FARMSTEAD TELEPHONE GROUP INC
Form 10-Q
August 12, 2003

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)
[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the quarterly period ended June 30, 2003

or

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Commission File Number: 0-15938

Farmstead Telephone Group, Inc.
(Exact name of registrant as specified in its charter)

Delaware	06-1205743
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
22 Prestige Park Circle East Hartford, CT	06108
(Address of principal executive offices)	(Zip Code)

(860) 610-6000
(Registrant's telephone number)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

As of July 31, 2003, the registrant had 3,305,288 shares of its $0.001 par value Common Stock outstanding.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED BALANCE SHEETS

	June 30,	December 31,

(In thousands)	2003	2002
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 292	$ 994
Accounts receivable, net (Note 2)	2,637	1,869
Inventories, net (Note 3)	2,359	2,309
Other current assets	382	69
Total Current Assets	5,670	5,241
Property and equipment, net	330	394
Other assets	299	238
Total Assets	$ 6,299	$ 5,873
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,434	$ 1,111
Debt maturing within one year (Note 4)	365	-
Accrued expenses and other current liabilities (Note 5)	347	385
Total Current Liabilities	2,146	1,496
Other liabilities	399	348
Total Liabilities	2,545	1,844
Commitments and contingencies (Note 9)		
Stockholders' Equity:		
Preferred stock, $0.001 par value; 2,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, $0.001 par value; 30,000,000 shares authorized; 3,305,288 and 3,298,958 shares issued and outstanding at June 30, 2003 and December 31, 2002, respectively	3	3
Additional paid-in capital	12,315	12,313
Accumulated deficit	(8,564)	(8,287)
Total Stockholders' Equity	3,754	4,029
Total Liabilities and Stockholders' Equity	$ 6,299	$ 5,873

See accompanying notes to consolidated financial statements.

2

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

(In thousands, except loss per share amounts)	For the Three Months Ended June 30, 2003	For the Three Months Ended June 30, 2002	For the Six Months Ended June 30, 2003	For the Six Months Ended June 30, 2002
Revenues:				
Equipment	$3,053	$4,207	$7,080	$ 9,877
Services and other revenue	758	557	1,170	914
Total revenues	3,811	4,764	8,250	10,791
Cost of Revenues:				
Equipment	2,091	3,223	4,869	7,300
Services and other revenue	537	345	824	578
Other cost of revenues	208	441	446	852
Total cost of revenues	2,836	4,009	6,139	8,730
Gross profit	975	755	2,111	2,061
Selling, general and administrative expenses	1,094	1,417	2,369	3,077
Operating loss	(119)	(662)	(258)	(1,016)
Interest expense	(8)	(10)	(10)	(22)
Other income	1	19	3	90
Loss before income taxes	(126)	(653)	(265)	(948)
Provision for income taxes	6	7	12	13
Net loss	$ (132)	$ (660)	$ (277)	$ (961)
Basic and diluted net loss per common share:	$ (.04)	$ (.20)	$ (.08)	$ (.29)
Weighted average common shares outstanding:				
Basic	3,305	3,289	3,302	3,285
Diluted	3,334	3,304	3,319	3,297

See accompanying notes to consolidated financial statements.

3

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
For the Six Months Ended June 30, 2003 and 2002

(In thousands)	2003	2002
Cash flows from operating activities:		
Net loss	$ (277)	$ (961)
Adjustments to reconcile net loss to net cash flows used in operating activities:		
Provision for (reversal of) doubtful accounts receivable	16	(51)
Provision for losses on inventories	15	45
Depreciation and amortization	88	115
Value of compensatory stock options issued	-	17
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	(784)	562
(Increase) decrease in inventories	(65)	833
(Increase) decrease in other assets	(374)	3
Increase (decrease) in accounts payable	323	(954)
Decrease in accrued expenses and other current liabilities	(38)	(10)
Increase in other liabilities	51	44
Net cash used in operating activities	(1,045)	(357)
Cash flows from investing activities:		
Purchases of property and equipment	(24)	(30)
Acquisition of InfiNet	-	(153)
Net cash used in investing activities	(24)	(183)
Cash flows from financing activities:		
Borrowings under revolving credit line	365	345
Repayments of capital lease obligation	-	(37)
Issuance of common stock	2	10
Capital distribution to minority interest partner	-	(128)
Net cash provided by financing activities	367	190
Net decrease in cash and cash equivalents	(702)	(350)
Cash and cash equivalents at beginning of period	994	1,479
Cash and cash equivalents at end of period	$ 292	$ 1,129
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 7	$ 20
Income taxes	4	17

See accompanying notes to consolidated financial statements.

FARMSTEAD TELEPHONE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BASIS OF PRESENTATION

The consolidated financial statements presented herein consist of the accounts of Farmstead Telephone Group, Inc. and its wholly owned subsidiaries, FTG Venture Corporation and InfiNet Systems, LLC (both are inactive). The accompanying consolidated financial statements as of and for the three and six months ended June 30, 2003 and 2002 have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission for interim financial statements. In the Company's opinion, the unaudited interim consolidated financial statements and accompanying notes reflect all adjustments, consisting of normal and recurring adjustments, that are necessary for a fair statement of results for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the results to be experienced for the entire fiscal year. Certain prior year amounts on the Consolidated Statements of Cash Flows have been reclassified to conform to the current interim period presentation. This Form 10-Q should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002

2. ACCOUNTS RECEIVABLE, NET

Accounts receivable, net consist of the following (in thousands):

	June 30, 2003	December 31, 2002
Trade accounts receivable	$2,438	$1,892
Other receivables	250	24
	2,688	1,916
Less: allowance for doubtful accounts	(51)	(47)
Accounts receivable, net	$2,637	$1,869

Other receivables consist of commissions, rebates and other dealer incentives due from Avaya, Inc., and are recorded in the consolidated financial statements when earned.

3. INVENTORIES, NET

Inventories are stated at the lower of cost or market, and are valued on an average cost basis. Inventories, net consist of the following (in thousands):

	June 30, 2003	December 31, 2002
Finished goods and spare parts	$2,176	$2,362
Work in process (a)	496	456

Rental equipment	77	53
	2,749	2,871
Less: reserves for excess and obsolete inventories	(390)	(562)
Inventories, net	$2,359	$2,309

4. DEBT MATURING WITHIN ONE YEAR

On February 19, 2003 the Company entered into a one-year, $1.5 million revolving loan agreement (the "BACC Agreement") with Business Alliance Capital Corporation ("BACC"), replacing the Wachovia Loan Agreement. Under the terms of the BACC Agreement, borrowings are advanced at 75% of eligible accounts receivable, as defined (primarily receivables that are less than 90 days old and, in the case of system sales, the receivable does not become "eligible" until the system has been installed), and at 25% of the value of eligible inventory, as defined (primarily inventory that was purchased pursuant to a firm customer order), provided that the amount advanced against eligible inventory shall not exceed $200,000 or 30% of all outstanding advances under the BACC Agreement. Interest is charged at the per annum rate of one and one-half percentage points (1.5%) above the prime rate, but not less than 5.75%, subject to a minimum interest charge based on a

5

minimum daily loan balance of $250,000 regardless of the actual loan balance. Under the BACC Agreement, the Company is charged an annual facility fee of 1% of the facility ($15,000) and a monthly service fee equal to .25% of the average outstanding loan balance, subject to a minimum daily loan balance of $250,000. As additional security to BACC, the Company issued a $300,000 standby letter of credit in favor of BACC, secured by cash, which can be drawn upon, up to the amount of the Company's outstanding obligation to BACC, ninety days after an event of default (see Note 9). The BACC Agreement restricts the Company from the payment of dividends and limits capital expenditures during the term of the agreement to $150,000, without the consent of BACC. The BACC Agreement contains no specific financial covenants, however it defines certain circumstances under which the agreement can be declared in default and subject to termination, including among others if (i) there is a material adverse change in the Company's business or financial condition; (ii) an insolvency proceeding is commenced; (iii) the Company defaults on any of its material agreements with third parties; (iv) the Company fails to comply with the terms, representations and conditions of the BACC Agreement, and (v) there are material liens or attachments levied against the Company's assets. In the event the BACC Agreement is terminated prior to its expiration date, the Company shall pay a fee in an amount equal to 5% of the advance limit of $1.5 million if such termination occurs on or prior to August 19, 2003; or 4% of the advance limit if such termination occurs thereafter.

As of June 30, 2003, outstanding borrowings under the BACC Agreement were $365,000. The unused portion of the credit facility as of June 30, 2003 was $1,135,000, all of which was available under the Company's borrowing formulas. The average and highest amounts borrowed during the three months ended June 30, 2003 were approximately $270,000 and $530,000, respectively. The average and highest amounts borrowed under all credit

facilities during the six months ended June 30, 2003 were approximately $151,000 and $530,000. The Company was in compliance with the provisions of its loan agreement as of June 30, 2003.

5. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities consist of the following (in thousands):

	June 30, 2003	December 31, 2002
Salaries, commissions and benefits	$206	$241
License fees	19	24
Other	122	120
Accrued expenses and other current liabilities	$347	$385

6. RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

FASB INTERPRETATION NO. 45. In November 2002, the Financial Accounting Standards Board issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 elaborates on the existing disclosure requirements for most guarantees, including loan guarantees such as standby letters of credit. It also requires that at the time a company issues a guarantee, the company must recognize an initial liability for the fair market value of the obligations it assumes under that guarantee and must disclose that information in its interim and annual financial statements. The initial recognition and measurement provisions of FIN 45 apply on a prospective basis to guarantees issued or modified after December 31, 2002. The Company adopted FIN 45 effective January 1, 2003. The Company has no guarantees of the type contemplated by FIN 45 requiring recognition of an initial liability on its books, however applicable disclosures are reflected in Note 9 - Commitments and Contingencies.

7. STOCK OPTIONS

The Company applies the disclosure only provisions of Financial Accounting Standards Board Statement ("SFAS") No. 123, "Accounting for Stock-based Compensation" ("SFAS 123") and SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" ("SFAS 148") for employee stock option awards. Had compensation cost for the Company's stock option plan been determined in accordance with the fair value-based method prescribed under SFAS 123, the Company's net loss and basic and diluted net loss per share would have approximated the pro forma amounts indicated below (dollars in thousands except per share amounts):

	Three months ended June 30,	Six months ende June 30,

	2003	2002	2003	2002
Net loss, as reported	$(132)	$(660)	$(277)	$ (96
Add: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(23)	(45)	(46)	(8
Pro forma net loss	$(155)	$(705)	$(323)	$(1,05
Pro forma net loss per share:				
Basic and diluted	$(.05)	$(.21)	$(.10)	$ (.3

The fair value of stock options used to compute pro forma net loss and net loss per share disclosures was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield of 0% for 2003 and 2002; expected volatility of 113% for 2003 and 2002; average risk-free interest rate of 2.78% for 2003 and 3.68% for 2002; and an expected option holding period of 5.6 years for 2003 and 2002.

8. MAJOR CUSTOMERS AND CONCENTRATIONS OF CREDIT RISK

During the three and six months ended June 30, 2003, no customer accounted for more than 10% of revenues. During the three and six months ended June 30, 2002, one customer accounted for 19% and 12%, respectively, of revenues. The Company extends credit to its customers in the normal course of business. As of June 30, 2003, one customer accounted for 20% of accounts receivable. As of December 31, 2002, one customer accounted for 11% of accounts receivable. Although the Company is subject to changes in economic conditions which may impact its overall credit risk, the Company sells to a wide variety of customers, and does not focus on any particular industry sector. The Company establishes its allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends and experience, and other information available to it. Management considers the Company's credit risk to be satisfactorily diversified and believes that its $51,000 allowance for doubtful accounts is adequate to absorb estimated losses as of June 30, 2003.

9. COMMITMENTS AND CONTINGENCIES

Letter of Credit. In connection with the Company's revolving credit agreement with BACC, the Company issued a $300,000 irrevocable standby letter of credit ("LC") in favor of BACC. The LC can be drawn upon by BACC to satisfy any outstanding obligations under the Company's loan agreement ninety days after an event of default. The LC is secured by cash, and since this cash is restricted from use by the Company during the term of the LC, it has been classified under other current assets in the consolidated balance sheet at June 30, 2003.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

The discussions set forth below and elsewhere in this Annual Report on Form 10-Q contain certain statements, based on current expectations,

estimates, forecasts and projections about the industry in which we operate and management's beliefs and assumptions, which are not historical facts and are considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 ("the Act"). Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate, or imply future results, performance, or achievements, and may contain the words "believe," "will be," "will continue," "will likely result," "anticipates," "seeks to," "estimates," "expects," "intends," "plans," "predicts," "projects," and similar words, expressions or phrases of similar meaning. Our actual results could differ materially from those projected in the forward-looking statements as a result of certain risks, uncertainties and assumptions, which are difficult to predict. Many of these risks and uncertainties are described under the heading "Risk, Uncertainties and Other Factors That May Affect Future Results" below. All forward-looking statements included in this document are based upon information available to us on the date hereof. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. In addition, other written or oral statements made or incorporated by reference from time to time by us or our representatives in this report, other reports, filings with the Securities and Exchange Commission, press releases, conferences, or otherwise may be forward-looking statements within the meaning of the Act.

RESULTS OF OPERATIONS

Overview. For the three months ended June 30, 2003, we recorded a net loss of $132,000 or $.04 per share on revenues of $3,811,000. This compares to a net loss of $660,000 or $.20 per share on revenues of $4,764,000 for the three months ended June 30, 2002. For the six months ended June 30, 2003, we recorded a net loss of $277,000 or $.08 per share on revenues of $8,250,000. This compares to a net loss of $961,000 or $.29 per share on revenues of $10,791,000 recorded for the six months ended June 30, 2002. We believe that our operating results for 2003 reflect the continuing soft market conditions for telecommunications products in the United States. Although we are encouraged by an increase in sales quotation activities, capital spending for telecommunications products remains sluggish, and we are not able to predict when business capital spending restraints will lessen. We have therefore remained in a somewhat defensive posture, attempting to offset the financial impact of a reduced revenue stream by reducing, more tightly controlling, and deferring where possible, operating costs and expenses. Our overall strategy has been to lower our breakeven point and return to profitability, through a combination of operating expense reductions and product purchasing initiatives to improve gross profit margins, and to conserve cash by better managing assets, principally accounts receivable and inventories. During 2003, this strategy has enabled us to significantly reduce our losses despite decreased revenues. Although second quarter revenues were 20% lower than second quarter 2002, and 24% lower year-to-date, we managed to reduce our comparative net losses by 80% and 71%, respectively. We accomplished this through reducing our selling, general and administrative expenses by 23% and by significantly increasing our profit margins from 16% to 26% quarter-over-quarter, and from 19% to 26% year-over-year, through personnel reductions, improved product buying and outsourcing equipment repair operations. Additionally, while second quarter revenues were 14% lower than first quarter 2003, our net loss was still 9% less.

During the remainder of 2003, our business focus will continue to

center on two main fronts - (1) strategies to increase sales volume by (i) expanding our sales force so as to provide more coverage of existing and potential customers located within the market areas which we serve; and (ii) broadening our product offerings; and (2) continuing efforts to lower our breakeven point by (i) focusing on gross margin improvements through improved product purchasing and outsourcing where possible; and (ii) bringing improved scalability to our business through reducing fixed expenses where possible, so that our operating expenses are more variable and can more quickly adjust to changes in sales volume. Should there be continued softness in the market conditions in the telecommunications equipment industry, however, we may experience continued decreases in revenues and deterioration in operating results. Additional information on major components of our operating performance for the three and six months ended June 30, 2003 follows below.

REVENUES

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2003	2002	2003	2002
End-user equipment sales	$2,661	$3,051	$6,283	$ 7,838
Equipment sales to resellers	392	1,156	797	2,039
Total equipment sales	3,053	4,207	7,080	9,877
Services	682	555	1,073	897
Other revenue	76	2	97	17
Total services and other revenue	758	557	1,170	914
Consolidated revenues	$3,811	$4,764	$8,250	$10,791

Equipment Sales

Total equipment sales for the three months ended June 30, 2003, were $3,053,000, a decrease of $1,154,000 or 27% from the comparable 2002 period. The decrease consisted of a $390,000 or 13% decline in end-user sales, and a $764,000 or 66% decline in equipment sales to resellers ("wholesale sales"). Total equipment sales for the six months ended June 30, 2003, were $7,080,000, a decrease of $2,797,000 or 28% from the comparable 2002 period. The decrease consisted of a $1,555,000 or 20% decline in end-user sales, and a $1,242,000 or 61% decline in wholesale sales. End user sales consist of both parts sales (new and refurbished), and of systems sales (complete systems and system upgrades).

We attribute these sales declines primarily to continuing softness in the U.S. economy and its negative impact on capital spending for telecommunications products. These conditions have also led to increased competition and downward pressure on sales prices. Another factor affecting our sales levels has been the transitioning of our sales force. During 2003, we have continued a strategy of diversifying our product offerings by marketing the sale of complete telecommunications systems to our customer base. This is a growth strategy, designed to augment our long-established

aftermarket parts business that continues as our primary source of revenues. This strategy necessitated the hiring of sales, service and technical design

personnel experienced in systems and applications design and sales. As a result, we have increased our focus on selling new systems and system upgrades, which while resulting in increased systems sales, coupled with the turnover of certain experienced parts salespersons over the last two years, has contributed to the reduction in aftermarket parts sales. For the three months ended June 30, 2003, systems sales represented $613,000 of our end-user equipment sales, an increase of 98% from the comparable 2002 period. For the six months ended June 30, 2003, system sales represented $2,045,000 of our end-user equipment sales, an increase of 91%. We remain committed to the continuing growth of our systems revenues and are currently implementing strategies to increase revenues from parts sales, including the implementation of on-line ordering processes and other direct-marketing approaches. To date, orders received electronically from customers through our on-line catalogs have not been significant. We are, however, still in the early stages of marketing this process to our customer base.

Services and other revenue

Services and other revenue for the three months ended June 30, 2003, were $758,000, an increase of $201,000 or 36% from the comparable 2002 period. The increase consisted of a $174,000 increase in services and a $74,000 increase in other revenue. Services and other revenue for the six months ended June 30, 2003, were $1,170,000, an increase of $256,000 or 28% from the comparable 2002 period. The increase consisted of a $176,000 increase in services and an $80,000 increase in other revenue. The increase in services revenue for both current year periods was primarily attributable to higher installation revenues as a result of the growth in system sales. Other revenue consisted primarily of commissions earned from selling Avaya maintenance contracts. In these transactions we act as a sales agent of Avaya, and the service obligations are borne entirely by Avaya. During 2003 we have increased our focus on selling these contracts as part of our strategy to develop new sources of revenue for the Company.

Significant portions of our sales revenues are derived from "Business Partner" relationships with Avaya. For the past several years, Avaya has been pursuing a strategy of more fully utilizing its dealer channel as a revenue source. Through our relationships with various Avaya sales personnel, we are often referred business by Avaya. Such referrals however, have been subject to fluctuation as Avaya's direct sales business itself fluctuates. We believe we are well positioned to benefit from our Avaya relationships as capital spending for telecommunications products improves.

We continue to remain cautious about the near term levels of capital spending for telecommunications products in the US. We still expect that our future sales revenues will improve in all of our current sales channels when capital spending improves, although no assurances can be given as to the timing of when this will occur. To combat this current environment, we are looking to hire additional sales personnel in order to provide increased coverage of our existing customer base. This will include a larger inside-sales staff to focus on smaller-market opportunities.

COST OF REVENUES AND GROSS PROFIT. Total cost of revenues for the

three months ended June 30, 2003 was $2,836,000, a decrease of $1,173,000 or 29% from the comparable 2002 period. The gross profit for the three months ended June 30, 2003 was $975,000, an increase of $220,000 or 29% from the comparable 2002 period. As a percentage of revenue, the gross profit margin was 26% for 2003, compared to 16% for the comparable 2002 period. Total cost of revenues for the six months ended June 30, 2003 was $6,139,000, a decrease of $2,591,000 or 30% from the comparable 2002 period. The gross profit for the six months ended June 30, 2003 was $2,111,000, an increase of $50,000 or 2% from the comparable 2002 period. As a percentage of revenue, the gross profit margin was 26% for 2003, as compared to 19% for the comparable 2002 period.

Our gross profit margins are dependent upon a variety of factors including (1) product mix - gross margins can vary significantly among parts sales, system sales and our various service offerings. The parts business, for example, involves hundreds of parts that generate significantly varying gross profit margins depending upon their availability, competition, and demand conditions in the marketplace; (2) customer mix - we sell parts to both end-users and to other equipment resellers. In our partnering relationship with Avaya, certain customers receive pre-negotiated discounts from Avaya which could lower our gross margins as we do business with these customers; (3) the level and amount of discounts and purchase rebates available to us from Avaya and its master distributors and (4) the level of overhead costs in relation to sales volume. Overhead costs consist primarily of product handling, purchasing, and facility costs. The combined effect of all of these factors will result in varying gross profit margins from period to period.

Gross Margins on Equipment Sales. For the three months ended June 30, 2003, the gross profit margin on equipment sales increased to 32% from 23% in 2002. This was primarily attributable to increased margins on both end-user and wholesale parts sales, largely due to lower inventory purchase costs. For the six months ended June 30, 2003, the gross profit margin on equipment sales increased to 31% from 26% in 2002. This was primarily attributable to (i) increased margins on both end-user and wholesale parts sales, largely due to lower inventory purchase costs; (ii) increased purchase discounts and system rebates from Avaya; and (iii) lower license fees paid to Avaya.

9

Gross Margins on Services and Other Revenue. For the three months ended June 30, 2003, the gross profit margin on services and other revenue was 29%, down from 38% in 2002. For the six months ended June 30, 2003, the gross profit margin on services and other revenue was 30%, down from 37% in 2002. The current year quarter and six-month profit margins were adversely impacted by a loss incurred on a large system installation. This reduced the profit margin on installation revenues to 18% from 34% quarter-over-quarter, and to 15% from 30% year-over-year.

Other Cost of Sales Expenses: Other cost of sales expenses consist of product handling, purchasing and facility costs and expenses. For the three months ended June 30, 2003, these expenses were $208,000, or 5% of revenues, compared to $441,000 or 9% of revenues in the comparable prior year period. For the six months ended June 30, 2003, these expenses were $446,000, or 5% of revenues, compared to $852,000 or 8% of revenues in the comparable prior year period. The expense reductions in each current year period reflect cost reduction initiatives which included personnel reductions of over 50%, and increased outsourcing of equipment repair.

We believe that there will continue to be pressure on gross profit margins until market conditions and product demand in the telecommunications industry improves, and we currently expect profit margins for the balance of 2003 to remain at current levels.

SELLING, GENERAL AND ADMINISTRATIVE ("SG&A") EXPENSES. SG&A expenses for the three months ended June 30, 2003 were $1,094,000, a decrease of $323,00 or 23% from the comparable 2002 period. SG&A expenses for the six months ended June 30, 2003 were $2,369,000, a decrease of $708,000 or 23% from the comparable 2002 period. SG&A expenses for the three months ended June 30, 2003 were 29% of revenues, compared to 30% of revenues in 2002, and for the six months ended June 30, 2003 and 2002 they were 29% of revenues. In response to lower sales levels, we have been more tightly controlling expenses, and deferring them where possible. We have also reduced our SG&A headcount by 14% from a year ago. As a result of this reduced headcount, coupled with lower sales commissions due to lower sales levels, compensation expense was $201,000 (21%) lower for the current year quarter, and $393,000 (21%) lower for the current year six month period, than their respective prior year periods. In addition, we incurred lower marketing, consulting, office and other employment related expenses than in the prior year period as a result of cost-reduction initiatives, and recorded lower depreciation expense. We will continue to monitor SG&A expenses and where possible, make certain expenses more variable in relation to sales volume.

INTEREST EXPENSE AND OTHER INCOME. Interest expense for the three months ended June 30, 2003 was $8,000, compared to $10,000 for the comparable 2002 period. Interest expense for the six months ended June 30, 2003 was $10,000, compared to $22,000 for the comparable 2002 period. The decrease in interest expense was attributable to lower average borrowings. Other income for the three and six months ended June 30, 2003 was $1,000 and $3,000, respectively, compared with $19,000 and $90,000 recorded for the respective three and six months ended June 30, 2002. Other income for the three and six months ended June 30, 2002 included $17,000 and $82,000, respectively, representing the fair value of common stock of Anthem, Inc., which we received at no cost, as part of the conversion of Anthem Insurance Companies, Inc. from a mutual insurance company to a stock insurance company. The balance of other income for all periods presented consisted primarily of interest earned on invested cash.

PROVISION FOR INCOME TAXES. The provision for income taxes for the three and six months ended June 30, 2003 was $6,000 and $12,000, respectively, compared to $7,000 and $13,000 for the respective prior year periods. The provision for income taxes consisted of estimated minimum state taxes in each period. We maintain a full valuation allowance against our net deferred tax assets, which consist primarily of net operating loss and capital loss carryforwards, and timing differences between the book and tax treatment of inventory and other asset valuations. Realization of these net deferred tax assets is dependent upon our ability to generate future taxable income.

LIQUIDITY AND CAPITAL RESOURCES

Working capital, defined as current assets less current liabilities, was $3,524,000 at June 30, 2003, compared to $3,745,000 at December 31, 2002. The working capital ratio was 2.6 to 1 at June 30, 2003, compared to 3.5 to 1 at December 31, 2002.

Operating activities used $1,045,000 during the six months ended June 30, 2003. Net cash used by operating activities consisted of a net loss of $277,000 adjusted for non-cash items of $119,000, and net cash used by changes in operating assets and liabilities of $887,000. Net cash used by

changes in operating assets and liabilities was primarily attributable to an increase in accounts receivable and inventories, partly offset by an increase in accounts payable, and the $300,000 reclassification of restricted cash (Note 9) to other current assets.

Investing activities used $24,000 during the six months ended June 30, 2003 to fund capital expenditures.

Financing activities generated $367,000 during the six months ended June 30, 2003, primarily attributable to working capital borrowings under our revolving credit facility with BACC. As of June 30, 2003, outstanding borrowings with BACC were $365,000. The unused portion of the revolving credit facility as of June 30, 2003 was $1,135,000, all of which was available to borrow. The average and highest amounts borrowed during the six months ended June 30, 2003 were approximately $151,000 and $530,000, respectively. We were in compliance with the provisions of our loan agreement as of June 30, 2003.

We are dependent upon generating positive cash flow from operations and upon our revolving credit facility to provide cash to satisfy working capital requirements. No assurances can be given that we will have sufficient cash resources to finance future growth. Historically, our working capital borrowings have increased during periods of revenue growth. This is because our cash receipts cycle is longer than our cash disbursements cycle. As our revenues from systems sales increases, as management expects, the cash receipts cycle may lengthen, unless we can consistently negotiate progress payments under our systems sales contracts. Under the current lending agreement, we are prohibited from borrowing against receivables generated by systems sales until the systems are installed. Under these circumstances, we could run out of availability and/or require a higher credit line. In order to obtain additional financing, we may first need to demonstrate improved operating performance.

Since 2002, we have been engaged in a project to develop an e-business platform, designed to enable our customers to transact business with us electronically. As of June 30, 2003, we have incurred cumulative expenditures of $85,000, and currently estimate that we could spend an additional $40,000 on this project during the balance of 2003 in order to complete the implementation of our on-line product catalogs, and integration of the related on-line ordering processes with our computer systems. There are currently no other material capital expenditures planned.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The discussion contained in the "Critical Accounting Policies and Estimates" section of our Annual Report on Form 10-K for the year ended December 31, 2002 is still considered current and is hereby incorporated into this Quarterly Report on Form 10-Q.

RISKS, UNCERTAINTIES AND OTHER FACTORS THAT MAY AFFECT FUTURE RESULTS

The discussion included in the "Risks, Uncertainties and Other Factors That May Affect Future Results" section included in our Annual Report on Form 10-K for the year ended December 31, 2002 is still considered current and applicable, and is hereby incorporated into this Quarterly Report on Form 10-Q.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Market risks that have the potential to affect our earnings and cash flows result primarily from changes in interest rates. Our cash equivalents, which consist of an investment in a money market fund consisting of high quality short term instruments, principally US government and agency issues and commercial paper, are subject to fluctuating interest rates. A 10 percent change in such current interest rates would not have a material effect on our results of operations or cash flow.

We are also exposed to market risk from changes in the interest rate related to our revolving credit facility, which is based upon the prime rate charged by a designated bank. Assuming an average borrowing level of $250,000 (which amount represented the assumed minimum loan balance for purposes of interest charges under the BACC credit facility) each 1 percentage point increase in the bank's prime rate would result in $2,500 of additional annual interest charges. Under current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes.

ITEM 4. CONTROLS AND PROCEDURES.

(a) Evaluation of Disclosure Controls and Procedures. Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of a date within 90 days prior to the filing date of this Quarterly Report on Form 10-Q. Based on such evaluation, such officers have concluded that our disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to our Company required to be included in our reports filed or submitted under the Exchange Act.

11

(b) Changes in Internal Controls. There were no significant changes in our internal controls or in other factors that could significantly affect such controls subsequent to the date of their most recent evaluation.

PART II. OTHER INFORMATION.

ITEMS 1, 2, 3 and 5 have been omitted because there is nothing to report or they are inapplicable.

Item 4. Submission of Matters to a Vote of Security Holders:

The proposals voted upon at the Company's Annual Meeting of Stockholders, held June 12, 2003, along with the voting results, were as follows:

(1) Election of Directors: All nominees were elected: The results of the balloting were as follows:

Nominees	Votes For	Votes Withheld

George J. Taylor, Jr.	3,117,809	89,417
Harold L. Hanson	3,117,809	89,417
Hugh M Taylor	3,117,909	89,317
Joseph J. Kelley	3,117,809	89,417
Ronald P. Pettirossi	3,117,709	89,517

(2) Ratification of the appointment of Carlin, Charron & Rosen LLP as independent auditors of the Company for the year ending December 31, 2003: The proposal was approved with 3,139,323 votes for, 64,962 votes against, and 2,941 abstentions.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K:

(a) Exhibits:

The following documents are filed as Exhibits to this Quarterly Report on Form 10-Q:

31.1 Certification of the Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of the Chief Executive Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of the Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K: No reports on Form 8-K were filed during the quarter for which this report is filed.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FARMSTEAD TELEPHONE GROUP, INC.

Dated: August 12, 2003

/s/ George J. Taylor, Jr.

George J. Taylor, Jr.
Chief Executive Officer, President

Dated: August 12, 2003

/s/ Robert G. LaVigne

Robert G. LaVigne
Executive Vice President, Chief
Financial Officer