

CKX LANDS, INC.  
Form DEFR14A  
April 04, 2018

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**SCHEDULE 14A**

**Amendment No. 1**

**(Rule 14a-101)**

**Proxy Statement Pursuant to Section 14(a) of the  
Securities Exchange Act of 1934**

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

Preliminary Proxy Statement

Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material Pursuant to §240.14a-12

**CKX Lands, Inc.**

**(Name of Registrant as Specified In Its Charter)**

**(Name of Person(s) Filing Proxy Statement, if other than the Registrant)**

Payment of Filing Fee (Check the appropriate box):

No fee required.

Fee computed on

table below per

Exchange Act

Rules 14a-6(i)(1)

and 0-11.

(1) Title of each  
class of  
securities to  
which  
transaction  
applies:

(2) Aggregate  
number of  
securities to  
which  
transaction  
applies:

(3) Per unit price  
or other  
underlying  
value of  
transaction  
computed  
pursuant to  
Exchange  
Act Rule  
0-11 (set  
forth the  
amount on  
which the  
filing fee is  
calculated  
and state  
how it was  
determined):

(4) Proposed  
maximum  
aggregate  
value of  
transaction:

(5) Total fee  
paid:

Fee paid  
previously with  
preliminary  
materials.  
Check box if any  
part of the fee is  
offset as provided  
by Exchange Act

Rule 0-11(a)(2)  
and identify the  
filing for which  
the offsetting fee  
was paid  
previously.  
Identify the  
previous filing by  
registration  
statement number,  
or the Form or  
Schedule and the  
date of its filing.

Amount

(1) Previously  
Paid:

Form,  
Schedule or  
(2) Registration  
Statement  
No.:

(3) Filing Party:

(4) Date Filed:

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CKX Lands, Inc.

Schedule 14A

Amendment No. 1

This amendment is being filed to insert the shareholder count of 456 into the 3rd paragraph on the Proxy Statement, page 3 of 11 on this amended filing and page 2 of 10 of the original filing.

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**CKX LANDS, INC.**

**1508 Hodges Street**

**Lake Charles, LA 70601**

**Tel. 337-493-2399**

**NOTICE OF ANNUAL MEETING OF STOCKHOLDERS**

**TO BE HELD THURSDAY MAY 3, 2018**

The Annual Meeting of the Stockholders of CKX Lands, Inc., will be held at 1508 Hodges Street, Lake Charles, Louisiana 70601, on Thursday, May 3, 2018, at 10:00 a.m., central time, for the following purposes:

1. To elect directors;
2. To vote on the proposal to ratify the appointment of MaloneBailey LLP as our independent registered public accounting firm for the fiscal year ended December 31, 2018;
3. To vote, by non-binding vote, on an advisory approval of our executive compensation; and
4. To transact such other business as may properly come before the meeting.

Only stockholders of record at the close of business on March 26, 2018, are entitled to notice of and to vote at the meeting.

IT IS IMPORTANT THAT YOUR SHARES BE REPRESENTED AT THE MEETING. THEREFORE, WHETHER OR NOT YOU PLAN TO ATTEND THE MEETING, PLEASE SIGN AND DATE YOUR PROXY AND RETURN IT IN THE ENCLOSED ENVELOPE, WHICH REQUIRES NO POSTAGE IF MAILED IN THE UNITED

STATES. IF YOU ATTEND THE MEETING AND VOTE IN PERSON, YOUR PROXY WILL NOT BE USED.

*/s/ Brian R. Jones*  
BRIAN R. JONES

President and Treasurer

April 3, 2018

**IMPORTANT NOTICE REGARDING THE  
AVAILABILITY OF PROXY MATERIALS FOR THE  
2018 ANNUAL MEETING OF SHAREHOLDERS  
TO BE HELD ON MAY 3, 2018**

**This Proxy Statement, the form of Proxy and the Company's Annual Report on Form 10-K for the year ended December 31, 2017 are available at [www.envisionreports.com/ckx](http://www.envisionreports.com/ckx).**

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CKX Lands, Inc.

## **PROXY STATEMENT**

### **APPROXIMATE DATE OF MAILING: APRIL 3, 2018**

The enclosed proxy card is solicited by the Board of Directors of CKX Lands, Inc. (“CKX Lands” or “Company”) for use at its Annual Meeting of Stockholders to be held on Thursday, May 3, 2018, at 10:00 a.m., central time, at 1508 Hodges Street, Lake Charles, Louisiana 70601 or any adjournments or postponements thereof. You may revoke your proxy at any time prior to it being voted by giving written notice to the Secretary of the Company, by submission of a later dated proxy through any of the permissible means of voting listed on the proxy card, or by voting in person at the meeting.

All expenses of preparing, printing and mailing the proxy statement and all materials used in the solicitation will be borne by the Company. Proxies may also be solicited in person or by telephone or fax by directors, officers and other employees of the Company, none of whom will receive additional compensation for such services. The Company will also request brokerage houses, custodians and nominees to forward these materials to the beneficial owners of the stock held of record by them and will pay the reasonable expenses of such persons for forwarding the material. The mailing address of CKX Lands is P.O. Box 1864, Lake Charles, LA 70602.

On March 26, 2018, CKX Lands had outstanding 1,942,495 shares of Common Stock, its only class of stock, held by 456 shareholders of record. Only stockholders of record at the close of business on March 26, 2018, will be entitled to receive notice of and to vote at the meeting. With respect to all matters that will come before the meeting, each stockholder may cast one vote for each share registered in his or her name on the record date. The presence, in person or by proxy, of holders of a majority of the outstanding shares of Common Stock entitled to vote at the meeting is necessary to constitute a quorum at the meeting. Stockholders voting, or abstaining from voting, by proxy on any issue will be counted as present for purposes of constituting a quorum. If a quorum is present, the election of directors will be determined by a plurality vote and the approval of the independent auditor and the non-binding advisory vote on our executive compensation will be determined by a majority of the votes cast at the meeting in person or by proxy. Abstentions will have no effect on the calculation of the vote on any matter at the meeting.

If you are the record holder of your shares, then the shares represented by your properly executed proxy card will be voted at the meeting in accordance with your directions set forth on the proxy, unless you revoke it. If you do not specify a choice on the proxy, the shares will be voted FOR the election of the nominees as directors, FOR approval of MaloneBailey LLP as auditors and FOR the approval of the compensation of the Company’s Named Executive Officer. The proxy also gives authority to the proxy holders to vote the shares in their discretion on any other matter

presented at the meeting, including matters as to which the Company has not received timely advance notice. If you hold your shares in an account at a brokerage firm, bank, broker-dealer, or other similar organization, then you are the beneficial owner of shares held in “street name,” and the proxy materials were forwarded to you by that organization. The organization holding your account is considered the stockholder of record for purposes of voting at the annual meeting. As a beneficial owner, you have the right to instruct that organization on how to vote the shares held in your account.

If your shares are held in the name of a broker, bank or other nominee, you will receive instructions from your broker, bank or other nominee that you must follow in order for your broker, bank or other nominee to vote your shares according to your instructions. Many brokerage firms and banks have a process for their beneficial holders to provide instructions via the Internet or over the telephone. If you are a beneficial owner of shares held in street name and you wish to vote in person at the annual meeting, **you must obtain a legal proxy from the organization that holds your shares.**

If the organization that holds your shares does not receive instructions from you on how to vote your shares, then under the rules of various national and regional securities exchanges, the organization that holds your shares may generally vote your shares in its discretion on routine matters, but it cannot vote on non-routine matters. **If the organization that holds your shares does not receive instructions from you on how to vote your shares on a non-routine matter, the organization that holds your shares will not have the authority to vote, and therefore cannot vote, on that matter with respect to your shares. This is generally referred to as a “broker non-vote.” The election of directors (Item 1) and matters relating to executive compensation (Item 3) are non-routine matters, so brokers may not vote your shares on Items 1 or 3 if you do not give specific instructions on how to vote. We encourage you to provide instructions to your broker or nominee regarding these proposals so your shares will be voted.**



The ratification of the independent auditors (Item No. 2) is a matter that we believe will be considered routine. Therefore, no broker non-votes are expected to occur in connection with Item No. 2.

Broker non-votes will be counted as present at the stockholders' meeting for the purposes of calculating a quorum but will not be counted as present for any other purpose or as a vote cast for or against a matter. Thus, we believe broker non-votes will have no effect on any matter at the meeting.

## BENEFICIAL OWNERSHIP OF COMMON STOCK

The following table provides information as of March 26, 2018, concerning beneficial ownership of Common Stock by each director, each director nominee, each executive officer, all directors and executive officers as a group, and each person known by CKX Lands to own beneficially more than 5% of the outstanding shares of Common Stock. Unless otherwise noted, the listed persons have sole voting and dispositive powers with respect to shares listed below. The address of each person listed below is c/o CKX Lands, Inc., 1508 Hodges Street, Lake Charles, LA 70601.

Name of Beneficial Owner	Number	Percent
	Beneficially Owned	of Class
Lee Boyer (1)	1,000	0.05 %
Max H. Hart (2)	9,805	0.50 %
Brian R. Jones	--	0.00 %
Eugene T. Minvielle, IV	--	0.00 %
Mary Watkins Savoy (1)	9,158	0.47 %
Charles D. Viccellio (1)	10,625	0.55 %
Mary Leach Werner (3)	21,276	1.10 %
Michael B. White (4)	367,638	18.93 %
All directors and executive officers as a group	419,502	21.58 %

(1) Mr. Boyer, Mrs. Savoy, and Mr. Viccellio have sole voting and/or investment power of their shares.

Includes 3,500 shares owned by a trust of which Mr. Hart is a co-trustee, 2,200 shares owned by a trust of which Mr. Hart is a co-trustee and 1,000 shares owned by a limited liability company of which Mr. Hart is a manager.  
 (2) Mr. Hart does not have the sole voting and/or investment powers over these 6,700 shares. Mr. Hart does have the sole voting and/or investment powers over the remaining 3,105 shares.

(3)

Includes 8,250 shares owned by a partnership of which Mrs. Werner is a partner and 11,250 shares owned by a corporation of which Mrs. Werner is a director. Mrs. Werner does not have the sole voting and/or investment power over these 19,500 shares. Mrs. Werner does have the sole voting and/or investment power over the remaining 1,776 shares.

- (4) Includes 367,638 shares owned by a L.L.C. of which Mr. White is sole manager and sole member. Mr. White does have the sole voting and/or investment power over these 367,638 shares.

#### **SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE**

Section 16(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), requires the Company's executive officers, directors and more than 10% stockholders to file with the Securities and Exchange Commission (SEC) reports on prescribed forms of their ownership and changes in ownership of Company stock and furnish copies of such forms to the Company. Based solely upon a review of the Form 3, 4 and 5 filings received from or filed by CKX Lands, Inc. on behalf of reporting persons during the most recent fiscal year, CKX Lands, Inc. is not aware of any failure to file on a timely basis any Form 3, 4 or 5 specifically during the most recent fiscal year.

**ITEM 1: ELECTION OF DIRECTORS**

The By-Laws of the Company specify that the number of directors shall not be less than five and not more than fifteen and the Board shall fix this number for the calendar year at the last meeting of the preceding year. The Board fixed the number of Board members for the calendar year 2018 at eight (8) members. Each director will hold office for one year and until his successor is elected and qualified. On the recommendation of the Nominating Committee, the Board of Directors has nominated the persons listed below for election as director. If a nominee should become unavailable for election, the persons voting the accompanying proxy may in their discretion vote for a substitute. All nominees have been with the same organization in the same position as listed below for the past five years unless noted. The table below also includes the specific qualifications and experience of each nominee that led to the conclusion that the nominee should serve as a director.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR EACH OF THE NOMINEES NAMED BELOW.

<u>Name</u>	<u>Age</u>	<u>Experience and Qualifications</u>	<u>Director Since</u>
Lee W. Boyer	60	Secretary of CKX Lands, Inc.; Attorney with Stockwell, Sievert, Viccellio, Clements & Shaddock, L.L.P.; President, Second University Homesites, Inc.; Manager, Jones-Boyer, LLC; Manager, Boyer Properties, LLC; Director, Mallard Bay, LLC. Mr. Boyer's experience in land management and oil and gas leasing activities makes him qualified to serve as a director.	2016
Max H. Hart (1) (2)	59	Principal, Haas-Hirsch Interests. Mr. Hart's experience in land management, oil and gas leasing activities, forestry, farming and rights of way makes him qualified to serve as a director.	2016
Brian R. Jones	57	President and Chairman of the Board of CKX Lands, Inc. since 2013 and Treasurer of CKX Lands, Inc. since 2006; Managing member of Brian R. Jones CPA, LLC. Mr. Jones' experience in public accounting, SEC compliance and land management makes him qualified to serve as a director.	2007
Eugene T. Minvielle, IV (1)	44	Chief Financial Officer and Treasurer of Marlin Energy, LLC. Mr. Minvielle's experience in oil and gas and financial reporting makes him qualified to serve as a director.	2018
Mary Watkins Savoy (1) (2) (3)	78	Private investments; Director of Mallard Bay, LLC. Mrs. Savoy's experience in land management and oil and gas leasing activities makes her qualified to serve as a director.	1998

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Charles D. Viccellio	84	Attorney (retired), Stockwell, Sievert, Viccellio, Clements & Shaddock, L.L.P. Mr. Viccellio's extensive legal experience in land management and oil and gas activities makes him qualified to serve as a director.	1996
Mary Leach Werner (2) (3)	50	Vice President and Director of North American Land Co., LLC. Vice President and Director of Sweet Lake Land & Oil Co., LLC. Mrs. Werner's experience in land management and oil and gas activities makes her qualified to serve as a director.	2004
Michael B. White (3)	61	Oil and gas ventures, farmland and timberland investments, sole manager of Ottley Properties, LLC. Mr. White's experience in oil and gas, farmland and timberland make him qualified to serve as a director.	2013

Member of the (1) Audit Committee, (2) Compensation Committee, (3) Nominating Committee.

Stockwell, Sievert, Viccellio, Clements & Shaddock, L.L.P. is a law firm. Second University Homesites, Inc., Jones-Boyer, LLC, and Boyer Properties, LLC are residential and commercial property management companies. Mallard Bay Corp., Haas-Hirsch Interests, North American Land Co., Inc., and Sweet Lake Land & Oil Co., Inc. are all land management companies. Marlin Energy, LLC is an upstream oil and gas company. Ottley Properties, LLC is an investment holding company. Brian R. Jones CPA, LLC is a CPA firm.

The Board of Directors has determined that director nominees Hart, Minvielle, Savoy, Werner, and White are “independent directors” as defined under the rules of the NYSE MKT. In connection with this assessment, the Board of Directors also determined that Hart, Minvielle, and Savoy are independent within the meaning of the NYSE MKT standards currently in effect and Rule 10A-3 of the Exchange Act applicable to members of the Audit Committee, and that Hart, Savoy and Werner are independent under the standards applicable to members of the Compensation Committee.

Each of the Company’s directors is requested to attend the Annual Meeting in person. All of the Company’s directors attended the Company’s 2017 Annual Meeting of Shareholders.

## **BOARD OF DIRECTORS LEADERSHIP STRUCTURE AND RISK OVERSIGHT**

CKX Lands’ president and treasurer, Brian R. Jones also serves as the Chairman of the Board of Directors. The Company believes this leadership structure is most appropriate for the communication of Company decisions, activities and other third-party communications to the Board members, management and company personnel due to the small company size and the lack of complexity in its operating activities.

The Company’s Board of Directors does not have a lead independent director. Independent Directors meet at least annually in executive session without non-independent or management Directors in attendance. During 2017, independent Directors met four times in executive session.

CKX Lands’ Board of Directors administers its risk oversight responsibilities by requiring specific Board authorization of all non-routine activities of the Company and through its Audit Committee’s quarterly review of the Company’s financial statements, management activities discussions and communication with external auditors.

During 2017, the Board of Directors held a total of five meetings. No director attended fewer than 75% of the aggregate of all board meetings and meetings of committees of which he or she is a member during 2017.

## **BOARD OF DIRECTORS' COMMITTEES**

The Board of Directors has an Audit Committee, Compensation Committee and Nominating Committee. The membership of each Committee consists solely of non-employee directors who meet the independence standards established by the NYSE MKT.

**AUDIT COMMITTEE:** The Audit Committee assists the Board of Directors in fulfilling its oversight responsibilities with respect to financial reports and other financial information, and selects and appoints the independent registered public accountants. The Company has determined that Mr. Minvielle qualifies as “audit committee financial expert” under Item 407(d)(5) of Regulation S-K. Each member of the Audit Committee meets the financial literacy requirements of the NYSE MKT. During 2017, the Audit Committee held four meetings. A copy of the Audit Committee’s charter is available on the company’s website, [www.ckxlands.com](http://www.ckxlands.com). All committee members attended all Audit Committee meetings during 2017.

**COMPENSATION COMMITTEE:** The Compensation Committee approves all executive compensation. The Compensation Committee does not have a charter. During 2017, the Compensation Committee held one meeting. All members attended the compensation committee meeting. Executive officers do not participate in the design of, deliberations about, or voting on their compensation or the compensation of directors. In light of the simplicity and relatively modest levels of the Company's executive and director compensation, the Company does not believe that there is any risk that could arise from its pay practices that would have a material adverse effect on it.

**NOMINATING COMMITTEE:** The Nominating Committee selects nominees for the Board of Directors.

The Nominating Committee identifies individuals qualified to become directors and recommends them to the Board for directorships. The Nominating Committee will consider persons recommended by stockholders to become nominees for election as directors. Recommendations for consideration by the Nominating Committee should be sent to the Secretary of the Company in writing together with appropriate biographical information. Please see "Stockholder Proposals."

The Committee identifies and evaluates nominees on the basis of their education, business experience, integrity, and knowledge of Southwest Louisiana particularly as it relates to land management. Nominees recommended by security holders will be evaluated by the same criteria. When identifying nominees for directorships, the Committee considers diversity of skills, experience and business background, and no specific minimum qualifications are required.

The Nominating Committee has in the past considered potential director candidates suggested by its members, other directors and management. Members on the committee and management have in the past interviewed potential candidates who were not incumbent directors, and the committee has then voted to recommend a slate of nominees to the Board.

The Nominating Committee does not have a charter and operates under a board resolution addressing the nominating process.

During 2017, the Nominating Committee held one meeting. All members attended the nominating committee meeting

## **DIRECTOR COMPENSATION**

The Company set director fees per meeting in 2017 at the levels below:

Meeting	Member		
	Chairperson	Non-Attending Attending	
Board of Directors	\$ 1,000	\$600	\$ 200
Audit Committee	800	400	--
Compensation Committee	300	200	--
Nominating Committee	\$ 300	\$200	\$ --

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Actual compensation paid to Directors during 2017 is presented below:

Director	Fees Paid
Lee W. Boyer	3,400
Max H. Hart	4,600
Brian R. Jones	5,000
Eugene T. Minvielle, IV	5,200

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We offer many of our services on a worldwide basis and we are therefore subject to risks associated with doing business internationally. We anticipate that net revenues from international operations will grow in the future and will represent a greater percentage of total net revenues. As a result, our future results could be negatively affected by a variety of factors, including: changes in a specific country's political or economic conditions; potential negative consequences from changes in tax laws; difficulty in staffing and managing widespread operations; and unfavorable labor regulations applicable to our International operations.

### **Future acquisitions could disrupt our ongoing business, distract our management and employees, increase our expenses and adversely affect our business.**

The majority of our growth is expected to be generated internally. In addition, current market conditions may provide us with the opportunity to partner with other quality institutions in the CRO market. As such, acquisitions that make financial sense, fill a strategic need, are of a manageable size, and complement our core competencies would be considered as a means to further supplement our internal growth. Although we may attempt to grow our business through acquisitions, we may not be able to identify acceptable businesses to acquire or be successful in negotiating mutually agreeable terms; and if we are successful in acquiring businesses, we may not be successful in integrating the acquired business with our existing operations and we may not realize the benefits anticipated from the acquisition of businesses. Although we have not previously used acquisitions as a means to expand our business, we may consider strategic acquisitions in the future. However, we may not be able to identify suitable acquisition opportunities or obtain any necessary financing on acceptable terms. Further, any future acquisitions could involve other risks, such as the assumption of additional expenses and liabilities, the dilution of earnings or dilution of our existing shareholders percentage of ownership, potential losses resulting from undiscovered liabilities of the acquired business not covered by indemnification we may obtain from the seller, and the diversion of management's attention from other business concerns.

If we were to close an acquisition, we would need to integrate the acquisition into our business operations. In doing so, we may face difficulties in coordinating and assimilating geographically separated units or organizations and integrating, motivating and retaining personnel with diverse business backgrounds. Further, we may not be able to successfully implement appropriate operational, financial and management systems and controls to achieve the anticipated benefits from an acquisition. In addition, our ability to integrate an acquisition could be affected by factors beyond our control, including regulatory developments, general economic conditions, and increased competition. The integration of an acquisition may also result in disruption to our existing business and the loss of existing key personnel and clients, or the loss of the acquired business's key personnel or clients.

An acquisition of a foreign business may involve still more risks, including not being able to successfully assimilate differences in foreign business practices and overcoming language barriers.

The occurrence of one or more of the above, or other factors, may adversely affect our ability to achieve the benefits anticipated from an acquisition. As a result, our financial condition or results of operations may be materially and adversely affected and we may not be able to grow our business in the manner we desire.

### **Our stock price may be volatile and could experience substantial declines.**

The market price of our common stock has experienced historical volatility and might continue to experience volatility in the future in response to quarter-to-quarter variations in: operating results;



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changes in backlog and new business results; the issuance of analysts' reports; market conditions in the industry; prospects of health care reform; changes in governmental regulations; and changes in general conditions in the economy or the financial markets.

The general equity markets have also experienced significant fluctuations in value. This volatility and the market variability has affected the market prices of securities issued by many companies, often for reasons unrelated to their operating performance, and may adversely affect the price of our common stock.

We have never declared a cash dividend on our common stock and do not anticipate paying cash dividends in the foreseeable future. Instead, we intend to retain future earnings for reinvestment in our business.

## **Failure to satisfy NASDAQ SmallCap Market maintenance criteria could negatively impact the liquidity and market price of our common stock.**

Our common stock began trading on the NASDAQ SmallCap Market in December 1997. There are several requirements for continued listing on the NASDAQ SmallCap Market including, but not limited to, a minimum stock price of \$1.00 per share and either (a) \$2.0 million or more in tangible net worth, (b) market capitalization of \$35.0 million or more, or (c) net income in the last fiscal year, or two of the last five fiscal years, of \$500,000 or more.

If our common stock price closes below \$1.00 per share for 30 consecutive days, we may receive notification from NASDAQ that our common stock will be delisted from the NASDAQ SmallCap Market unless the stock closes at or above \$1.00 per share for at least ten consecutive days during the 90-day period following such notification. In the future, our common stock price or tangible net worth may fall below the NASDAQ SmallCap Market listing requirements, or we may not comply with other listing requirements, with the result being that our common stock might be delisted. If our common stock is delisted, we may list our common stock for trading over-the-counter. Delisting from the NASDAQ SmallCap Market could adversely affect the liquidity and price of our common stock and it could have a long-term impact on our ability to raise future capital through a sale of our common stock. In addition, it could make it more difficult for investors to obtain quotations or trade our stock.

## **Our common stock may not continue to qualify for exemption from the penny stock restrictions, which may make it more difficult for you to sell your shares.**

The SEC has adopted regulations which define a penny stock to be any equity security that has a market price of less than \$5.00 per share, or with an exercise price of less than \$5.00 per share, subject to certain exceptions. For any transaction involving a penny stock, unless exempt, these rules require delivery, prior to any transaction in a penny stock, of a disclosure schedule relating to the penny stock market. Disclosure is also required to be made about current quotations for the securities and about commissions payable to both the broker-dealer and the registered representative. Finally, broker-dealers must send monthly statements to purchasers of penny stocks disclosing recent price information for the penny stock held in the account and information on the limited market in penny stocks. These penny stock restrictions will not apply to our shares of common stock as long as: (1) they continue to be listed on the NASDAQ SmallCap Market; (2) certain price and volume information is publicly available about our shares on a current and continuing basis; and (3) we meet certain minimum net tangible assets or average revenue criteria. Our common stock may not continue to qualify for an exemption from the penny stock restrictions. If our shares of common stock were subject to the rules on penny stocks, the liquidity of our common stock would be adversely affected.



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**ITEM 2. DESCRIPTION OF PROPERTY**

As of December 31, 2003, we leased approximately 34,026 square feet of administrative and corporate offices from an independent landlord in Wayne, Pennsylvania, under a lease expiring in December 2010. The rent in 2003 was \$72,305 per month.

We lease approximately 1,350 square feet of office space from an independent landlord for our International operations in the Surrey Research Park, Guilford, Surrey, United Kingdom. The lease expires in 2005 with rent of £2,947 per month (or approximately \$5,000).

**ITEM 3. LEGAL PROCEEDINGS**

The Company is involved in litigation and other legal matters which have arisen in the normal course of business. Although the ultimate results of these matters are not currently determinable, management does not expect that they will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of security holders in the fourth quarter of 2003.

**Table of Contents****PART II****ITEM 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is quoted in the NASDAQ Small Cap Market under the symbol CVGR. The following table indicates the high and low bid sale prices per share for each quarter over the last two fiscal years.

Quarter Ended	2003		2002	
	High Bid	Low Bid	High Bid	Low Bid
March 31	\$ 2.85	\$ 1.75	\$ 4.90	\$ 2.76
June 30	2.85	1.86	5.50	3.40
September 30	3.05	2.10	3.85	2.13
December 31	2.79	2.11	2.96	1.79

As of March 9, 2004, there were more than 630 holders of record of our common stock, however, we believe that there are approximately 3,600 additional shareholders in street name who beneficially own our common stock in various brokerage accounts.

We have never declared a cash dividend on our common stock and do not anticipate paying cash dividends in the foreseeable future.

On July 31, 2003, Dr. Borow, our President and Chief Executive Officer, exercised an employee stock option to acquire 500,000 shares of our common stock. The option had a grant date of August 6, 1998, an expiration date of August 5, 2003 and an exercise price of \$0.6875. As payment for the shares issued and related withholding taxes, we received from Dr. Borow 140,432 Covalent common shares that were owned by him. The shares received are included as treasury stock in our Consolidated Balance Sheet at December 31, 2003.

**ITEM 6. SELECTED FINANCIAL DATA**

The following table represents selected historical consolidated financial data. The statement of operations data for the years ended December 31, 2001, 2002 and 2003 and balance sheet data at December 31, 2002 and 2003 are derived from our audited consolidated financial statements included elsewhere in this report. The statement of operations data for each of the years ended December 31, 1999 and 2000, and the balance sheet data at December 31, 1999, 2000 and 2001 are derived from audited consolidated financial statements not included in this report. The historical results are not necessarily indicative of the operating results to be expected in the future. The selected data should be read together with Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and our financial statements and notes to the financial statements.





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	Year Ended December 31,				
	2003	2002	2001	2000	1999
	(in thousands, except per share data)				
Net revenue	\$ 20,836	\$ 24,677	\$ 18,353	\$ 12,027	\$ 14,747
Operating expenses (1)	21,946	20,607	14,804	10,088	12,573
Income(Loss) from operations	(1,110)	4,070	3,549	1,939	2,174
Other income(expense)	4	(11)	(56)	31	108
Income(Loss) before income taxes	(1,106)	4,060	3,493	1,970	2,283
Income tax provision(benefit)	(544)	1,605	1,458	834	845
Cumulative effect of change in accounting for revenue recognition, net of tax				136	
Net income(loss)	\$ (562)	\$ 2,454	\$ 2,035	\$ 1,000	\$ 1,438
Net income(loss) per common share:					
Basic	\$ (0.04)	\$ 0.19	\$ 0.16	\$ 0.08	\$ 0.12
Diluted	\$ (0.04)	\$ 0.19	\$ 0.16	\$ 0.08	\$ 0.12
Weighted average common and common equivalent shares outstanding					
Basic	12,747	12,591	12,420	12,168	12,059
Diluted	12,747	13,199	12,963	12,932	12,485
Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$ 2,070	\$ 2,121	\$ 3,455	\$ 87	\$ 559
Working capital (2)	10,511	10,772	7,898	5,203	3,644
Total assets	20,385	20,836	15,113	9,311	8,742
Long term debt	87	3	62	75	
Total liabilities	9,043	9,108	6,223	3,071	3,985
Shareholders' equity	11,342	11,728	8,889	6,240	4,758

- (1) Excludes the impact of reimbursement for out-of-pocket expenses.  
(2) Working capital is calculated as current assets minus current liabilities.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION****General**

We are a clinical research organization who is a leader in the design and management of complex clinical trials for the pharmaceutical, biotechnology and medical device industries. Our mission is to provide our clients with high quality, full-service support for their clinical trials. We offer therapeutic expertise, experienced team management and advanced technologies. Our headquarters is in Wayne, Pennsylvania and our International operations are based in Guildford, Surrey, United Kingdom.

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Net revenue is derived principally from the design, management and monitoring of clinical research studies. Clinical research service contracts generally have terms ranging from several months to several years. A portion of the contract fee is generally payable upon execution of the contract, with the balance payable in installments over the life of the contract. Several of our older contracts contain payment schedules that are weighted towards the later stages of the contract. The majority of our net revenue is recognized from fixed-price contracts on a proportional performance basis. To measure the

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performance, we compare actual direct costs incurred to estimated total contract direct costs, which is the best indicator of the performance of the contract obligations as the costs relate to the labor hours incurred to perform the service.

Contracts generally may be terminated by clients immediately or with short notice. Clinical trials may be terminated or delayed for several reasons including, among others, unexpected results or adverse patient reactions to the drug, inadequate patient enrollment or investigator recruitment, manufacturing problems resulting in shortages of the drug, client budget constraints or decisions by the client to de-emphasize or terminate a particular trial or development efforts on a particular drug. Depending on the size of the trial in question, a client's decision to terminate or delay a trial in which we participate could have a material and adverse effect on our backlog, future revenue and results from operations. In 2003, we experienced contract cancellations as discussed in Item 1.

## **Critical Accounting Policies and Estimates**

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto.

Our consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. On an ongoing basis, management evaluates its judgments and estimates. Management bases its judgments and estimates on historical experience and on various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. Management considers the following policies to be most critical in understanding the more complex judgments that are involved in preparing our consolidated financial statements and the uncertainties that could affect our results of operations and financial condition.

## **Revenue Recognition**

The majority of our net revenue is recognized from fixed-price contracts on a proportional performance basis. To measure the performance, we compare actual direct costs incurred to estimated total contract direct costs, which is the best indicator of the performance of the contract obligations as the costs relate to the labor hours incurred to perform the service. Total direct costs are incurred for each contract and compared to estimated total direct costs for each contract to determine the percentage of the contract that is completed. This percentage is multiplied by the estimated total contract value to determine the amount of net revenue recognized. A formal project review process takes place quarterly although most projects are evaluated on an ongoing basis. Management reviews the estimated total direct costs on each contract to determine if estimated amounts are correct, and estimates are adjusted as needed. If we determine that a loss will result from the performance of a fixed-price contract, the entire amount of the estimated loss is charged against income in the period in which such determination is made. Because of the inherent uncertainties in estimating direct costs required to complete a project, particularly complex, multi-year studies, it is possible that the estimates used will change and could result in a material change to our estimates. Original estimates might also be changed due to changes in the scope of work. We attempt to negotiate contract amendments with the client to cover these services provided outside the terms of the original contract. There can be no assurance that the client will agree to the proposed amendments, and we ultimately bear the risk of cost overruns. During 2003 we performed services and incurred expense related to several changes in scope for a large clinical development program for which the related contract amendments were not signed until March 2004. We have recognized the costs for such services during 2003, however, we expect to



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recognize the related revenues for these services in the first quarter 2004. For terminated studies, our contracts frequently entitle us to receive the costs of winding down the terminated project, as well as all fees earned by us up to the time of termination.

Costs and estimated earnings in excess of related billings on uncompleted contracts represents net revenue recognized to date that is currently unbillable to the client pursuant to contractual terms. In general, amounts become billable upon the achievement of milestones or in accordance with predetermined payment schedules set forth in the contracts with our clients. Several of our older contracts contain payment schedules that are weighted towards the later stages of the contract. Billings in excess of related costs and estimated earnings on uncompleted contracts represent amounts billed in excess of net revenue recognized at the balance sheet date.

## Reimbursable Out-of-Pocket Expenses

On behalf of our clients, we pay fees to investigators and other out-of-pocket costs for which we are reimbursed at cost, without mark-up or profit. In connection with the required implementation on January 1, 2002, of Financial Accounting Standards Board Emerging Issues Task Force Rule No. 01-14 ( EITF 01-14 ), Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred , out-of-pocket costs are included in Operating Expenses, while the reimbursements received are reported separately as Reimbursement Revenue in the Consolidated Statements of Operations.

As is customary in the industry, we exclude from revenue and expense in the Consolidated Statement of Operations fees paid to investigators and the associated reimbursement since we act as agent on behalf of our clients with regard to investigators. These investigator fees are not reflected in our Net Revenue, Reimbursement Revenue, Reimbursement Out-of-Pocket Expenses, and/or Direct Expenses. The amounts of these investigator fees were \$10.5 million, \$8.1 million, and \$4.7 million for the years ended December 31, 2003, 2002, and 2001 respectively.

## Concentration of Credit Risk

Our accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts are concentrated with a small number of companies within the pharmaceutical, biotechnology and medical device industries. The significant majority of this exposure is to large, well established firms. Credit losses have historically been minimal. As of December 31, 2003, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$14.5 million. Of this amount, the exposure to our three largest clients was 72% of the total, with the three largest clients representing 37%, 30%, and 5% of total exposure, respectively. As of December 31, 2002, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$16.6 million. Of this amount, the exposure to our three largest clients was 89% of the total, with the three largest clients representing 41%, 40%, and 8% of total exposure, respectively.

## Operating Expenses

Direct expenses include amounts incurred during the period that are directly related to the management or completion of a clinical trial or related project and generally include direct labor and related benefit charges, other direct costs and certain allocated expenses. Direct costs as a percentage of net revenues tend to fluctuate from one period to another as a result of changes in the mix of services provided and the various studies conducted during any time period. Selling, general and administrative expenses include the salaries,

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wages and benefits of all administrative, finance and business development personnel, and all other support expenses not directly related to specific contracts.

**Table of Contents****Stock-Based Compensation**

The company has adopted equity incentive plans that provide for the granting of stock options to employees, directors, advisors and consultants. We account for grants of options to employees and directors under these plans applying the intrinsic value method provided for in Accounting Principles Board ( APB ) Opinion No. 25 Accounting for Stock Issued to Employees and related interpretations. No stock-based compensation expense is reflected in net income as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. In addition to APB Opinion No. 25, we provide the disclosures required by Statement of Financial Accounting Standards ( SFAS ) No. 123 Accounting for Stock-Based Compensation and by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure.

**Results of Operations**

The following table sets forth amounts for certain items in our consolidated statements of operations expressed as a percentage of net revenue. The following table excludes revenue and costs related to reimbursable out-of-pocket expenses because they are not generated by the services we provide, do not yield any gross profit to us, and do not have any impact on our net income. We believe this information is useful to our investors because it presents the net revenue and expenses that are directly attributable to the services we provide to our clients and provides a more accurate picture of our operating results and margins.

**Percentage of Net Revenue, Excluding Reimbursable Out-of-Pocket Expenses**

	<b>Year Ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
Net revenue	100.0%	100.0%	100.0%
Operating Expenses			
Direct	74.0%	60.0%	52.4%
Selling, general and administrative	27.1%	20.9%	25.5%
Depreciation	4.2%	2.6%	2.8%
Income(Loss) from Operations	(5.3)%	16.5%	19.3%
Net Income(Loss)	(2.7)%	9.9%	11.1%

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**Year Ended December 31, 2003 Compared With Year Ended December 31, 2002**

Net revenue for 2003 decreased 16% to \$20.8 million as compared to \$24.7 million for 2002. The decrease in net revenue was a result of a lower than anticipated level of, and delay in obtaining, new business awards as well as the fact that several projects were winding down as they entered the later stages of their development schedules. Also reducing net revenue were increases in the estimate of the cost to complete for several projects. New business awards and changes of scope for 2003 were approximately \$21.7 million as compared to approximately \$18.6 million for 2002, an increase of 17%. If we are not able to increase our level of new business production, our business, financial condition and results of operations would be materially and adversely affected. We have announced \$4.8 million in new contracts for the current calendar year. For the year ended December 31, 2003, net revenue from our three largest clients amounted to 69% of our net revenue, with the three largest clients representing 41%, 21%, and 7% of net revenue, respectively. For the year ended December 31, 2002, net revenue from our three largest clients amounted to 86% of our net revenue, with the three largest clients representing 46%, 30%, and 10% of net revenue, respectively.

Reimbursement revenue consisted of reimbursable out-of-pocket expenses incurred on behalf of our clients. Reimbursements are made at cost, without mark-up or profit, and therefore have no impact on net income.

Direct expenses included compensation and other expenses directly related to conducting clinical studies. These costs increased by \$600 thousand to \$15.4 million for the year ended December 31, 2003 from \$14.8 million for the year ended December 31, 2002. The increase in direct expenses resulted principally from higher personnel costs to handle project requirements. Direct expenses as a percentage of net revenue were 74% for the year ended December 31, 2003 as compared to 60% for the year ended December 31, 2002. The increase in the ratio was principally due to the lower level of net revenue reported during 2003 against an existing base of fixed direct expenses.

Selling, general, and administrative expenses included the salaries, wages and benefits of all administrative, financial and business development personnel and all other support expenses not directly related to specific contracts. Selling, general and administrative expenses for the year ended December 31, 2003 were \$5.7 million, or 27% of net revenue, as compared to \$5.1 million, or 21% of net revenue, for the year ended December 31, 2002. The increase of \$600 thousand primarily reflected higher rent expense. The increase as a percentage of net revenue generally reflects the impact of increased rent expense against a lower level of net revenue.

Depreciation and amortization expense increased to \$878 thousand for the year ended December 31, 2003 from \$643 thousand for the year ended December 31, 2002, primarily as a result of having a full year of depreciation expense for leasehold improvements added during late 2002.

Income from operations decreased by \$5.2 million, to a loss from operations of \$1.1 million, primarily for the reasons noted in the preceding paragraphs.

Net interest income for the year ended December 31, 2003 was \$4 thousand compared to net interest expense of \$11 thousand for the year ended December 31, 2002, largely the result of having more cash to invest.



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The effective income tax rate (benefit) for the year ended December 31, 2003 and 2002 was (49)% and 40%, respectively. The 2003 credit rate reflects a loss from operations in the U.S. and positive earnings from outside the United States that still benefit from the utilization of a tax loss carryforward.

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The net income (loss) for the year ended December 31, 2003 decreased to \$(562) thousand, or \$(.04) per diluted share, as compared to \$2.5 million, or \$0.19 per diluted share for the year ended December 31, 2002, primarily for the reasons noted above.

The operating results for the year ended December 31, 2003 included in this Annual Report on Form 10-K reflect some minor changes from the results reported in the Company's announcement of its operating results on March 10, 2004. The principal changes increased the net loss by approximately \$100 thousand, as compared to the results previously reported, relating primarily to the reversal of a portion of the tax benefit. In addition, compared to the results previously reported, net revenues increased by \$69 thousand with \$145 thousand of offsetting operating expense increases. These changes increased the loss from operations \$77 thousand and increased the net loss by \$29 thousand. The other change was a reclassification of \$64 thousand of franchise taxes to operating expense, which resulted in a slight increase in the tax benefit. On a per share basis (basic and diluted), these changes increased the net loss by \$.01 from (\$.03) to (\$.04) per share. In addition, reimbursement revenue (and the related expense) increased by \$597 thousand as compared to the previously reported results, but these items do not impact the Company's net operating results. These changes also resulted in some minor changes to related items on the Company's consolidated balance sheet and statement of cash flows at and for the year ended December 31, 2003. The consolidated balance sheet as of December 31, 2003 also includes some adjustments to current liabilities primarily related to investigator payments, which did not impact results of operations for the year ended December 31, 2003.

### **Year Ended December 31, 2002 Compared With Year Ended December 31, 2001**

Net revenue for 2002 increased 34% to \$24.7 million as compared to \$18.4 million for 2001. The increase of \$6.3 million resulted from new business awards and changes of scope as well as an increase in the average size and number of Phase I through Phase IV trials being conducted. In 2002, there were approximately 35 clinical trials and other studies conducted as compared to 27 in 2001. New business awards and changes of scope in 2002 were \$18.6 million as compared to \$24.4 million in 2001. During the 3<sup>rd</sup> quarter, two studies, aggregating \$3.7 million, were terminated by two separate sponsors due to a combination of the sponsor's internal budget constraints and safety and efficacy issues identified during the course of the study. The termination of these studies did not have a material impact on net revenues in 2002. During the 4<sup>th</sup> quarter, two changes of scope for services previously provided contributed approximately \$1.1 million to net revenue. Net revenue from our three largest clients amounted to 86% of our net revenue, with the three largest clients representing 46%, 30%, and 10% of net revenue, respectively. For 2001, net revenue from our three largest clients amounted to 85% of our net revenue, with the three largest clients representing 55%, 18%, and 12% of net revenue, respectively.

Reimbursement revenue consisted of reimbursable out-of-pocket expenses incurred on behalf of our clients. Reimbursements are made at cost, without mark-up or profit, and therefore have no impact on net income.

Direct expenses included compensation and other expenses directly related to conducting clinical studies. These costs increased by \$5.2 million to \$14.8 million in 2002 from \$9.6 million in 2001. The increase in direct expenses resulted principally from the increase in personnel costs associated with a higher average size and number of Phase I through Phase IV trials being conducted. Direct expenses as a percentage of net revenue were 60% for 2002 as compared to 52% for 2001. The increase was principally due to the mix of levels of personnel involved in the contracts performed, variations in the utilization of personnel and the mix of contracts being performed during each period. In addition, during the third quarter of 2002, we made an adjustment to cost and revenue estimates on a significant contract, the effect of which was to reduce income from operations by \$564 thousand and to increase the ratio of direct expense to net revenue.

Selling, general, and administrative expenses included the salaries, wages and benefits of all administrative, financial and business development personnel and all other support expenses not directly related to specific contracts. Selling, general and administrative expenses for 2002 were \$5.1 million, or 21% of net revenue, as compared to \$4.7 million, or 25% of net revenue, for 2001. The

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increase of \$475 thousand reflects increased staff expenses, rent and insurance expenses. The decrease as a percentage of net revenue reflects obtaining reimbursements for a larger portion of out-of-pocket expenses in 2002 as well as greater control over administrative expenses.

Depreciation and amortization expense increased to \$643 thousand for 2002 from \$522 thousand for 2001 as a result of additional purchases of office and computer equipment.

Income from operations of \$4.1 million increased by \$521 thousand, or 15%, primarily for the reasons noted in the preceding paragraphs.

Net interest expense for 2002 was \$11 thousand compared to net interest expense of \$56 thousand for 2001, a positive change of \$45 thousand, largely the result of having a lower amount of capital leases and less short term indebtedness outstanding.

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The effective income tax rate for 2002 and 2001 was 40% and 42%, respectively. The decrease of 2% is largely the result of the ability to utilize carryforwards available as the result of prior losses generated outside the United States.

Net income for the year ended December 31, 2002 increased 21% to \$2.5 million, or \$0.19 per diluted share, as compared to \$2.0 million, or \$0.16 per diluted share for 2001, primarily for the reasons noted in the preceding paragraphs.

## **Liquidity and Capital Resources**

The clinical research organization industry is generally not considered capital intensive. We expect to continue to fund our operations from existing cash resources, cash flow from operations and borrowings under our line of credit. We expect that our principal cash requirements on both a short and long-term basis will be for the funding of our operations and capital expenditures. We expect to continue expanding our operations through internal growth, expansion of our existing services, continued expansion of our international operational capabilities, and the development of new products and services for the pharmaceutical, biotechnology and medical device industries. We believe that our existing cash resources, cash generated from operations, and the borrowing availability under our line of credit will provide sufficient liquidity for the foreseeable future. However, in the event that we make significant acquisitions in the future, we may need to raise additional funds through additional borrowings or the issuance of debt or equity securities.

Our contracts usually require a portion of the contract amount to be paid at the time the contract is initiated. Additional payments are generally made upon completion of negotiated performance milestones, or on a regularly scheduled basis, throughout the life of the contract. Several of our older contracts contain payment schedules that are weighted towards the later stages of the contract. Accordingly, cash receipts do not necessarily correspond to costs incurred and revenue recognized. For terminated studies, our contracts frequently entitle us to receive the costs of winding down the terminated project, as well as all fees earned by us up to the time of termination.

Net revenue is recognized on a proportional performance basis. We typically receive a low volume of large-dollar receipts. As a result, the number of days net revenue outstanding in accounts receivable, costs and estimated earnings in excess of related billings, customer advances, and billings in excess of related costs will fluctuate due to the timing and size of billings and cash receipts. At December 31, 2003, the net days revenue outstanding was 188 days compared to 130 days at December 31, 2002. Compared to December 31, 2002, accounts receivable decreased \$1.9 million to \$5.7 million at December 31, 2003, primarily due to the timing of billings and progress payments for clinical trials. Of the accounts receivable balance at December 31, 2003, 3% of the total was over 60 days past invoice date.

Compared to December 31, 2002, costs and estimated earnings in excess of related billings on uncompleted contracts decreased \$300 thousand to \$8.7 million at December 31, 2003. The decrease primarily represents timing differences between the net revenue recognized on the trials being managed and the billing milestones or payment schedules contained in the contracts with our clients. The balance at December 31, 2003 primarily consisted of 4 clinical trials, which individually constituted 41%, 19%, 11% and 9% of the balance. These clinical trials are expected to be billed during 2004. The decrease in the liability account billings in excess of related costs and estimated earnings on uncompleted contracts of \$600 thousand to \$1.2 million as of December 31, 2003 from \$1.8 million as of December 31, 2002, resulted from continued progress on several contracts with billing schedules weighted toward the earlier phases of the study. The decrease in customer advances of \$600 thousand to \$3.0 million as of December 31, 2003 from \$3.6 million as of December 31, 2002 resulted primarily from the net utilization of customer advances for investigator payments.



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Our net cash provided by operating activities was \$428 thousand for the year ended December 31, 2003, compared with net cash used by operating activities of \$987 thousand for the year ended December 31, 2002. The primary factors underlying this change was the decrease in our costs and estimated earnings in excess of related billings on uncompleted contracts relative to the end of the prior year and a significant increase in cash collections of receivables. Net cash used by investing activities, consisting principally of purchases of property, equipment and leasehold improvements, was \$581 thousand for the year ended December 31, 2003, compared with net cash used by investing activities of \$664 thousand for the year ended December 31, 2002. Purchases and leasehold improvements for the year ended December 31, 2003 included leasehold improvements, software and hardware, including host servers and computers for our corporate office and field-based personnel. Net cash provided by financing activities was \$3 thousand for the year ended December 31, 2003, compared with net cash provided by financing activities of \$300 thousand for the year ended December 31, 2002. The primary difference related to the scheduled repayment of capital lease obligations. As a result of these cash flows, our cash and cash equivalents balance at December 31, 2003 was \$2.1 million as compared to \$2.1 million at December 31, 2002.

We maintain a demand line of credit with a bank under which maximum borrowings are the lesser of \$2.5 million or 75% of eligible accounts receivable, as defined in the loan agreement, and bear interest at the LIBOR Market Index Rate plus 2.65%. As of December 31, 2003, there were no borrowings under the line of credit, and the maximum available under the terms of the line of credit was \$2.3 million. The line of credit was renewed on June 17, 2003 and expires on June 30, 2004. Borrowings under the line of credit are secured by substantially all of our assets. Our agreement with the bank provides that we maintain a minimum tangible net worth of \$10.75 million and a ratio of total liabilities to tangible net worth of not more than 1.25 to 1.00. As of December 31, 2003, we were in compliance with these covenants.

## **Off Balance Sheet Financing Arrangements**

As of December 31, 2003, we did not have any off-balance sheet financing arrangements or any equity ownership interests in any variable interest entity or other minority owned ventures.

## **Contractual Obligations and Commitments**

For 2003, we entered into new capital lease obligations totaling \$123 thousand as compared to \$0 in new capital lease obligations in 2002. These leases were recorded as assets and in general were for peripheral office equipment. We are committed under a number of non-cancelable operating leases, primarily related to office space and other office equipment.

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Below is a summary of our future payment commitments by year under contractual obligations as of December 31, 2003. Actual amounts paid under these agreements could be higher or lower than the amounts shown below as a result of changes in volume and other variables:

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>Thereafter</u>	<u>Total</u>
Obligations under capital leases	\$ 24,268	\$ 23,709	\$ 26,314	\$ 29,204	\$ 7,791	\$	\$ 111,286
Operating Leases	961,777	960,171	921,018	937,259	952,728	1,956,495	6,689,448
Employment agreements	403,000	325,000	81,250				809,250
Service agreements	8,926,000						8,926,000
<b>Total</b>	<b>\$ 10,315,045</b>	<b>\$ 1,308,880</b>	<b>\$ 1,028,582</b>	<b>\$ 966,463</b>	<b>\$ 960,519</b>	<b>\$ 1,956,495</b>	<b>\$ 16,535,984</b>

In 2004, we anticipate capital expenditures of approximately \$150 thousand - \$250 thousand for leasehold improvements, software applications, workstations, personal computer equipment and related assets. A significant portion of our service agreement commitments, which are primarily comprised of investigator payments, are expected to be reimbursed under agreements with clients.

**Recently Issued Accounting Standards**

In June 2001, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 143, Accounting for Asset Retirement Obligations. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. Adoption of SFAS No. 143 did not have a material impact on our financial statements.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Previous accounting guidance was provided by EITF No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS No. 146 replaces EITF No. 94-3 and is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. Adoption of SFAS No. 146 did not have a material impact on our financial statements.

In November 2002, the EITF finalized its tentative consensus on EITF Issue 00-21, Revenue Arrangements with Multiple Deliverables , which provides guidance on the timing and method of revenue recognition for sales arrangements that include the delivery of more than one product or service. EITF 00-21 is effective prospectively for arrangements entered into in fiscal periods beginning after June 15, 2003. Adoption of EITF Issue 00-21 did not have a material impact on our financial statements.

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In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*. SFAS No. 148 amends SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide for alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires disclosure of comparable information for all companies, regardless of whether they have adopted the fair value or intrinsic value method of accounting for stock-based employee compensation. SFAS No. 148 is effective for financial statements issued for fiscal years ending after December 15, 2002, and interim periods beginning after December 15, 2002. Adoption of SFAS No. 148 did not have a material impact on our financial statements, other than expanding our disclosures.

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities*. Interpretation No. 46 provides an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements* with respect to the consolidation of variable interest entities. Interpretation No. 46 requires existing unconsolidated variable interest entities to be consolidated by



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their primary beneficiaries if the entities do not effectively disperse risks among the parties involved. In December 2003, the FASB issued a revision to FIN 46, or FIN 46R, to clarify some of the provisions of FIN 46. We currently have no entities which have the characteristics of a variable interest entity. Furthermore, we do not expect that the adoption of the remaining provision of FIN 46R in the quarter ending March 31, 2004 will have an impact on our financial statements.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS No. 133,

Accounting for Derivative Instruments and Hedging Activities. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, except as stated below and for hedging relationships designated after June 30, 2003. The provisions of SFAS No. 149 that relate to Statement 133 Implementation Issues that have been effective for fiscal quarters that began prior to June 15, 2003, should continue to be applied in accordance with their respective effective dates. The Company has not entered into any derivative transactions and therefore the adoption of this standard has not had a material impact on our financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, which establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 requires that an issuer classify a financial instrument that is within its scope, which may have previously been reported as equity, as a liability (or an asset in some circumstances). This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Adoption of SFAS No. 150 has not had a material impact on our financial statements. The FASB is addressing certain implementation issues associated with the application of SFAS No. 150 including those related to mandatorily redeemable financial instruments representing noncontrolling subsidiaries included in consolidated financial statements. The Company will monitor the actions of the FASB and assess the impact, if any, that these actions may have on its financial statements.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

### **Market Risk**

The fair value of cash and cash equivalents, restricted cash, accounts receivable, costs and estimated earnings in excess of related billings on uncompleted contracts, accounts payable, accrued expenses and billings in excess of related costs and estimated earnings on uncompleted contracts were not materially different than their carrying amounts as reported at December 31, 2003 and December 31, 2002.

As of December 31, 2003, the Company was not a counterparty to any forward foreign exchange contracts or any other transaction involving a derivative financial instrument.

### **Foreign Currency Exchange Risk**

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The Company is exposed to foreign currency exchange risk through its international operations. For the year ended December 31, 2003, approximately 6%, of our net revenue was derived from contracts denominated in other than U.S. Dollars. Our financial statements are denominated in U.S. Dollars. As a result, factors associated with international operations, including changes in foreign currency exchange rates, could affect our results of operations and financial condition. Contracts entered into in

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the United States are denominated in U.S. Dollars. Contracts entered into by our international subsidiary are generally denominated in pounds sterling or Euros. To date, we have not engaged in any derivative or contractual hedging activities related to our foreign exchange exposures. We believe that these exposures are limited by virtue of their size relative to our overall operations as well as the partial natural hedge afforded by our local currency expenditures to service these local currency contracts.

Assets and liabilities of the Company's international operations are translated into U.S. Dollars at exchange rates in effect on the balance sheet date and equity accounts are translated at historical exchange rates. Revenue and expense items are translated at average exchange rates in effect during the quarter. Gains or losses from translating foreign currency financial statements are recorded in other comprehensive income. The cumulative translation adjustment included in other comprehensive income for the years ended December 31, 2003, December 31, 2002 and December 31, 2001 was \$99 thousand, \$18 thousand, and \$9 thousand respectively.

We believe that the effects of inflation generally have not had a material adverse impact on our operations or financial condition.

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Our financial statements listed below are contained herein beginning at page F-1:

(a) Financial Statements

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(b) Financial Statements Schedules

All schedules have been omitted because either they are not required or are not applicable or because the required information has been included elsewhere in the Financial Statements or the notes thereto.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

Our management, including our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2003. Our disclosure controls and procedures are designed to provide reasonable assurance that the information required to be disclosed in this annual report on Form 10-K has been appropriately recorded, processed, summarized and reported. Based on that evaluation, our principal executive and principal financial officers have concluded that our disclosure controls and procedures are effective at the reasonable assurance level. Our management, including our principal executive and principal financial officers, has evaluated any changes in our internal control over financial reporting that occurred during the year ended December 31, 2003, and has concluded that there was no change that occurred during the year ended December 31, 2003 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



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**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF REGISTRANT**

Information concerning Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act, is incorporated herein by reference to the similarly titled section in our definitive proxy materials for our 2004 Annual Meeting of Stockholders.

**ITEM 11. EXECUTIVE COMPENSATION**

Information concerning Executive Compensation is incorporated herein by reference to the similarly titled section in our definitive proxy materials for our 2004 Annual Meeting of Stockholders.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Information concerning Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters is incorporated herein by reference to the similarly titled section in our definitive proxy materials for our 2004 Annual Meeting of Stockholders.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

Information concerning Certain Relationships and Related Transactions is incorporated herein by reference to the similarly titled section in our definitive proxy materials for our 2004 Annual Meeting of Stockholders.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information concerning Principal Accountant Fees and Services is incorporated herein by reference to the similarly titled section in our definitive proxy materials for our 2004 Annual Meeting of Stockholders.

**ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K**

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### (a) Exhibits

- 3.1 Certificate of Incorporation of Covalent Group, Inc., a Delaware corporation, filed with the Secretary of State of the State of Delaware on April 16, 2002. <sup>(1)</sup>
- 3.2 Bylaws of Covalent Group, Inc., a Delaware corporation. <sup>(1)</sup>
- 10.1 Covalent Group, Inc. 2002 Equity Incentive Plan. <sup>(2)</sup>
- 10.2 Amended and Restated Covalent Group, Inc. 1996 Stock Incentive Plan. <sup>(3)</sup>
- 10.3 1995 Stock Option Plan. <sup>(4)</sup>
- 10.4 Lease between Dean Witter Realty Income Partnership II and Covalent Group, Inc. dated November 14, 1996. <sup>(4)</sup>
- 10.5 Fourth Amendment to Lease between FV Office Partners, L.P. (successor to Dean Witter Realty Income Partnership II) and Covalent Group, Inc. dated November 27, 2001. <sup>(5)</sup>
- 10.6 Fifth Amendment to Lease between FV Office Partners, L.P. and Covalent Group, Inc. dated December 13, 2002. <sup>(6)</sup>
- 10.7 Loan Agreement with Wachovia Bank, National Association dated June 17, 2003. <sup>(7)</sup>

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10.8	Employment Agreement between Covalent Group, Inc. and Kenneth M. Borow, M.D. <sup>(6)</sup>
10.9	Form of Indemnification Agreement between Covalent Group, Inc., a Delaware Corporation, and its officers and directors. <sup>(8)</sup>
10.10	Amended and Restated Employment Agreement between Covalent Group, Inc. and Brian Dickson, M.D. <sup>(9)</sup>
21	Subsidiaries of the Registrant.
23	Consent of Deloitte & Touche LLP.
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Accounting Officer required by Rule 13a-14(a) or Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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(1) Filed as an Exhibit on Form 8-K (No. 0-21145) filed with the Securities & Exchange Commission on July 2, 2002 and incorporated herein by reference.

(2) Incorporated by reference to Appendix E of the Proxy Statement for the 2002 Annual Meeting of Stockholders.

(3) Incorporated by reference to Annex A of the Proxy Statement for the 2000 Annual Meeting of Stockholders.

(4) Filed as an Exhibit to our Annual Report on Form 10-KSB (No. 0-21145) filed with the Securities and Exchange Commission on March 30, 1998 and incorporated herein by reference.

(5) Filed as an Exhibit to our Annual Report on Form 10-KSB (No. 0-21145) filed with the Securities and Exchange Commission on April 1, 2002 and incorporated herein by reference.

(6) Filed as an Exhibit to our Annual Report on Form 10-KSB (No. 0-21145) filed with the Securities and Exchange Commission on March 31, 2003 and incorporated herein by reference.

(7) Filed as an Exhibit to our Quarterly Report on Form 10-Q (No. 0-21145) filed with the Securities & Exchange Commission on August 13, 2003 and incorporated herein by reference.

(8) Filed as an Exhibit to our Quarterly Report on Form 10-QSB (No. 0-21145) filed with the Securities & Exchange Commission on August 13, 2002 and incorporated herein by reference.

(9) Filed as an Exhibit to our Quarterly Report on Form 10-Q (No. 0-21145) filed with the Securities & Exchange Commission on November 13, 2003 and incorporated herein by reference.

(b) Form 8-K

None.



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COVALENT GROUP, INC.

CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2003, 2002 and 2001

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INDEPENDENT AUDITORS' REPORT

The Board of Directors and Stockholders of:

Covalent Group, Inc.

Wayne, Pennsylvania

We have audited the accompanying consolidated balance sheets of Covalent Group, Inc. and subsidiaries (the "Company") as of December 31, 2003 and 2002, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Covalent Group, Inc. and subsidiaries as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche LLP

Philadelphia, Pennsylvania

March 29, 2004

**Table of Contents****Covalent Group, Inc.****Consolidated Statements of Operations**

	Year Ended December 31,		
	2003	2002	2001
Net revenue	\$ 20,835,742	\$ 24,677,061	\$ 18,353,481
Reimbursement revenue	5,793,459	4,510,425	1,593,172
<b>Total Revenue</b>	<b>26,629,201</b>	<b>29,187,486</b>	<b>19,946,653</b>
<b>Operating Expenses</b>			
Direct	15,417,144	14,817,692	9,611,407
Reimbursement out-of-pocket expenses	5,793,459	4,510,425	1,593,172
Selling, general and administrative	5,650,693	5,146,286	4,671,212
Depreciation and amortization	877,623	642,833	521,811
<b>Total Operating Expenses</b>	<b>27,738,919</b>	<b>25,117,236</b>	<b>16,397,602</b>
<b>Income (Loss) from Operations</b>	<b>(1,109,718)</b>	<b>4,070,250</b>	<b>3,549,051</b>
Interest Income	16,545	10,935	11,275
Interest Expense	(12,962)	(21,536)	(67,729)
<b>Net Interest Income (Expense)</b>	<b>3,583</b>	<b>(10,601)</b>	<b>(56,454)</b>
<b>Income (Loss) before Income Taxes</b>	<b>(1,106,135)</b>	<b>4,059,649</b>	<b>3,492,597</b>
<b>Income Tax Provision (Benefit)</b>	<b>(544,032)</b>	<b>1,605,335</b>	<b>1,457,964</b>
<b>Net Income (Loss)</b>	<b>\$ (562,103)</b>	<b>\$ 2,454,314</b>	<b>\$ 2,034,633</b>
<b>Net Income (Loss) per Common Share</b>			
<b>Basic</b>	<b>\$ (0.04)</b>	<b>\$ 0.19</b>	<b>\$ 0.16</b>
<b>Diluted</b>	<b>\$ (0.04)</b>	<b>\$ 0.19</b>	<b>\$ 0.16</b>
<b>Weighted Average Common and Common Equivalent Shares Outstanding</b>			
<b>Basic</b>	<b>12,746,973</b>	<b>12,591,229</b>	<b>12,420,388</b>
<b>Diluted</b>	<b>12,746,973</b>	<b>13,199,483</b>	<b>12,962,628</b>

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

**Table of Contents****Covalent Group, Inc.****Consolidated Balance Sheets**

	<b>December 31,</b>	
	<b>2003</b>	<b>2002</b>
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 2,069,687	\$ 2,121,439
Restricted cash	604,185	419,791
Accounts receivable	5,709,326	7,586,575
Prepaid expenses and other	166,322	380,404
Prepaid taxes	1,267,501	
Costs and estimated earnings in excess of related billings on uncompleted contracts	8,740,964	9,024,854
<b>Total Current Assets</b>	<b>18,557,985</b>	<b>19,533,063</b>
<b>Property and Equipment, Net</b>	<b>1,805,331</b>	<b>1,281,149</b>
<b>Other Assets</b>	<b>21,665</b>	<b>22,265</b>
<b>Total Assets</b>	<b>\$ 20,384,981</b>	<b>\$ 20,836,477</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 3,545,039	\$ 2,755,520
Accrued expenses	263,664	403,735
Income tax payable		111,646
Obligations under capital leases	24,268	59,418
Billings in excess of related costs and estimated earnings on uncompleted contracts	1,181,426	1,817,697
Customer advances	3,032,758	3,612,856
<b>Total Current Liabilities</b>	<b>8,047,155</b>	<b>8,760,872</b>
<b>Long Term Liabilities</b>		
Obligations under capital leases	87,018	2,907
Other liabilities	698,050	
Deferred income tax	211,040	344,225
<b>Total Long Term Liabilities</b>	<b>996,108</b>	<b>347,132</b>
<b>Total Liabilities</b>	<b>9,043,263</b>	<b>9,108,004</b>
<b>Stockholders' Equity</b>		
Common stock, \$.001 par value 25,000,000 shares authorized, 13,235,483 and 12,664,583 shares issued and outstanding respectively	13,235	12,665
Additional paid-in capital	11,372,674	10,887,759
Retained earnings	289,918	852,021
Accumulated other comprehensive income	124,865	26,344
<b>Less:</b>	<b>11,800,692</b>	<b>11,778,789</b>

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Treasury stock, at cost, 152,932 and 12,500 shares, respectively	(458,974)	(50,316)
<b>Total Stockholders' Equity</b>	<b>11,341,718</b>	<b>11,728,473</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 20,384,981</b>	<b>\$ 20,836,477</b>

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

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**Table of Contents****COVALENT GROUP, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

	Number of  Common  Shares	Par Value	Additional Paid-In Capital	Retained Earnings (Accum. Deficit)	Accum. Other Comprehensive Income (Loss)	Treasury Stock at Cost	Total Stockholders' Equity
Balance at December 31, 2000	12,213,309	\$ 12,213	\$ 9,915,656	\$ (3,636,926)	\$ (595)	\$ (50,316)	\$ 6,240,032
Net income				2,034,633			2,034,633
Other comprehensive income:							
Foreign currency translation adjustment					8,978		8,978
Total comprehensive income							2,043,611
Issuance of common shares - exercise of stock options	189,404	190	330,576				330,766
Exercise of stock warrants	100,000	100	274,900				275,000
Balance at December 31, 2001	12,502,713	\$ 12,503	\$ 10,521,132	\$ (1,602,293)	\$ 8,383	\$ (50,316)	\$ 8,889,409
Net income				2,454,314			2,454,314
Other comprehensive income:							
Foreign currency translation adjustment					17,961		17,961
Total comprehensive income							2,472,275
Issuance of common shares - exercise of stock options	161,870	162	366,627				366,789
Balance December 31, 2002	12,664,583	\$ 12,665	\$ 10,887,759	\$ 852,021	\$ 26,344	\$ (50,316)	\$ 11,728,473
Net loss				(562,103)			(562,103)
Other comprehensive income:							
Foreign currency translation adjustment					98,521		98,521
Total comprehensive income							(463,582)
Issuance of common shares - exercise of stock options	570,900	570	484,915			(408,658)	76,827
Balance December 31, 2003	13,235,483	\$ 13,235	\$ 11,372,674	\$ 289,918	\$ 124,865	\$ (458,974)	\$ 11,341,718

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

**Table of Contents****Covalent Group, Inc.****Consolidated Statements of Cash Flows**

	Year Ended December 31,		
	2003	2002	2001
<b>Operating Activities:</b>			
Net income (loss)	\$ (562,103)	\$ 2,454,314	\$ 2,034,633
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities:			
Depreciation and amortization	877,623	642,833	521,811
Changes in assets and liabilities:			
Restricted cash	(184,394)	232,256	(39,525)
Accounts receivable	1,877,249	(5,493,721)	(440,367)
Prepaid expenses and other	214,082	(83,202)	(189)
Prepaid Taxes	(1,267,501)		
Costs and estimated earnings in excess of related billings on uncompleted contracts	283,890	(1,706,912)	(1,768,485)
Other assets	600	15,805	(3,997)
Accounts payable	789,519	1,173,272	1,129,605
Accrued expenses	(140,071)	(157,865)	119,599
Income taxes payable	(111,646)	(517,252)	(91,362)
Deferred taxes	(133,185)	100,000	323,186
Billings in excess of related costs and estimated earnings on uncompleted contracts	(636,271)	1,622,575	(336,519)
Customer advances	(580,098)	730,496	2,068,386
<b>Net Cash Provided by (Used) In Operating Activities</b>	<b>427,694</b>	<b>(987,401)</b>	<b>3,516,776</b>
<b>Investing Activities:</b>			
Purchases of property and equipment	(580,755)	(663,785)	(722,566)
<b>Net Cash Used In Investing Activities</b>	<b>(580,755)</b>	<b>(663,785)</b>	<b>(722,566)</b>
<b>Financing Activities:</b>			
Net repayments and borrowings under capital leases	(74,039)	(66,668)	(41,388)
Proceeds from exercise of stock options	76,827	366,789	605,766
<b>Net Cash Provided By Financing Activities</b>	<b>2,788</b>	<b>300,121</b>	<b>564,378</b>
<b>Effect of Exchange Rate Changes on Cash and Cash Equivalents</b>	<b>98,521</b>	<b>17,961</b>	<b>8,978</b>
<b>Net Increase (Decrease) In Cash and Cash Equivalents</b>	<b>(51,752)</b>	<b>(1,333,104)</b>	<b>3,367,566</b>
<b>Cash and Cash Equivalents, Beginning of Period</b>	<b>2,121,439</b>	<b>3,454,543</b>	<b>86,977</b>
<b>Cash and Cash Equivalents, End of Period</b>	<b>\$ 2,069,687</b>	<b>\$ 2,121,439</b>	<b>\$ 3,454,543</b>

The accompanying notes are an integral

part of these consolidated financial statements.

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Covalent Group, Inc.

### **Notes To Consolidated Financial Statements**

#### **1. DESCRIPTION OF BUSINESS:**

In this discussion, the terms, Company , we , us , and our , refer to Covalent Group, Inc. and subsidiaries, except where it is made clear otherwise.

We are a clinical research organization who is a leader in the design and management of complex clinical trials for the pharmaceutical, biotechnology and medical device industries. Our mission is to provide our clients with high quality, full-service support for their clinical trials. We offer therapeutic expertise, experienced team management and advanced technologies. Our headquarters is based in Wayne, Pennsylvania and our International operations are in Guildford, Surrey, United Kingdom.

Our clients consist of many of the largest companies in the pharmaceutical, biotechnology and medical device industries. From protocol design and clinical program development, to proven patient recruitment, to managing the regulatory approval process, we have the resources to directly implement or manage Phase I through Phase IV clinical trials and to deliver clinical programs on time and within budget. We have clinical trial experience across a wide variety of therapeutic areas such as cardiovascular, endocrinology/metabolism, diabetes, neurology, oncology, immunology, vaccines, infectious diseases, gastroenterology, dermatology, hepatology, womens health and respiratory medicine. We have the capacity and expertise to conduct clinical trials on a global basis. As of December 31, 2003 we were managing studies in 22 countries, including the United States, Canada, Western and Eastern Europe, the Middle East, South Africa, Australia and Scandinavia.

In November 2000, we established Covalent Group, Ltd., a wholly-owned subsidiary in the United Kingdom, to support existing contracts on clinical trials and expand our presence internationally. We were incorporated in August 1989 in Nevada and in June 2002, the Company changed its state of incorporation to Delaware.

#### **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

##### **Use of Estimates**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ( generally accepted accounting principles ) require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

##### **Consolidation**

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The consolidated financial statements for 2003, 2002 and 2001 include our accounts and the accounts of our wholly-owned subsidiaries. Intercompany transactions and balances have been eliminated in consolidation.

### Cash and Cash Equivalents

We consider all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

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### **Restricted Cash**

We received advance payments from one of our clients as part of a long-term contract, which includes a separate restricted cash account to be utilized for payment of investigator fees. As of December 31, 2003 and 2002, this restricted cash amount was \$604 thousand and \$420 thousand, respectively. This amount is also included in customer advances in the accompanying balance sheets.

### **Revenue Recognition**

The majority of our net revenue is recognized from fixed-price contracts on a proportional performance basis. To measure the performance, we compare actual direct costs incurred to estimated total contract direct costs, which is the best indicator of the performance of the contract obligations as the costs relate to the labor hours incurred to perform the service. Total direct costs are incurred for each contract and compared to estimated total direct costs for each contract to determine the percentage of the contract that is completed. This percentage is multiplied by the estimated total contract value to determine the amount of net revenue recognized. A formal project review process takes place quarterly although most projects are evaluated on an ongoing basis. Management reviews the estimated total direct costs on each contract to determine if estimated amounts are correct, and estimates are adjusted as needed. If we determine that a loss will result from the performance of a fixed-price contract, the entire amount of the estimated loss is charged against income in the period in which such determination is made. Because of the inherent uncertainties in estimating direct costs required to complete a project, particularly complex, multi-year studies, it is possible that the estimates used will change and could result in a material change to our estimates. Original estimates might also be changed due to changes in the scope of work. We attempt to negotiate contract amendments with the client to cover these services provided outside the terms of the original contract. There can be no assurance that the client will agree to the proposed amendments, and we ultimately bear the risk of cost overruns. For terminated studies, our contracts frequently entitle us to receive the costs of winding down the terminated project, as well as all fees earned by us up to the time of termination.

Costs and estimated earnings in excess of related billings on uncompleted contracts represents net revenue recognized to date that is currently unbillable to the client pursuant to contractual terms. In general, amounts become billable upon the achievement of milestones or in accordance with predetermined payment schedules set forth in the contracts with our clients. Billings in excess of related costs and estimated earnings on uncompleted contracts represent amounts billed in excess of net revenue recognized at the balance sheet date.

### **Reimbursable Out-of-Pocket Expenses**

On behalf of our clients, we pay fees to investigators and other out-of-pocket costs for which we are reimbursed at cost, without mark-up or profit. Effective January 1, 2002, in connection with the required implementation of Financial Accounting Standards Board ( FASB ) Emerging Issues Task Force Rule No. 01-14 ( EITF 01-14 ), Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred , out-of-pocket costs are included in Operating Expenses, while the reimbursements received are reported separately as Reimbursement Revenue in the Consolidated Statements of Operations.

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As is customary in the industry, we exclude from revenue and expense in the Consolidated Statement of Operations fees paid to investigators and the associated reimbursement since we act as agent on behalf of our clients with regard to investigators. These investigator fees are not reflected in our Net Revenue, Reimbursement Revenue, Reimbursement Out-of-Pocket Expenses, and/or Direct Expenses. The amounts of these investigator fees were \$10.5 million, \$8.1 million, and \$4.7 million for the years ended December 31, 2003, 2002, and 2001 respectively.

## **Accounts Receivable**

Accounts receivable and costs and estimated earnings in excess of related billings on completed contracts represent amounts due from our customers who are concentrated primarily in the pharmaceutical, biotechnology and medical device industries. Included in accounts receivable are amounts due from customers in connection with unbilled out-of-pocket pass-through costs in the amount of \$1.3 million as of December 31, 2003 and \$947 thousand as of December 31, 2002.

## **Concentration of Credit Risk**

Our accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts are concentrated with a small number of companies within the pharmaceutical, biotechnology and medical device industries. The significant majority of this exposure is to large, well established firms. Credit losses have historically been minimal. As of December 31, 2003, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$14.5 million. Of this amount, the exposure to our three largest clients was 72% of the total, with the three largest clients representing 37%, 30%, and 5% of total exposure, respectively. As of December 31, 2002, the total of accounts receivable and costs and estimated earnings in excess of related billings on uncompleted contracts was \$16.6 million. Of this amount, the exposure to our three largest clients was 89% of the total, with the three largest clients representing 41%, 40%, and 8% of total exposure, respectively.

## **Financial Instruments**

The fair value of cash and cash equivalents, restricted cash, accounts receivable, costs and estimated earnings in excess of related billings on uncompleted contracts, accounts payable, accrued expenses and billings in excess of related costs and estimated earnings on uncompleted contracts were not materially different than their carrying amounts as reported at December 31, 2003 and December 31, 2002.

As of December 31, 2003, the Company was not a counterparty to any forward foreign exchange contracts or any other transaction involving a derivative financial instrument.

## **Property and Equipment**

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Property and equipment are recorded at cost. Depreciation is provided using the straight-line method over the estimated useful lives of the assets, which range from 3 to 8 years for equipment and furniture and fixtures and the remaining lease term for leasehold improvements and assets under capital lease. Depreciation and amortization for the years ended December 31, 2003 and 2002 was \$878 thousand and \$643 thousand, respectively. Expenditures for maintenance and repairs are charged to expense as incurred. When assets are sold or retired, the cost and accumulated depreciation are removed from the accounts, and any gain or loss is included in operations.

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**Table of Contents****Operating Expenses**

Direct expenses include amounts incurred during the period that are directly related to the management or completion of a clinical trial or related project and generally include direct labor and related benefit charges, other direct costs and certain allocated expenses. Direct costs as a percentage of net revenues tend to fluctuate from one period to another, as a result of changes in the mix of services provided and the various studies conducted during any time period. Selling, general and administrative expenses include the salaries, wages and benefits of all administrative, finance and business development personnel, and all other support expenses not directly related to specific contracts.

**Stock-Based Compensation**

The company has adopted equity incentive plans that provide for the granting of stock options to employees, directors, advisors and consultants. We account for grants of options to employees and directors under these plans applying the intrinsic value method provided for in Accounting Principles Board ( APB ) Opinion No. 25 Accounting for Stock Issued to Employees and related interpretations. No stock-based compensation expense is reflected in net income as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. In addition to APB Opinion No. 25, we provide the disclosures required by Statement of Financial Accounting Standards ( SFAS ) No. 123 Accounting for Stock-Based Compensation and by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure. See Note 10.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation to stock-based employee compensation:

	Year Ended December 31,		
	2003	2002	2001
Net Income (Loss) - as reported	\$ (562,103)	\$ 2,454,314	\$ 2,034,633
Deduct: Pro forma stock-based compensation expense determined under the fair value method, net of related tax effects	(477,056)	(860,285)	(1,227,773)
Pro forma Net Income (Loss)	\$ (1,039,159)	\$ 1,594,029	\$ 806,860
Net Income (Loss) Per Share			
Basic - as reported	\$ (0.04)	\$ 0.19	\$ 0.16
Basic - pro forma	\$ (0.08)	\$ 0.13	\$ 0.06
Diluted - as reported	\$ (0.04)	\$ 0.19	\$ 0.16
Diluted - pro forma	\$ (0.08)	\$ 0.12	\$ 0.06

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### **Foreign Currency Translations**

Assets and liabilities of the Company's international operations are translated into U.S. dollars at exchange rates in effect on the balance sheet date and equity accounts are translated at historical exchange rates. Revenue and expense items are translated at average exchange rates in effect during the year. Gains or losses from translating foreign currency financial statements are recorded in other comprehensive income. The cumulative translation adjustment included in other comprehensive income for the years ended December 31, 2003, December 31, 2002 and December 31, 2001 was \$99 thousand, \$18 thousand, and \$9 thousand respectively.

### **Income Taxes**

Income taxes are computed using the asset and liability approach, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns. In estimating future tax consequences, the Company generally considers all expected future events other than enactment of changes in tax law or rates. If it is more likely than not that some portion or all of a deferred tax asset will not be realized, a valuation allowance is recorded.

### **Earnings (Loss) Per Share**

Earnings (loss) per share is calculated in accordance with SFAS No. 128, Earnings Per Share. Basic earnings (loss) per share is computed by dividing net income (loss) for the period by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares plus the dilutive effect of warrants and outstanding stock options under the Company's equity incentive plans. For 2003, diluted net loss per common share is the same as basic net loss per common share, since the effects of potentially dilutive securities are antidilutive.

### **Supplemental Cash Flow Information**

Cash paid for income taxes net of refunds for the years ended December 31, 2003, 2002, and 2001 was \$1.0 million, \$2.0 million, and \$1.2 million, respectively. Cash paid for interest for the years ended December 31, 2003, 2002, and 2001 was \$13 thousand, \$22, and \$68 thousand, respectively. We entered into capital leases with obligations totaling \$123 thousand, \$0, and \$73 thousand during the years ended December 31, 2003, 2002, and 2001, respectively.

The acquisition of property and equipment through lease incentives totaled \$814 for year ended December 31, 2003. During 2002 and 2001 there were no acquisitions of property and equipment through lease incentives.

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On July 31, 2003, Dr. Borow, President and Chief Executive Officer of Covalent Group, Inc., exercised an employee stock option to acquire 500,000 shares of Covalent common stock. The option had a grant date of August 6, 1998, an expiration date of August 5, 2003 and an exercise price of \$0.6875. As payment for the shares issued and related withholding taxes, Covalent Group, Inc. received from Dr. Borow 140,432 Covalent common shares that were owned by him. The shares received by the Company are included as treasury stock in our Consolidated Balance Sheet at December 31, 2003.

**Reclassifications**

Certain prior year balances have been reclassified to conform to the current year presentation.

**Recently Issued Accounting Standards**

In June 2001, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 143, Accounting for Asset Retirement Obligations. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This Statement requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. Adoption of SFAS No. 143 did not have a material impact on our financial statements.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Previous accounting guidance was provided by EITF No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS No. 146 replaces EITF No. 94-3 and is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. Adoption of SFAS No. 146 did not have a material impact on our financial statements.

In November 2002, the EITF finalized its tentative consensus on EITF Issue 00-21, Revenue Arrangements with Multiple Deliverables , which provides guidance on the timing and method of revenue recognition for sales arrangements that include the delivery of more than one product or service. EITF 00-21 is effective prospectively for arrangements entered into in fiscal periods beginning after June 15, 2003. Adoption of EITF Issue 00-21 did not have a material impact on our financial statements.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. SFAS No. 148 amends SFAS No. 123, Accounting for Stock-Based Compensation , to provide for alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires disclosure of comparable information for all companies, regardless of whether they have adopted the fair value or intrinsic value method of accounting for stock-based employee compensation. SFAS No. 148 is effective for financial statements issued for fiscal years ending after December 15, 2002, and interim periods beginning after December 15, 2002. Adoption of SFAS No. 148 did not have a material impact on our financial statements, other than expanding our disclosures.



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In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities. Interpretation No. 46 provides an interpretation of Accounting Research Bulletin No. 51, Consolidated Financial Statements with respect to the consolidation of variable interest entities. Interpretation No. 46 requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among the parties involved. In December 2003, the FASB issued a revision to FIN 46, or FIN 46R, to clarify some of the provisions of FIN 46. We currently have no entities which have the characteristics of a variable interest entity. Furthermore, we do not expect that the adoption of the remaining provision of FIN 46R in the quarter ending March 31, 2004 will have an impact on our financial statements.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS No. 133,

Accounting for Derivative Instruments and Hedging Activities. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, except as stated below and for hedging relationships designated after June 30, 2003. The provisions of SFAS No. 149 that relate to Statement 133 Implementation Issues that have been effective for fiscal quarters that began prior to June 15, 2003, should continue to be applied in accordance with their respective effective dates. The Company has not entered into any derivative transactions and therefore the adoption of this standard has not had a material impact on our financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, which establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 requires that an issuer classify a financial instrument that is within its scope, which may have previously been reported as equity, as a liability (or an asset in some circumstances). This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Adoption of SFAS No. 150 has not had a material impact on our financial statements. The FASB is addressing certain implementation issues associated with the application of SFAS No. 150 including those related to mandatorily redeemable financial instruments representing noncontrolling interests in subsidiaries included in consolidated financial statements. The Company will monitor the actions of the FASB and assess the impact, if any, that these actions may have on its financial statements.

### 3. PROPERTY & EQUIPMENT:

	December 31,	
	2003	2002
Property & equipment consists of the following:		
Equipment	\$ 2,935,501	\$ 2,664,968
Furniture & fixtures	549,305	530,585
Leasehold improvements	1,168,441	168,622
Equipment under capital lease	316,265	193,265
	<u>4,969,512</u>	<u>3,557,440</u>
Accumulated depreciation	(3,164,181)	(2,276,291)
Property and equipment, net	<u>\$ 1,805,331</u>	<u>\$ 1,281,149</u>

**Table of Contents**4. **PREPAID EXPENSES AND OTHER:**

Prepaid expenses and other includes loans to non-executive officer employees at December 31, 2003 and 2002 of approximately \$3 thousand and \$61 thousand, respectively.

5. **INCOME TAXES:**

The components of the income tax provision are as follows:

	Year Ended December 31,		
	2003	2002	2001
Current:			
Federal	\$ (406,859)	\$ 1,260,625	\$ 1,016,432
State	(3,988)	244,710	197,307
	(410,847)	1,505,335	1,213,739
Deferred:			
Federal	(96,103)	83,744	204,523
State	(37,082)	16,256	39,702
	(133,185)	100,000	244,225
	\$ (544,032)	\$ 1,605,335	\$ 1,457,964

Income tax expense differs from the amount currently payable because certain expenses, primarily depreciation and accruals, are reported in different periods for financial reporting and income tax purposes.

The federal statutory income tax rate is reconciled to the effective income tax rate as follows:

	Year Ended		
	December 31,		
	2003	2002	2001
Federal statutory rate	(34.0)%	34.0%	34.0%

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State income taxes, net of federal benefit	(3.0)%	4.2%	4.4%
Adjustment to prior year accrual	(12.0)%		
Other	(.2)%	1.2%	3.3%
	<u>          </u>	<u>          </u>	<u>          </u>
	(49.2)%	39.4%	41.7%
	<u>          </u>	<u>          </u>	<u>          </u>

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The components of the net current and long-term deferred tax assets and liabilities, measured under SFAS No. 109, are as follows:

	Year Ended December 31,		
	2003	2002	2001
Deferred Tax Asset			
Long Term contract revenue	\$	\$ 82,467	\$ 202,061
Investment valuation		96,679	96,628
Net Operating Losses	61,029		
Other		68,857	
	61,029	248,003	298,689
Deferred tax liabilities			
Depreciation	(79,339)	(144,902)	(92,791)
Accrual	(192,730)	(447,326)	(447,326)
Other			(2,794)
	(272,069)	(592,228)	(542,911)
Net deferred tax liability	\$ (211,040)	\$ (344,225)	\$ (244,222)

As of December 31, 2003, we had state operating loss carryforwards of \$1,017,146 which expire in various periods through 2023.

6. LINE OF CREDIT:

We maintain a demand line of credit with a bank under which maximum borrowings are the lesser of \$2.5 million or 75% of eligible accounts receivable, as defined in the loan agreement, and bear interest at the LIBOR Market Index Rate plus 2.65%. As of December 31, 2003, there were no borrowings under the line of credit, and the maximum available under the terms of the line of credit was \$2.3 million. The line of credit was renewed on June 17, 2003 and expires on June 30, 2004. Borrowings under the line of credit are secured by substantially all of our assets. Our agreement with the bank provides that we maintain a minimum tangible net worth of \$10.75 million and a ratio of total liabilities to tangible net worth of not more than 1.25 to 1.00. As of December 31, 2003, we were in compliance with these covenants.

7. EARNINGS(LOSS) PER SHARE:

Earnings(loss) per share is calculated in accordance with SFAS No. 128, Earnings Per Share. Basic earnings(loss) per share is computed by dividing net income(loss) for the period by the weighted average number of common shares outstanding during the period. Diluted earnings(loss) per share is computed by dividing net income(loss) by the weighted average number of common shares plus the dilutive effect of outstanding stock options under the Company's equity incentive plans. For 2003, diluted net loss per common share is the same as basic net loss per share, since the effects of potentially dilutive securities are anti-dilutive. Stock options outstanding that are not included in the table below because of their anti-dilutive effect for the year ended December 31, 2003 were 1,351,946, for the year ended December 31, 2002 were 913,400 and for the year ended December 31, 2001 were 1,023,200.

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The net income and weighted average common and common equivalent shares outstanding for purposes of calculating net income per common share were computed as follows:

	Year Ended December 31,		
	2003	2002	2001
Net Income (Loss)	\$ (562,103)	\$ 2,454,314	\$ 2,034,633
Weighted average number of common shares outstanding used in computing basic earnings per share	12,746,973	12,591,229	12,420,338
Dilutive effect of stock options outstanding		608,254	542,240
Weighted average shares used in computing diluted earnings per share	12,746,973	13,199,483	12,962,628
Basic earnings (loss) per share	\$ (0.04)	\$ 0.19	\$ 0.16
Diluted earnings (loss) per share	\$ (0.04)	\$ 0.19	\$ 0.16

8. STOCKHOLDERS' EQUITY:Treasury Stock

We have 152,932 common shares in treasury. The shares are valued using the cost method of accounting for treasury stock.

9. EXERCISE OF EMPLOYEE STOCK OPTION

On July 31, 2003, Dr. Borow, President and Chief Executive Officer of Covalent Group, Inc., exercised an employee stock option to acquire 500,000 shares of Covalent common stock. The option had a grant date of August 6, 1998, an expiration date of August 5, 2003 and an exercise price of \$0.6875. As payment for the shares issued and related withholding taxes, Covalent Group, Inc. received from Dr. Borow 140,432 Covalent common shares that were owned by him. The shares received by the Company are included as treasury stock in our Consolidated Balance Sheet at December 31, 2003.

10. STOCK-BASED COMPENSATION:

We have adopted equity incentive plans that provide for the granting of stock options to employees, directors, advisors and consultants. We account for grants of options to employees and directors under these plans applying the intrinsic value method provided for in Accounting Principles Board ( APB ) Opinion No. 25 Accounting for Stock Issued to Employees and related interpretations. No stock-based compensation expense is reflected in net income as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of the grant. In addition to APB Opinion No. 25, we provide the disclosures required by SFAS No. 123 Accounting for Stock-Based Compensation and by SFAS No. 148 Accounting for Stock-Based Compensation Transition and Disclosure. See Note 2 for disclosure of Pro Forma Net Income and Net Income Per Share.

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For purposes of determining the pro forma amounts in Note 2, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Year Ended		
	December 31,		
	2003	2002	2001
Risk-free interest rate	2.11% - 3.54%	2.61% - 4.74%	3.50% - 5.75%
Expected dividend yield	-	-	-
Expected life	5 years	5 years	5 years
Expected volatility	49%	58%	87%

Based upon the above assumptions, the weighted average fair value of the stock options granted for the years ended December 31, 2003, 2002, and 2001 was \$1.01, \$1.82, and \$1.60 respectively. As of December 31, 2003, the weighted average remaining contractual life of stock options outstanding was 2.4 years. Because additional option grants are expected to be made each year, the above pro forma disclosures are not representative of pro forma effects on reported net income for future years.

**2002 Equity Incentive Plan**

In March 2002, the Board of Directors approved the 2002 Equity Incentive Plan, which was approved by the shareholders in June 2002. Upon adoption, a total of 1,000,000 shares were available for grant under this plan. The plan provides for the granting of incentive and non-qualified stock options for the purchase of shares of common stock to directors, officers, employees, advisors and consultants, as defined under the provisions of the plan.

**1996 Equity Incentive Plan**

The Company's 1996 Stock Incentive Plan and 1995 Stock Option Plan provide for the granting of incentive and non-qualified stock options for the purchase of shares of common stock to directors, officers, employees and consultants, as defined under the provisions of the plans. The 1996 Stock Incentive Plan was amended in 2000 to increase the number of common shares available for grant from 2,500,000 to 3,000,000. The stock incentive plan provides for the granting of incentive and non-qualified stock options for the purchase of shares of common stock to directors, employees and non-employee consultants, as defined under the provisions of the plan.



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Aggregate stock option activities for all plans for the years ended December 31, 2003, 2002, and 2001 were as follows:

	<b>Number of Shares</b>	<b>Range of Exercise Prices per Share</b>	<b>Weighted Average Exercise Price per Share</b>
Options outstanding at December 31, 2000	2,134,300	\$ 0.69 - 4.88	\$ 2.74
Granted	903,400	1.63 - 3.50	2.55
Exercised	(189,400)	0.69 - 2.86	1.75
Canceled	(420,200)	1.56 - 4.88	3.61
Options outstanding at December 31, 2001	2,428,100	\$ 0.69 - 4.47	\$ 2.56
Granted	394,175	2.05 - 4.49	3.37
Exercised	(161,870)	1.25 - 4.38	2.25
Canceled	(256,133)	0.69 - 4.38	2.93
Options outstanding at December 31, 2002	2,404,272	\$ 0.69 - 4.49	\$ 2.68
Granted	354,000	2.05 - 2.59	2.2
Exercised	(570,900)	0.69 - 2.19	0.85
Canceled	(438,376)	1.94 - 4.47	2.78
Options outstanding at December 31, 2003	1,748,996	\$ 1.80 - 4.49	\$ 3.15
Exercisable options outstanding at:			
December 31, 2001	1,332,575	\$ 0.69 - 4.47	\$ 2.26
December 31, 2002	1,403,920	\$ 0.69 - 4.49	\$ 2.33
December 31, 2003	984,225	\$ 1.80 - 4.49	\$ 3.36

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The following table summarizes information regarding stock options outstanding at December 31, 2003:

Options Outstanding				Options Exercisable	
Range of Exercise Prices	Number Outstanding At December 31, 2003	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price per Share	Number Exercisable December 31, 2003	Weighted Average Exercise Price
\$1.80	5,000	2.2	\$ 1.80	3,000	\$ 1.80
1.94	137,650	2.1	1.94	84,590	1.94
2.05-2.54	362,125	3.5	2.30	94,708	2.42
2.57-2.90	429,821	3.0	2.80	229,407	2.81
3.00-3.90	172,000	2.9	3.41	86,600	3.42
4.00-4.49	642,400	1.3	4.06	485,920	4.04
	<u>1,748,996</u>	<u>2.4</u>	<u>\$ 3.15</u>	<u>984,225</u>	<u>\$ 3.36</u>

As of December 31, 2003, there were 1,101,850 stock options available for grant under our stock option plans.

11. **EMPLOYEE BENEFIT PLAN:**

The Company sponsors a 401(k) retirement savings plan that is available to substantially all its U.S. based full-time employees who elect to participate. Effective January 1, 2003, the Company began providing a matching contribution equal to 50% on the first 2% of the participant's compensation (excluding bonus payments). In 2003 company matching contributions were \$71 thousand. Matching contributions are determined each payroll period. The matching contribution is credited to the participant using a graded vesting schedule with six or more years of service required to become fully vested. The method for crediting vesting service is the plan year.

12. **SEGMENT DISCLOSURES:**

The Company has adopted the provisions of SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information which establishes standards for reporting business segment information. The Company operates in one segment predominantly in the clinical research industry providing a broad range of clinical research services on a global basis to the pharmaceutical, biotechnology and medical device industries.

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The following table summarizes the distribution of net revenue and contracts with significant clients:

	Year Ended December 31,					
	2003		2002		2001	
	Percentage of Revenues	Number of Contracts	Percentage of Revenues	Number of Contracts	Percentage of Revenues	Number of Contracts
Client A	41%	12	46%	14	18%	8
Client B	21	3	30	4	55	4
Client C	7	1	10	3	12	3
Top Three Clients	69%	16	86%	21	85%	15

Client A, B and C in the table above represent the three largest clients for each year, but do not necessarily represent the same client for each year shown.

The significant clients above represented 83% and 94%, respectively, of the balance of cost and estimated earnings in excess of related billings on uncompleted contracts at December 31, 2003 and 2002.

The following table summarizes the distribution of net revenues from external clients by geographical area:

	Year Ended December 31,		
	2003	2002	2001
U.S.	\$ 19,678,729	\$ 23,826,702	\$ 18,252,613
Europe	1,157,013	850,359	100,868
Total	\$ 20,835,742	\$ 24,677,061	\$ 18,353,481

13. **CAPITAL AND OPERATING LEASE COMMITMENTS:**

We entered into new capital lease obligations totaling \$123 thousand during 2003. Leased equipment accounted for as a capital lease at December 31, 2003 totaled \$316,265 with associated accumulated amortization of \$206,450.

Future minimum lease payments on capital lease obligations at December 31, 2003 are as follows:

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For the year ending December 31:	
2004	\$ 34,645
2005	31,704
2006	31,704
2007	31,704
2008	7,926
	<hr/>
Total	\$ 137,683
Less amount representing interest	(26,397)
	<hr/>
Present value of capital lease payments	\$ 111,286
	<hr/>

We are committed under a number of non-cancelable operating leases, primarily related to office space and other office equipment. Total lease expense was \$987 thousand for the year ended December 31, 2003, \$695 thousand for the year ended December 31, 2002, and \$470 thousand for the year ended December 31, 2001.

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Future minimum lease payments on operating lease obligations at December 31, 2003, are as follows:

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>Thereafter</u>	<u>Total</u>
Operating leases	\$ 961,777	\$ 960,171	\$ 921,018	\$ 937,259	\$ 952,728	\$ 1,956,495	\$ 6,689,448

## 14. OTHER LIABILITIES

As of January 1, 2003, the Company increased by approximately 12,700 to 34,000 the amount of square feet under lease in the same building. The term of the lease was also extended to 2010 and monthly lease payments increased from \$50 thousand to \$72 thousand. As an incentive for the Company to acquire the additional space, the lessor granted the Company \$814 thousand in lease incentives that were used to pay for architectural fees, renovations and improvement costs for the new space. The lease incentives were capitalized as if the Company incurred the costs to make the improvements and are included in Property and Equipment. These assets and the related liability are amortized over the remaining life of the lease at a rate of approximately \$116 thousand per year as an additional amortization expense and a reduction in rent expense, respectively. The accounting for these lease incentives has no impact on net income, stockholders' equity or cash flow.

**Table of Contents**15. QUARTERLY FINANCIAL DATA (UNAUDITED):

	For the Quarter Ended			
	March 31	June 30	September 30	December 31
<u>2003</u>				
Net Revenues	\$ 6,387,062	\$ 5,732,295	\$ 3,876,593	\$ 4,839,792
Income(Loss) From Operations	806,995	110,492	(987,516)	(1,039,689)
Net Income(Loss)	482,093	70,899	(392,284)	(722,811)
Net Income(Loss) Per Common Share				
Basic	\$ 0.04	\$ 0.01	\$ (0.03)	\$ (0.06)
Diluted	\$ 0.04	\$ 0.01	\$ (0.03)	\$ (0.06)
<u>2002</u>				
Net Revenue	\$ 5,444,561	\$ 6,195,726	\$ 6,001,436	\$ 7,035,338
Income From Operations	1,082,409	1,239,329	573,194	1,175,318
Net Income	631,474	773,067	380,137	669,636
Net Income Per Common Share				
Basic	\$ 0.05	\$ 0.06	\$ 0.03	\$ 0.05
Diluted	\$ 0.05	\$ 0.06	\$ 0.03	\$ 0.05

## 16. COMMITMENTS AND CONTINGENCIES:

We have entered into an employment agreement with one of our officers that calls for specified minimum annual compensation of \$325,000 per year over a three-year period and includes provisions for continuation of salary upon termination as defined in the agreement.

The Company is involved in litigation and other legal matters which have arisen in the normal course of business. Although the ultimate results of these matters are not currently determinable, management does not expect that they will have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

The contract research organization industry is subject to legislation and regulations that are revised or amended on an on-going basis. The impact of complying with such legislation and regulations could materially affect our business.

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**SIGNATURES**

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**COVALENT GROUP, INC.**

Dated: March 26, 2004

By: /s/ Kenneth M. Borow, M.D.

Kenneth M. Borow, M.D.

President, Chief Executive Officer and Director

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Dated: March 26, 2004

By: /s/ Kenneth M. Borow, M.D.

Kenneth M. Borow, M.D.

President, Chief Executive Officer and Director

Dated: March 26, 2004

By: /s/ Daniel W. Hood, CPA

Daniel W. Hood, CPA

Controller and Principal Accounting Officer

(financial and accounting officer)

Dated: March 26, 2004

By: /s/ Thomas E. Hodapp

Thomas E. Hodapp

Director

Dated: March 26, 2004

By: /s/ Scott M. Jenkins

Scott M. Jenkins

Director

Dated: March 26, 2004

By: /s/ Earl M. Collier, Jr.

Earl M. Collier, Jr.

Director

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EXHIBIT INDEX

<b><u>Exhibit</u></b>	<b><u>Description</u></b>
21	Subsidiaries of the Registrant.
23	Consent of Deloitte & Touche LLP.
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.