareholders that are not making a demand on the notes and will continue to accrue the 7% interest for an indefinite period of time. We expect that these shareholders will continue to permit these notes to remain outstanding, but they have the right to demand full payment at any time and they may do so, which would have a material adverse effect on our financial condition.

There is intense competition in the speaker business with other companies that are much larger and national in scope and have greater financial resources than we have. We will require additional capital to continue our growth in the wholesale speaker market. We are relying upon our ability to obtain the necessary financing through the issuance of equity and upon our relationships with our lenders to sustain our viability.

In the past, we have been able to privately borrow money from individuals by the issuance of notes and have sold our common stock to raise capital. We intend to continue to do so as needed. However, we cannot be certain that we will continue to be able to successfully obtain such financing. If we fail to do so, we may be unable to continue as a viable business.

FORWARD LOOKING INFORMATION

This report, as well as our other reports filed with the SEC and our press releases and other communications, contain forward-looking statements made

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pursuant to the safe harbor provisions of the Securities Litigation Reform Act of 1995. Forward-looking statements include all statements regarding our expected financial position, results of operations, cash flows, dividends, financing plans, strategy, budgets, capital and other expenditures, competitive positions, growth opportunities, benefits from new technology, plans and objectives of management, and markets for stock. These forward-looking statements are based largely on our expectations and, like any other business, are subject to a number of risks and uncertainties, many of which are beyond our control. The risks include those stated in the "Risk Factors" section of our Annual Report on Form 10-KSB and economic, competitive and other factors affecting our operations, markets, products and services, expansion strategies and other factors discussed elsewhere in this report, in our Annual Report on Form 10-KSB and in the other documents we have filed with the Securities and Exchange Commission. In light of these risks and uncertainties, there can be no assurance that the forward-looking information contained in this report will in fact prove accurate, and our actual results may differ materially from the forward-looking statements.

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ITEM 3. CONTROLS AND PROCEDURES.

As of October 1, 2002, our Chief Executive Officer and Chief Financial Officer evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2002.

Since October 1, 2002, our independent auditors completed their audit of our financial statements for the year ended December 31, 2002. As a result of such audit, we have been required to make restatements and reclassifications of our unaudited financial statements filed for the quarters ended March 31, June 30 and September 30, 2002. Such restatements and reclassifications call into question the effectiveness of our disclosure controls and procedures. We are currently considering enhancements to our controls and procedures.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

We refer you to Item 1 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 for a discussion of a claim by Alfred V. Greco filed in the Supreme Court of the State of New York, County of New York, for unpaid legal fees, seeking a total of \$50,772, plus interest, costs and disbursements. In the third quarter of 2002, the parties entered into a settlement agreement with respect to this matter, and we believe our obligations under such agreement are not material to the business.

Item 2. Changes in Securities.

In the quarter ended September 30, 2002, the Company sold 50,000 shares of preferred stock for \$125,000 in cash. All sales were made to accredited investors. Each share of preferred stock is convertible into ten shares of common stock after one year. The sales were made in reliance on Section 4(2) of the Securities Act of 1933, as amended.

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We also agreed to issue 375,000 shares of common stock under consulting agreements entered into during the quarter ended September 30, 2002. The issuances were made in reliance on Section 4(2) of the Securities Act of 1933, as amended.

The net proceeds from the sale of stock in the third quarter of 2002 were used for working capital purposes. We did not use any registered securities broker-dealers in connection with any sales of stock. All of the foregoing uses of proceeds were direct or indirect payments to nonaffiliates.

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

(a) Exhibits. The following are being filed as exhibits to this Report:

| Exhibit No. | Description of Exhibit |
|-------------|---|
| ----- | ----- |
| 10.1 | Letter Agreement, dated July 17, 2002, between SLS International, Inc. and Alfred V. Greco PLLC regarding settlement of Alfred V. Greco v. SLS International, Inc. |
| 10.2 | Letter Agreement, dated July 17, 2002, between SLS International, Inc. and Alfred V. Greco PLLC regarding services to be provided by Alfred V. Greco PLLC |
| 10.3 | Consulting Agreement, dated August 15, 2002, between SLS International, Inc. and Atlantic Services Ltd. |
| 10.4 | Consulting Agreement, dated September 10, 2002, between SLS International, Inc. and Art Malone Jr. |
| 99.1 | Chief Executive Officer and Chief Financial Officer Certification of Periodic Report (filed as Exhibit 99.1 to Form 10-QSB filed with the SEC on November 14, 2002) |

(b) Reports on Form 8-K. We filed no Reports on Form 8-K during the quarter ended September 30, 2002.

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SIGNATURE

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.

SLS INTERNATIONAL, INC.

(Registrant)

Date: May 21, 2003

By /s/ John Gott

John Gott
President and
Chief Financial Officer

