

FARMSTEAD TELEPHONE GROUP INC  
Form 10-Q  
May 16, 2005

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UNITED STATES
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 March 31, 2005

or

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

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

Commission File Number: 0-15938

Farmstead Telephone Group, Inc.

-----
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

06-1205743
(IRS Employer
Identification No.)

22 Prestige Park Circle
East Hartford, CT
(Address of principal executive offices)

06108
(Zip Code)

(860) 610-6000
(Registrant's telephone number, including area code)

-----
(Former name, former address and former fiscal year,
if changed since last report)

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 preceeding 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 April 30, 2005, the registrant had 3,342,730 shares of its \$0.001 par value Common Stock outstanding.

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### PART I - FINANCIAL INFORMATION

#### ITEM 1. FINANCIAL STATEMENTS.

#### FARMSTEAD TELEPHONE GROUP, INC. CONSOLIDATED BALANCE SHEETS

(In thousands)	March 31, 2005	December 31, 2004
-----		
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 247	\$ 217

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Accounts receivable, net	1,544	1,453
Inventories, net	1,588	1,627
Other current assets	359	378
-----		
Total Current Assets	3,738	3,675
-----		
Property and equipment, net	281	268
Deferred financing costs (Note 7)	415	-
Other assets	104	107
-----		
Total Assets	\$ 4,538	\$ 4,050
=====		
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,656	\$ 1,110
Debt maturing within one year	153	187
Accrued expenses and other current liabilities	609	242
-----		
Total Current Liabilities	2,418	1,539
-----		
Postretirement benefit obligation	624	593
Notes payable	60	39
-----		
Total Liabilities	3,102	2,171
-----		
Commitments and contingencies (Note 11)		
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; 3,342,730 and 3,322,182 shares issued and outstanding at March 31, 2005 and December 31, 2004, respectively	3	3
Additional paid-in capital	12,513	12,320
Accumulated deficit	(11,059)	(10,420)
Accumulated other comprehensive loss	(21)	(24)
-----		
Total Stockholders' Equity	1,436	1,879
-----		
Total Liabilities and Stockholders' Equity	\$ 4,538	\$ 4,050
=====		

See accompanying notes to consolidated financial statements.

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(In thousands, except per share amounts)	2005	2004
<hr/>		
Revenues:		
Equipment	\$1,965	\$2,922
Services and other revenue	444	484
<hr/>		
Net revenues	2,409	3,406
<hr/>		
Cost of revenues:		
Equipment	1,319	2,046
Services and other revenue	234	272
Other cost of revenues	102	211
<hr/>		
Total cost of revenues	1,655	2,529
<hr/>		
Gross profit	754	877
Selling, general and administrative expenses	1,384	1,210
<hr/>		
Operating loss	(630)	(333)
Interest expense	(8)	(6)
Other income	3	1
<hr/>		
Loss before income taxes	(635)	(338)
Provision for income taxes	4	3
<hr/>		
Net loss	\$ (639)	\$ (341)
<hr/>		
Basic and diluted net loss per common share	\$ (.19)	\$ (.10)
Weighted average common shares outstanding:		
Basic and diluted	3,328	3,313
<hr/>		

FARMSTEAD TELEPHONE GROUP, INC.  
CONSOLIDATED STATEMENT OF CHANGES  
IN STOCKHOLDERS' EQUITY (UNAUDITED)  
Three Months ended March 31, 2005

(In thousands)	Common Stock		Additional	Accum-
	Shares	Amount	Paid-in	ulated
			Capital	Deficit
<hr/>				
Balance at December 31, 2004	3,322	\$3	\$12,320	\$(10,420)
Net loss	-	-	-	(639)
Amortization of pension liability adjustment				
Comprehensive loss				

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Issuance of warrants	-	-	186	-
Issuance of common stock	21	-	7	-
-----				
Balance at March 31, 2005	3,343	\$3	\$12,513	\$(11,059)
=====				

See accompanying notes to consolidated financial statements.

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

(In thousands)	Three Months Ended March 31,	
	2005	2004
-----		
Cash flows from operating activities:		
Net loss	\$(639)	\$(341)
Adjustments to reconcile net loss to net cash flows provided by (used in) operating activities:		
Provision for doubtful accounts receivable	9	9
Provision for losses on inventories	8	9
Depreciation and amortization	25	36
Decrease in accumulated other comprehensive loss	3	2
Increase in accrued postretirement benefit obligation	31	29
Changes in operating assets and liabilities:		
Increase in accounts receivable	(100)	(485)
(Increase) decrease in inventories	31	(380)
Increase in other assets	(7)	(36)
Increase in accounts payable	546	265
Increase in accrued expenses and other current liabilities	167	119
-----		
Net cash provided by (used in) operating activities	74	(773)
-----		
Cash flows from investing activities:		
Purchases of property and equipment	(3)	(12)
-----		
Net cash used in investing activities	(3)	(12)
-----		
Cash flows from financing activities:		
Borrowings (repayments) under revolving credit line	(46)	305
Proceeds from issuance of common stock	7	2
Repayments of capital lease obligations	(2)	-
-----		
Net cash (used in) provided by financing activities	(41)	307
-----		
Net increase (decrease) in cash and cash equivalents	30	(478)
Cash and cash equivalents at beginning of period	217	827
-----		
Cash and cash equivalents at end of period	\$ 247	\$ 349

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Supplemental disclosure of cash flow information:

Cash paid during the period for:		
Interest	\$ 8	\$ 6
Income taxes	2	4
Non-cash financing and investing activities:		
Purchase of equipment under capital lease	36	-
Value of warrant issued in connection with revolving credit facility	186	-

See accompanying notes to consolidated financial statements.

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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 (inactive) and InfiNet Systems, LLC (inactive). The accompanying consolidated financial statements as of March 31, 2005 and for the three months ended March 31, 2005 and 2004 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, which are necessary for a fair presentation of its financial position and operating results for the interim periods presented. The results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the entire fiscal year. 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, 2004.

2. OPERATIONS:

As presented in the consolidated financial statements contained in this report, the Company incurred a net loss of \$639,000 for the quarter ended March 31, 2005. In addition, the Company has incurred substantial losses in each of the past four fiscal years. These losses have been primarily the result of significant declines in revenues over these periods. As further described in the Company's Annual Report on Form 10-K for the year ended December 31, 2004, the Company has taken several measures to turnaround its operating performance. The turnaround strategy is principally based upon building a larger and more highly qualified sales force, and diversifying the Company's product offerings and targeted customers. The business strategy is to transition to a full communications solutions provider, becoming less dependent on parts sales, and developing more sources of recurring revenues, such as through installation and maintenance services. As a part of the turnaround plan, the Company hired a new President and CEO in October 2004, and two Executive Vice Presidents - one responsible for operations (hired in January 2005) and one responsible for sales (hired in March 2005). In March, the Company significantly expanded its sales infrastructure and opportunities, first by

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the hiring of twenty three sales and sales support professionals formerly employed by Avaya Inc., and second by entering into a trial agreement with Avaya to provide products and services to the SMB ("small-to-medium sized business") market which commenced in March with the launch of a nationwide SMB sales program. At the end of March 2005, the Company's direct sales force was 83% larger than in March 2004, and March 2005 bookings and revenues were significantly higher than in recent months. The Company intends to hire additional sales professionals during 2005 as required to meet its SMB revenue expectations. In May 2005, the Company formed a wholly-owned subsidiary named "One IP Voice" which, when operational, will offer carrier-based hosted IP telephony services along with network services. Its primary target will be the SMB market.

In order to finance its business expansion plans, effective March 31, 2005 the Company entered into a \$3 million credit arrangement with a new lender, replacing a \$1.7 million credit facility with Business Alliance Capital Corporation. For additional information, refer to Note 7, Debt Obligations contained herein.

3. RECLASSIFICATIONS

Certain amounts in prior years' financial statements have been reclassified to conform to the 2005 presentation.

4. ACCOUNTS RECEIVABLE, NET

(Dollars in thousands)	March 31, 2005	December 31, 2004
Trade accounts receivable	\$1,383	\$1,379
Less: allowance for doubtful accounts	(69)	(60)
Trade accounts receivable, net	1,314	1,319
Other receivables	230	134
Accounts receivable, net	\$1,544	\$1,453

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Other receivables consist of commissions, rebates and other dealer incentives due from Avaya Inc., and are recorded in the consolidated financial statements when earned. Refer to Note 1, "Accounting for Manufacturer Incentives" in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

5. INVENTORIES, NET

(Dollars in thousands)	March 31, 2005	December 31, 2004
------------------------	-------------------	----------------------

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Finished goods and spare parts	\$1,292	\$1,341
Work in process (a)	296	352
Rental equipment	42	52
-----		
	1,630	1,745
Less: reserves for excess and obsolete inventories	(42)	(118)
-----		
Inventories, net	\$1,588	\$1,627
=====		

6. PROPERTY AND EQUIPMENT, NET

(Dollars in Thousands)	Estimated Useful Lives (Yrs.)	March 31, 2005	December 31, 2004
-----			
Computer and office equipment	3 - 5	\$ 1,073	\$ 1,073
Furniture and fixtures	5 - 10	288	288
Leasehold improvements	10	171	171
Capitalized software development costs	5	98	98
Automobile	5	50	50
Leased equipment under capital lease		36	36
		-----	
Less: accumulated depreciation and amortization		1,716	1,671
		-----	
Property and equipment, net		\$ 281	\$ 266
=====			

Leased equipment under capital lease consists of computer equipment.

7. DEBT OBLIGATIONS

(Dollars In thousands)	March 31, 2005	December 31, 2004
-----		
BACC revolving credit facility note	\$ 133	\$ 179
Installment purchase note	46	47
Leased equipment under capital lease	34	-
-----		
	213	226
Less: debt maturing within one year	(153)	(187)
-----		
Long-term debt obligations	\$ 60	\$ 39
=====		



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### Credit Arrangements:

On March 31, 2005, the Company terminated its \$1.7 million revolving credit facility with Business Alliance Capital Corporation ("BACC"), repaying the outstanding balance and an early-termination fee of \$68,000 on April 1, 2005. The average and highest amounts borrowed under the BACC facility during the three months ended March 31, 2005 were approximately \$223,000 and \$447,000, respectively.

On March 31, 2005, the Company entered into a financing transaction with Laurus Master Fund, Ltd., ("Laurus"), providing for a three-year, \$3 million ("Capital Availability Amount") revolving loan credit facility which includes a Secured Revolving Note (the "Revolving Note") and a Secured Convertible Minimum Borrowing Note (together with the Revolving Note, the "Laurus Notes"). The initial Minimum Borrowing Note was set at \$500,000, the proceeds of which were advanced to the Company on April 4, 2005. Amounts outstanding under the Laurus Notes will either be paid in cash at their March 31, 2008 maturity date or, at Laurus' option, by converting such amounts into shares of the Company's common stock from time

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to time. The Company also issued Laurus a five-year warrant (the "Warrant") to purchase an aggregate of 500,000 shares of common stock of the Company at an exercise price of \$1.82 per share. The warrant exercise price was set at 130% of the average closing price of the Company's common stock over the ten trading days preceding the execution of the agreement, and is subject to anti-dilution protection adjustments. This transaction was completed in a private offering pursuant to an exemption from registration under Section 4(2) of the Securities Act of 1933, as amended.

The fair value of the Warrant was estimated using the Black-Scholes pricing model with the following assumptions: fair market value of the underlying common stock of \$1.08 per share (which amount represents the closing price of the common stock on the date that the principal terms and conditions of the financing were approved by both parties); zero dividends; expected volatility of 55%; a risk-free interest rate of 3.9% and an expected holding period of 4.5 years. The resulting value of \$186,299 has been recorded on the books in deferred financing costs, and will be amortized to expense over the term of the facility. Also included in deferred financing costs on the balance sheet at March 31, 2005 is \$229,000 of fees and expenses incurred by the Company in connection with the Laurus facility, including a \$117,000 prepaid facility fee, a \$50,000 broker fee, and \$62,000 of legal and other direct costs incurred. These fees will be charged to expense on a pro-rata basis over the term of the facility.

The following describes certain of the material terms of the financing transaction with Laurus. The description below is not a complete description of the material terms of the financing transaction and is qualified in its entirety by reference to the agreements entered into in connection with the financing which were included as exhibits to the Company's Annual Report on Form 10-K for the year ended December 31, 2004:

**Principal Borrowing Terms and Prepayment:** Borrowings are advanced pursuant to a formula consisting of (i) 90% of eligible accounts receivable, as defined (primarily receivables that are less than 90 days old), and (ii) 30% of eligible inventory, as defined (primarily inventory classified as "finished goods"), up to a maximum inventory advance of \$600,000, less any reserves required by Laurus. Interest on the

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outstanding borrowings is charged at the per annum rate of two percentage points (2%) above the prime rate, but not less than 6%. The interest rate charged, however, will be decreased by 2% (or 200 basis points) for every 25% increase in the market price of the Company's common stock above the fixed conversion price, down to a minimum interest charge of 0.0%. The Company will additionally be charged a fee equal to 0.25% of the unused portion of the facility. Should the Company terminate the financing agreement with Laurus prior to the maturity date, the Company will incur an early payment fee equal to 4%, 3% and 2% of the Capital Availability Amount if terminated in the first, second or third year, respectively, of the term.

**Security and Events of Default.** Borrowings under the Laurus Notes are secured by a lien on substantially all of the Company's assets. The Security 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 or there are material liens or attachments levied against the Company's assets; (iv) the Company's common stock ceases to be publicly traded; and (v) the Company fails to comply with the terms, representations and conditions of the agreement. Upon the occurrence of an Event of Default, the interest rate charged will be increased by 1-1/2 % per month until the default is cured; should the default continue beyond any applicable grace period, Laurus could require the Company to repay 120% of any principal and interest outstanding under the agreement.

**Conversion Rights and Limitation.** All or a portion of the outstanding principal and interest due under the Laurus Notes may be converted, at the option of the Holder, into shares of the Company's common stock, subject to certain limitations as defined, if the market price of the common stock is 15% above the fixed conversion price of \$1.54 per share for five consecutive trading days in any month. The fixed conversion price was originally set at 110% of the average closing price of the Company's common stock over the ten trading days preceding the execution of the agreement, and is subject to anti-dilution protection adjustments. The fixed conversion price will be reset once \$1.5 million of debt has been converted. Upon receipt of a conversion notice from the Holder, the Company can elect to pay cash to the Holder in lieu of issuing shares of common stock, at a price per share equal to the intraday high price of the stock. By agreement between the parties, Laurus will not own greater than 4.99% of the outstanding shares of the Company's common stock except that (i) upon the occurrence and during the continuance of an Event of Default, or (ii) upon 75 days prior notice to the Company, their ownership could increase to 19.99%.

**Registration Rights.** Pursuant to the terms of a Registration Rights Agreement, the Company is obligated to file and obtain effectiveness for a registration statement registering the resale of shares of the Company's common stock issuable upon conversion of the Laurus Notes and the exercise of the Warrant. If the registration statement is not timely filed, or declared effective the Company will be subject to certain penalties.

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Obligations under Capital Lease:

In March 2005, the Company entered into non-cancelable lease

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agreement to finance \$36,112 of computer equipment. Monthly lease payments are \$1,103 with a \$1.00 purchase option at the end of 36 months. The effective interest rate on the capitalized lease obligation is 10.38%. The note balance at March 31, 2005 was \$34,257, of which \$12,037 was classified under debt maturing within one year.

Note Payable:

The Company is financing an automobile through a \$50,056, 3.75% note payable to a finance company. The note is payable in 38 monthly installments of \$799, with a final payment of \$24,236 on January 7, 2008. The note balance at March 31, 2005 was \$45,975, of which \$8,154 was classified under debt maturing within one year.

8. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

(Dollars in thousands)	March 31, 2005	December 31, 2004
Salaries, commissions and benefits	\$257	\$167
Accrued deferred financing costs	200	-
Other	152	75
-----		
Accrued expenses and other current liabilities	\$609	\$242
=====		

Refer to Note 7 for information on the nature of the deferred financing costs. Other accrued expenses include a one-time \$68,000 fee for the early termination of the BACC credit facility.

9. RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS No. 123 (revised 2004)"), revising FASB Statement 123, "Accounting for Stock-Based Compensation" and superseding APB Opinion No. 25, "Accounting for Stock Issued to Employees,". This Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, focusing primarily on transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123 (revised 2004) requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award. Accounting for share-based compensation transactions using the intrinsic method supplemented by pro forma disclosures will no longer be permissible. This statement is effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005 and the Company will adopt the standard in the first quarter of fiscal 2006. The adoption of this standard will have an impact on the Company's results of operations as it will be required to expense the fair value of all share based payment; however the Company has not yet determined whether or not this impact will be significant.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an

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amendment of ARB No. 43, Chapter 4,". This statement clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). It also requires that these items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal". This statement also clarifies the circumstances under which fixed overhead costs associated with operating facilities involved in inventory processing should be capitalized. The provisions of SFAS No. 151 are effective for fiscal years beginning after June 15, 2005 and the Company will adopt this standard in its third quarter of fiscal 2005. The Company has not determined the impact, if any, that this statement will have on its consolidated financial position or results of operations.

10. 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 and warrant awards. Had compensation cost for the Company's stock option plan and issued warrants been determined in accordance with the fair value-based

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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 March 31,	
	----- 2005	2004 -----
Net loss, as reported	\$ (638)	\$ (341)
Add: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(202)	(21)
Pro forma net loss	\$ (840)	\$ (362)
Pro forma net loss per share: Basic and diluted	\$ (.25)	\$ (.05)

The weighted-average fair value of options and warrants granted during the three months ended March 31, 2005 and 2004 was \$.35 and \$.56, respectively. The fair value of stock options and warrants 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 2005 and 2004; expected volatility of 55% for 2005 and 109% for 2004; average risk-free interest rate of 3.8% for 2005 and 3.02 % for 2004; and an expected option holding period of 3.5 years for 2005 and 4.7 years for 2004.

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### 11. COMMITMENTS AND CONTINGENCIES

#### Employment agreements:

On January 15, 2005 the Company hired Mr. Alfred G. Stein for the position of Executive Vice President. From September 13, 2004 to his date of hire, Mr. Stein was a consultant to the Company, assisting management in the development of a strategic re-direction of the Company's sales organization and product offerings, for which he earned \$40,000 in consulting fees. Mr. Stein has an employment agreement expiring December 31, 2007 which includes the following key provisions: (i) an annual base salary of \$175,000, (ii) an annual bonus of up to 100% of base salary based upon the attainment of a Board-approved annual business plan which includes revenue and operating profit targets and (iii) the grant of a five-year warrant to purchase up to 250,000 shares of common stock at an exercise price of \$0.67 per share, which was equal to the closing price of the common stock on the date of hire. The Company is currently in the process of registering 150,000 of the shares underlying the warrant, and has agreed to register the remaining 100,000 shares by January 15, 2007.

On March 1, 2005, the Company hired Mr. Nevelle R. Johnson to the position of Executive Vice President. Mr. Johnson's responsibilities include management of the Company's national sales organization, as well as the development of new product and service offerings. Mr. Johnson has an employment agreement expiring December 31, 2008 which includes the following key provisions: (i) an initial annual base salary of \$200,000; (ii) an annual bonus of up to 50% of base salary based upon attaining earnings targets approved by the Board of Directors; (iii) the grant of a five-year warrant to purchase up to 250,000 shares of common stock at an exercise price of \$1.10 per share, which was equal to the closing price of the common stock on the date of hire; and (iv) payment by the Company of life insurance premiums not exceeding \$5,000 per month, provided that the Company attains at least 75% of targeted earnings. The Company is currently in the process of registering 100,000 of the shares underlying the warrant, and has agreed to register an additional 100,000 shares by March 1, 2007 and the remaining 50,000 shares by March 1, 2008;

Both Mr. Stein's and Mr. Johnson's employment agreements provide severance pay should they terminate their agreements for "good cause", as defined, or should the Company terminate their agreements without cause, or in the event of a change in control of the Company, as defined. Severance pay would amount to three times the amount of the then-current base salary and the average bonus paid during the three most recent calendar years. These individuals would not be entitled to any severance or other compensation if they voluntarily terminate their employment or if they are terminated by the Company "for cause", as defined. Their agreements also contain non-compete stipulations.

### 12. EMPLOYEE BENEFIT PLANS

The components of the net periodic benefit cost included in the results of operations for the three months ended March 31, 2005 and 2004 are as follows:

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(Dollars in thousands)                      2005                      2004

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Service cost	\$22	\$20
Interest cost	10	9
Recognized actuarial losses	2	2
-----		
Net expense	\$34	\$31
=====		

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 Quarterly 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 "Risks, 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 ("SEC"), 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 March 31, 2005, we reported a net loss of \$639,000 or \$.19 per share on revenues of \$2,409,000. This compares with a net loss of \$341,000 or \$.10 per share on revenues of \$3,406,000 recorded for the three months ended March 31, 2004. The net loss for 2005 includes a one-time expenses aggregating \$84,000 incurred in connection with the termination of our credit facility with Business Alliance Capital Corporation. There are several factors which have contributed to these results. First, there continues to be intense competition in the market areas that we serve, particularly with our larger, "Enterprise" customers. This has led to continued sales price erosion and some loss of market share, particularly in the sale of parts, which we believe has become more of a commodity and subject to "price shopping" by customers. Our strategy to diversify our product offerings by selling complete systems and system upgrades has not yet generated enough incremental revenues to compensate for the decline in parts sales. Second, we recognize the need for a larger and more effective sales force, particularly during these times. Revenue

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growth is dependent upon a highly trained sales force. Third, we continue to believe that corporations are still cautious about capital equipment spending. Although there have been some signs of improvement in our industry, and we are experiencing increased sales quotation activities, our overall order flow has been below our expectations.

As further described in our Annual Report on Form 10-K for the year ended December 31, 2004, we have taken several measures to turnaround our operating performance. The turnaround strategy is principally based upon building a larger and more highly qualified sales force, and diversifying our product offerings and targeted customers. The business strategy is to transition to a full communications solutions provider, becoming less dependent on parts sales, and developing more sources of recurring revenues, such as through installation and maintenance services. As a part of the turnaround plan, we hired a new President and CEO in October 2004, and two Executive Vice Presidents - one responsible for operations (hired in January 2005) and one responsible for sales (hired in March 2005). In March, we significantly expanded our sales infrastructure and opportunities, first by the hiring of twenty three sales and sales support professionals formerly employed by Avaya Inc., and second by entering into a trial agreement with Avaya to provide products and services to the SMB ("small-to-medium sized business") market which commenced in March with the launch of a nationwide SMB sales program. At the end of March 2005, our direct sales force was 83% larger than in March 2004, and March 2005 revenues were significantly higher than in recent months. We intend to hire additional sales professionals during 2005 as required to

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meet our SMB revenue expectations. In May 2005, the Company formed a wholly-owned subsidiary named "One IP Voice" which, when operational, will offer carrier-based hosted IP telephony services along with network services. Its primary target will be the SMB market.

In order to finance our business expansion plans, effective March 31, 2005 we entered into a \$3 million credit arrangement with a new lender, replacing a \$1.7 million credit facility with Business Alliance Capital Corporation. For additional information on our financial resources, refer to Note 7, "Debt Obligations", and the "Liquidity and Capital Resources" section which follows.

Additional information on our results of operations and financial condition for the three months ended March 31, 2005 follows below.

### Revenues

(Dollars in thousands)	Three Months Ended March 31,			
	2005	%	2004	%
End-user equipment sales	\$1,875	78	\$2,763	81
Equipment sales to resellers	90	4	159	5
Total equipment sales	1,965	82	2,922	86

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Services	287	12	367	11
Other revenue	157	6	117	3
-----				
Total services and other revenue	444	18	484	14
-----				
Consolidated revenues	\$2,409	100	\$3,406	100
=====				

Equipment Sales

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Equipment Sales. Total equipment sales for the three months ended March 31, 2005 were \$1,965,000, down \$957,000 or 33% from the comparable 2004 period. The decrease consisted of declines in both end-user sales and sales to resellers. End-user sales consist of both parts sales (new and refurbished), and systems sales (complete systems and system upgrades). Factors affecting end-user equipment sales for 2005 have previously been described in the "Overview" section above. During 2005, we continued a strategy of diversifying our product offerings by marketing the sale of complete telecommunications systems to our customer base. In addition, in March 2005, through the significant expansion of our sales force, we began targeting the SMB marketplace, which is primarily oriented towards systems sales.

Equipment sales to resellers ("wholesale sales") decreased by \$69,000 or 43% from the comparable 2004 period. Wholesale sales have been impacted by the same factors noted above that have impacted end-user sales.

Services and Other Revenues

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Three Months Ended March 31, (Dollars in thousands)	2005	2004
-----		
Services:		
Installations	\$258	\$331
Rentals and repair	29	36
Other revenues	157	117
-----		
Services and other revenues	\$444	\$484
=====		

Service revenues for the three months ended March 31, 2005 were \$287,000, down \$80,000 or 22% from the comparable 2004 period. The decrease was primarily attributable to lower installation revenues, due to the decline in our parts sales resulting in lower move, add and change billings, and a decline in systems sales requiring our installation services. An increase or decrease in installation revenues, however, does not always coincide with the reported increase or decrease in system sales since installations may occur in different periods than the related system sale.

Other revenue for the three months ended March 31, 2005 was \$157,000, up \$40,000 or 34% from the comparable 2004 period. The increase was attributable to higher commissions earned on Avaya maintenance contract



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sales, partly offset by lower freight billed to customers on product shipments due to lower sales volume. In the sale of Avaya maintenance contracts, all of the equipment service obligations are borne entirely by Avaya.

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Cost of Revenues and Gross Profit. Total cost of revenues for the three months ended March 31, 2005 was \$1,655,000, down \$874,000 or 35% from the comparable 2004 period. The gross profit for the three months ended March 31, 2005 was \$754,000, down \$123,000 or 14% from the comparable 2004 period. As a percentage of revenue, the overall gross profit margin was 31% for 2005, compared to 26% for the comparable 2004 period.

In general, 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. Our larger "Enterprise" companies often receive significant purchase discounts from Avaya, which could cause us to accept lower gross margins as we compete against Avaya directly for this business; (3) the level and amount of vendor discounts and purchase rebates available to us from Avaya and its master distributors; (4) excess capacity - as sales volume falls, overhead costs, consisting primarily of product handling, purchasing, and facility costs, become a higher percentage of sales dollars; (5) competitive pressures - as a result of the slowdown in capital equipment spending in our industry, and the large number of Avaya dealers nationwide, we have been faced with increased price competition; and (6) obsolescence charges. The combined effect of all of these factors could result in varying gross profit margins from period to period.

Gross Profit Margins on Equipment Sales. For the three months ended March 31, 2005, the gross profit margin on equipment sales increased to 33% from 30% in 2004. The increase was attributable to higher profit margins on system sales, as the Company increased its sales of smaller, "non-PBX" systems. This increase was partly offset by a 2 percentage point decrease in end-user parts margins. The reduced parts profit margins are attributable to the fact that the parts business has become more of a "commodity" business and less of a "value-added" business. It has therefore become more prone to price-shopping by customers, who are tending more towards awarding contracts to the lowest bidder. In addition, the Company was not subject to any license fees payable to Avaya during 2005 due to that program's termination in June 2004. License fees expensed in the comparable 2004 period accounted for a 2 percentage point reduction of the 2004 gross profit margin. We expect continued pressure on our equipment profit margins going forward, particularly in the sale of parts and systems to our larger, "Enterprise" customers, due to continuing price competition in our marketplace.

Gross Profit Margins on Services and Other Revenue. For the three months ended March 31, 2005, the Company realized an overall 47% profit margin on its combined service and other revenues, compared to 44% recorded in 2004. The profit margin on the services component was 30% in 2005 compared to 35% in 2004; the decline being attributable to installation services. This result, however, was more than offset by an increase in profit margins generated by other sources of revenue. For the three months ended March 31, 2005, the Company realized an 80% profit margin on other

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revenues, compared to 70% recorded in 2004. This increase was attributable to higher commission revenues from the sale of Avaya maintenance contracts, which generated a 100% profit margin.

**Other Cost of Revenues.** Other cost of revenues consists of product handling, purchasing and facility costs and expenses. For the three months ended March 31, 2005, these expenses were 48% lower than 2004, and represented approximately 5% of 2004 equipment sales revenues, compared to 7% of 2004 equipment sales revenues. The reduction in other cost of revenues primarily resulted from lower personnel levels as well as lower facility costs and expenses.

**Selling, General and Administrative ("SG&A") Expenses.** SG&A expenses for the three months ended March 31, 2005 were \$1,384,000, up \$174,000 or 14% from the comparable 2004 period. SG&A expenses for the three months ended March 31, 2005 were 57% of revenues, compared to 36% of revenues in 2004. Virtually all of the increase was attributable to increased personnel levels and to expenses associated with the termination of the BACC credit facility. As a part of the Company's turnaround plan, it hired a new President and CEO in October 2004, and two Executive Vice Presidents - one responsible for operations (hired in January 2005) and one responsible for sales (hired in March 2005). In addition, by March 2005, the Company's direct sales force was increased by 83% from March 2004. In connection with the replacement of the BACC credit facility with the Laurus credit facility, the Company incurred in March 2005 one-time expenses totaling \$84,000, which included a \$68,000 early termination fee, and the write-off of the remaining balance of its annual loan commitment fee with BACC.

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We expect our SG&A expenses to increase as we complete the build out of our executive management and sales team; however we will continue the close monitoring of our expense levels going forward into 2005 and expect that our SG&A expenses will decline as a percent of revenues by the end of 2005.

**Interest Expense and Other Income.** Interest expense for the three months ended March 31, 2005 was \$8,000, compared with \$6,000 for 2004. The increase was attributable to higher average borrowing levels and higher borrowing rates. Other income for both periods presented consisted of interest earned on invested cash.

**Provision for Income Taxes.** The provision for income taxes represents estimated minimum state taxes in all reported periods. 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 \$1,320,000 at March 31, 2005, a decrease of \$816,000 or 38% from \$2,136,000 at December 31, 2004. The working capital ratio was 1.6 to 1 at March 31, 2005, compared to 2.4 to 1 at December 31, 2004. Operating activities provided \$74,000 during 2005, compared to the use of \$773,000 in the comparable 2004 period. Net cash provided by operating activities in 2005 consisted of a net loss of \$639,000 less non-cash items of \$76,000,

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and net cash generated by changes in operating assets and liabilities of \$637,000. Net cash generated by changes in operating assets and liabilities was primarily attributable to an increase in accounts payable as we lengthened our vendor payment cycles in response to reduced availability under our credit facility with Business Alliance Capital Corporation ("BACC") and lower sales than anticipated during January and February 2005.

Investing activities used \$3,000 during 2005, compared to \$12,000 in 2004. Net cash used by investing activities in 2005 and 2004 consisted of capital expenditures. Capital expenditure requirements during the quarter ended March 31, 2005 were principally for computer equipment to support our expanded personnel levels, which were largely financed through capital leases. There are currently no material commitments for capital expenditures, although we will continue to purchase computer equipment as we continue the expansion of our sales force. Pursuant to our loan agreement with Laurus, we may obtain external financing on capital expenditures up to \$500,000 in any fiscal year period before requiring Laurus's prior approval.

Financing activities used \$41,000 during 2005 principally from net repayments under our revolving credit line. On March 31, 2005, we terminated our \$1.7 million revolving credit facility with BACC, repaying the outstanding balance on April 1, 2005. The average and highest amounts borrowed under the BACC facility during the three months year ended March 31, 2005 were approximately \$223,000 and \$447,000, respectively. On March 31, 2005, we entered into a financing transaction with Laurus Master Fund, Ltd., ("Laurus"), providing for a three-year, \$3 million revolving loan credit facility. Our borrowing formulas with Laurus are less restrictive than the formulas provided under the BACC agreement, and they provided us with a calculated initial availability of approximately \$950,000 after the funding of the initial \$500,000 minimum borrowing note. Refer to Note 7, "Debt Obligations", of the Notes to Consolidated Financial Statements included herein for further information on the principal terms and conditions of this financing transaction.

Our ability to provide cash to satisfy working capital requirements continues to be dependent upon generating positive cash flow from operations and upon formula borrowings under our revolving credit facility. 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 up-front deposits and progress payments under our systems sales contracts. No assurances can be given that we will have sufficient cash resources to finance all of our future growth plans, and it may become necessary to seek additional financing sources for such purposes. In order to obtain additional financing, we may first need to demonstrate improved operating performance.

### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The discussion included in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2004 under the subheading "Critical Accounting Policies and Estimates" is still considered current and applicable, and is hereby incorporated into this Quarterly Report on Form 10-Q.

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### RISKS, UNCERTAINTIES AND OTHER FACTORS THAT MAY AFFECT FUTURE RESULTS

The discussion included in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2004 under the subheading "Risks, Uncertainties and Other Factors That May Affect Future Results" 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.

The discussion included in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2004, "Quantitative and Qualitative Disclosures About Market Risk", is still considered current and applicable, and is hereby incorporated into this Quarterly Report on Form 10-Q.

### ITEM 4. CONTROLS AND PROCEDURES.

(a) Evaluation of Disclosure Controls and Procedures. We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) that are designed to ensure that information required to be disclosed in our reports filed under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the Security and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief (principal) Executive Officer and Chief (principal) Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

An evaluation was conducted by our Chief Executive Officer and Chief Financial Officer of the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in our reports filed under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the Security and Exchange Commission's rules and forms.

(b) Changes in Internal Controls. There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the most recently completed fiscal quarter that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION.

### ITEM 1. LEGAL PROCEEDINGS

None.

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Refer to the Company's Current Report on Form 8-K filed April 5, 2005.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

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None.

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

None.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. 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.

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: May 11, 2005

/s/ Jean-Marc Stiegemeier

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Jean-Marc Stiegemeier  
Chief Executive Officer & President

Dated: May 11, 2005

/s/ Robert G. LaVigne

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Robert G. LaVigne  
Executive Vice President, Chief  
Financial Officer

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