FARMSTEAD TELEPHONE GROUP INC
Form 10-Q/A
May 26, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q/A

(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, 2005
or

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

Commission File Number: 001-12155
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 preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
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, 2005, the registrant had 3,352,730 shares of its $0.001 par value Common Stock outstanding.

EXPLANATORY NOTE:

This Form 10-Q/A to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2005, initially filed with the Securities and Exchange Commission on August 11, 2005, amends Part I, Items

1 and 2 for the three and six months ended June 30, 2005. This Form 10-Q/A continues to reflect circumstances as of the date of the original filing of the Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2005 and we have not updated the disclosures contained herein to reflect events that occurred at a later date, except for items related to the restatement or where otherwise indicated.

The accompanying consolidated financial statements as of June 30, 2005 and for the three and six months ended June 30, 2005 have been restated to correct an error pertaining to the accounting for warrants and outstanding borrowings under convertible notes issued to the Laurus Master Fund Ltd. ("Laurus") in connection with a three-year Secured Revolving Note agreement dated March 31, 2005. See a more detailed discussion of the restatement in Item 1, Note 1- "Restatement" to the Notes to Consolidated Financial Statements.

We anticipate filing an amended report on Form 10-Q for the quarterly period ended September 30, 2005 which will reflect a continuation of corrections in the accounting for convertible notes and warrants issued to Laurus during 2005. The consolidated financial statements for the years ended December 31, 2005, 2004 and 2003 included in our Annual Report on Form 10-K for the year ended December 31, 2005 should be relied upon.

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PART I - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS.

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED BALANCE SHEETS

(In thousands)	June 30, 2005	December 31, 2004
	(Unaudited) (As Restated)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 390	$ 217
Accounts receivable, net	3,467	1,453
Inventories, net	1,429	1,627
Other current assets	101	378
Total Current Assets	5,387	3,675
Property and equipment, net	289	268
Deferred financing costs (Note 6)	569	-
Other assets	107	107
Total Assets	$ 6,352	$ 4,050
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 2,674	$ 1,110
Accrued expenses and other current liabilities	341	242
Current portion of convertible debt, net of unamortized discount of $251 (Note 6)	699	-
Revolving credit facility note (Note 8)	-	179
Derivative financial instruments (Note 7)	231	-
Debt maturing within one year (Note 8)	31	8
Total Current Liabilities	3,976	1,539
Postretirement benefit obligation	656	593
Convertible debt, net of unamortized discount of $307 (Note 6)	193	-
Long-term debt (Note 8)	62	39
Derivative financial instruments (Note 7)	394	-
Total Liabilities	5,281	2,171

Commitments and contingencies (Note 12)		
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; 3,352,730 and 3,322,182 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively	3	3
Additional paid-in capital	12,337	12,320
Accumulated deficit	(11,250)	(10,420)
Accumulated other comprehensive loss	(19)	(24)
Total Stockholders' Equity	1,071	1,879
Total Liabilities and Stockholders' Equity	$ 6,352	$ 4,050

See accompanying notes to consolidated financial statements.

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
(In thousands, except loss per share amounts)	2005	2004	2005	2004
		(As Restated)		(As Restated)
Revenues:				
Equipment	$3,723	$2,584	$5,688	$5,506
Services and other revenue	760	305	1,204	789
Total revenues	4,483	2,889	6,892	6,295
Cost of Revenues:				
Equipment	2,695	1,970	4,014	4,016
Services and other revenue	321	189	555	461
Other cost of revenues	131	126	233	337
Total cost of revenues	3,147	2,285	4,802	4,814
Gross profit	1,336	604	2,090	1,481
Selling, general and administrative expenses	1,765	1,010	3,148	2,220
Operating loss	(429)	(406)	(1,058)	(739)
Other income (expense):				
Interest expense (Note 14)	(48)	(6)	(56)	(12)
Derivative instrument income	681	-	287	-
Other income	1	1	4	2

Total other income (expense)	634	(5)	235	(10)
Income (loss) before income taxes	205	(411)	(823)	(749)
Provision for income taxes	3	3	7	6
Net income (loss)	$ 202	$ (414)	$ (830)	$ (755)
Net income (loss) per common share:				
Basic	$ .06	$ (.12)	$ (.25)	$ (.23)
Diluted	$ .05	$ (.12)	$ (.25)	$ (.23)
Weighted average common shares outstanding:				
Basic	3,353	3,316	3,340	3,314
Diluted	4,391	3,316	3,340	3,314

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(UNAUDITED)
Six Months ended June 30, 2005 (As Restated)

(In thousands)	Common Stock Shares	Amount	Additional Paid-in Capital	Accum-ulated Deficit	Accumulated Other Comprehensive Loss
Balance at December 31, 2004	3,322	$3	$12,320	$(10,420)	$(24)
Net loss	-	-	-	(830)	-
Amortization of pension liability	-	-	-	-	5
Comprehensive loss	-	-	-	-	-
Issuance of common stock	31	-	17	-	-
Balance at June 30, 2005	3,353	$3	$12,337	$(11,250)	$(19)

See accompanying notes to consolidated financial statements.

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FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
For the Six Months Ended June 30, 2005 and 2004

(In thousands)	2005	2004
	(As Restated)	

Cash flows from operating activities:		
Net loss	$ (830)	$(755)
Adjustments to reconcile net loss to net cash flows used in operating activities:		
Provision for doubtful accounts receivable	18	18
Provision for losses on inventories	18	68
Depreciation and amortization of property and equipment	53	73
Amortization of deferred financing costs	23	-
Amortization of discounts on convertible debt	19	-
Unrealized gain on derivative instruments	(287)	-
Decrease in accumulated other comprehensive loss	5	4
Changes in operating assets and liabilities:		
Increase in accounts receivable	(2,032)	(119)
Decrease (increase) in inventories	180	(245)
Decrease in other assets	277	7
Increase in accounts payable	1,564	5
Increase in accrued expenses and other current liabilities	99	174
Increase in postretirement benefit obligation	63	57
Net cash used in operating activities	(830)	(713)
Cash flows from investing activities:		
Purchases of property and equipment	(18)	(23)
Net cash used in investing activities	(18)	(23)
Cash flows from financing activities:		
(Repayments) borrowings under revolving credit line	(179)	218
Borrowings under convertible debt facility	1,450	-
Deferred financing costs	(257)	-
Proceeds from issuance of common stock	17	2
Repayments of long-term debt and capital lease obligations	(10)	-
Net cash provided by financing activities	1,021	220
Net increase (decrease) in cash and cash equivalents	173	(516)
Cash and cash equivalents at beginning of period	217	827
Cash and cash equivalents at end of period	$ 390	$311
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 20	$ 14
Income taxes	2	4
Non-cash financing and investing activities:		
Purchase of equipment under capital lease	56	-
Discount on warrants issued to Laurus	335	-
Discounts on issuance of convertible debt	557	-

See accompanying notes to consolidated financial statements.

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

1. BASIS OF PRESENTATION, BUSINESS OPERATIONS, AND SIGNIFICANT ACCOUNTING POLICIES

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 June 30, 2005 and for the three and six months ended June 30, 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 interim periods are not necessarily indicative of the results that may be expected for the entire fiscal year. This Form 10-Q/A 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.

Restatement

The accompanying consolidated financial statements as of June 30, 2005 and for the three and six months ended June 30, 2005 (the "2005 Financial Statements") have been restated to correct an error pertaining to the accounting for warrants and outstanding borrowings under convertible notes issued to the Laurus Master Fund Ltd. ("Laurus") in connection with a three-year Secured Revolving Note agreement dated March 31, 2005. Specifically, the Company has adjusted its 2005 Financial Statements in order to apply the accounting methodology required under EITF Issue 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock". Applying this methodology resulted in the recording of derivative financial instrument liabilities attributable to borrowings under the credit agreement and to the freestanding warrants issued to Laurus, and non-cash derivative instrument income of $681,000 and $287,000 for the three and six months ended June 30, 2005, respectively. The effect of the foregoing on the 2005 Financial Statements is as follows (in thousands, except per share amounts):

Consolidated Balance Sheet:	June 30, 2005	
	As Previously Reported	As Restated
Total assets	$6,190	$6,352
Total liabilities	5,215	5,281
Stockholders' equity	975	1,071

Consolidated Results of Operations:	Three Months Ended June 30, 2005		Six Months Ended June 30, 2005	
	As Previously Reported	As Restated	As Previously Reported	As Restated
Operating loss	$(429)	$(429)	$(1,058)	$(1,058)
Net income (loss)	(474)	202	(1,112)	(830)
Net income (loss) per common share:				
Basic	$(.14)	$ .06	$ (.33)	$ (.25)
Diluted	(.14)	.05	(.33)	(.25)

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Business Operations

As presented in the consolidated financial statements contained in this report, the Company incurred net income of $202,000 for the three months ended June 30, 2005 and a net loss of $830,000 for the six months ended June 30, 2005. These results include non-cash derivative instrument income of $681,000 for the three-month period, and $287,000 for the six-month period, arising from borrowings under a three-year convertible revolving credit facility entered into effective March 31, 2006, and the issuance of freestanding warrants in connection therewith, as more fully described in Note 6, Convertible Debt. Excluding the non-cash derivative instrument income, the Company otherwise incurred losses of $479,000 and $1,117,000 during the three and six months ended June 30, 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 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 85% larger than in June 2004. As a result of these efforts, the Company has been successful in uplifting revenues, as revenues for the three and six months ended June 30, 2005 were 55% and 9% higher than the comparable prior year

periods. In fact, the $4,483,000 in revenues for the quarter ended June 30, 2005 was the highest revenue quarter since the second quarter of 2002, and the Company recorded a profit for the month of June, which was the Company's first profitable month since May 2003.

In May 2005, the Company took steps to further diversify its product offerings, forming 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 Laurus, replacing a $1.7 million credit facility with Business Alliance Capital Corporation. For additional information, refer to Note 6 - Convertible Debt contained herein.

Significant Accounting Policies

Derivative financial instruments

We do not use derivative instruments to hedge exposures to cash flow, market, or foreign currency risks.

We review the terms of convertible debt and equity instruments we issue to determine whether there are embedded derivative instruments, including the embedded conversion option, that are required to be bifurcated and accounted for separately as a derivative financial instrument. In circumstances where the convertible instrument contains more than one embedded derivative instrument, including the conversion option, that is required to be bifurcated, the bifurcated derivative instruments are accounted for as a single, compound derivative instrument. Also, in connection with the sale of convertible debt and equity instruments, we may issue freestanding warrants that may, depending on their terms, be accounted for as derivative instrument liabilities, rather than as equity. We may also issue options or warrants to non-employees in connection with consulting or other services they provide.

Certain instruments, including convertible debt and equity instruments and the freestanding options and warrants issued in connection with those convertible instruments, may be subject to registration rights agreements, which impose penalties for failure to register the underlying common stock by a defined date. The existence of the potential cash penalties under the related registration rights agreement requires that the embedded conversion option be accounted for as a derivative instrument liability. Similarly, the potential cash penalties under the related registration rights agreement may require us to account for the freestanding options and warrants as derivative financial instrument liabilities, rather than as equity. In addition, when the ability to physical or net-share settle the conversion option or the exercise of the freestanding options or

warrants is deemed to not be within the control of the Company, the embedded conversion option or freestanding options or warrants may be required to be accounted for as a derivative financial instrument liability.

Derivative financial instruments are measured at their fair value. For derivative financial instruments that are accounted for as liabilities,

the derivative instrument is initially recorded at its fair value and is then revalued at each reporting date, with changes in the fair value reported as charges or credits to income. For option-based derivative financial instruments, we use the Black-Scholes option pricing model to value the derivative instruments. When the convertible debt or equity instruments contain embedded derivative instruments that are to be bifurcated and accounted for as liabilities, the total proceeds allocated to the convertible host instruments are first allocated to the fair value of all the bifurcated derivative instruments. The remaining proceeds, if any, are then allocated to the convertible instruments themselves, usually resulting in those instruments being recorded at a discount from their face amount.

To the extent that the fair values of any freestanding and/or bifurcated derivative instrument liabilities exceed the total proceeds received, an immediate charge to income is recognized, in order to initially record the derivative instrument liabilities at their fair value. The discount from the face value of the convertible debt, together with the stated interest on the instrument, is amortized over the life of the instrument through periodic charges to income, usually using the effective interest method.

The classification of derivative instruments, including whether such instruments should be recorded as liabilities or as equity, is reassessed periodically, including at the end of each reporting period. If reclassification is required, the fair value of the derivative instrument, as of the determination date, is reclassified. Any previous charges or credits to income for changes in the fair value of the derivative instrument are not reversed. Derivative instrument liabilities are classified in the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument could be required within 12 months of the balance sheet date.

2. RECLASSIFICATIONS

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

3. ACCOUNTS RECEIVABLE, NET

(In thousands)	June 30, 2005	December 31, 2004
Trade accounts receivable	$3,051	$1,379
Less: allowance for doubtful accounts	(78)	(60)
Trade accounts receivable, net	2,973	1,319
Other receivables	494	134
Accounts receivable, net	$3,467	$1,453

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

4. INVENTORIES, NET

(In thousands)	June 30, 2005	December 31, 2004
Finished goods and spare parts	$1,260	$1,341
Work in process (a)	208	352
Rental equipment	13	52
	1,481	1,745
Less: reserves for excess and obsolete inventories	(52)	(118)
Inventories, net	$1,429	$1,627

5. PROPERTY AND EQUIPMENT, NET

(In thousands)	Estimated Useful Lives (Yrs.)	June 30, 2005	December 31, 2004
Computer and office equipment	3 - 5	$ 1,062	$ 1,071
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	3	56	-
		1,725	1,678
Less: accumulated depreciation and amortization		(1,436)	(1,410)
Property and equipment, net		$ 289	$ 268

Leased equipment under capital lease consists of computer equipment.

6. CONVERTIBLE DEBT

(In thousands)	June 30, 2005	December 31, 2004

Borrowing under secured revolving credit facility note	$ 950	$ -
Secured convertible Minimum Borrowing Note	500	-
Less: unamortized discount attributable to the revolving credit facility note	(251)	-
Less: unamortized discount attributable to the Minimum Borrowing Note	(307)	-
Convertible Debt, net of unamortized discounts	892	-
Less: current portion	(699)	-
Convertible Debt, net of unamortized discounts	$ 193	$ -

On March 31, 2005, the Company entered into a financing transaction with 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 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 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 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, at the Fixed Conversion Price ("FCP") of $1.54. The FCP 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 FCP will be reset once $1.5 million of debt has been converted. The Laurus Notes contain a mandatory conversion feature such that, if the average closing price of the common stock as reported by Bloomberg, L.P. on the Principal Market for five (5) consecutive trading days in any calendar month shall be greater than 115% of the FCP, the Holder shall convert into shares of common stock such portion of the principal amount outstanding under any Minimum Borrowing Note (together with accrued interest and fees in respect thereof) on such date equal to ten percent (10%) of the aggregate dollar trading volume of the common stock for the period of twenty-two (22) trading days preceding the date of the mandatory conversion. The Holder shall not be required under any circumstances to make more than one (1) mandatory conversion in any calendar month. 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%. 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.

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. On June 24, 2005, the Company completed the registration of the common stock issuable upon conversion of the initial Minimum Borrowing Note and the Warrant.

The unused portion of the Laurus credit facility as of June 30, 2005 was $1,549,617, all of which was available to borrow. The average and highest amounts borrowed under the Laurus credit facility during the three months ended June 30, 2005 were approximately $815,000 and $1,640,000,

respectively. The average and highest amounts borrowed under all credit facilities during the six months ended June 30, 2005 were approximately $521,000 and $1,640,000, respectively. The Company was in compliance with the provisions of its loan agreement as of June 30, 2005.

Since the secured convertible notes are not considered to be conventional convertible debt, the embedded conversion option in the secured convertible notes is subject to the requirements of EITF Issue 00-19. The Company is also required to bifurcate the embedded conversion option and account for it as a derivative instrument liability because of the potential penalties that we may have to pay Laurus under the Registration Rights Agreement, together with the fact that the conversion price of the debt can be adjusted if we issue common stock at a lower price. In addition, other embedded derivative instruments in the secured convertible notes, including the interest rate reset feature and Laurus' right to put the debt back to us with a 20% premium upon certain Events of Default, were considered in determining the derivative instrument to bifurcate and account for. This derivative instrument liability was initially recorded at its fair value and is then adjusted to fair value at the end of each subsequent period, with any changes in the fair value charged or credited to income in the period of change. The most significant component of this compound derivative instrument is the embedded conversion option, which is revalued using the Black-Scholes option pricing model.

The proceeds received from Laurus under the initial Minimum Borrowing Note ("MBN") were first allocated to the fair value of the bifurcated embedded derivative instruments included in the MBN, with the remaining proceeds allocated to the MBN, resulting in the recognition of a $323,000 discount to the principal amount of the MBN. This discount, together with

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the stated interest on the MBN, is being amortized using an effective interest method over the term of the MBN. Since there are frequent borrowings and repayments under the revolving note, the value of the embedded derivative instruments is calculated upon advances, and the discount is recognized as the advances are repaid, with the stated interest recognized currently.

The 500,000 warrants issued to Laurus were initially valued at $335,000, using the Black-Scholes option pricing model and the following assumptions: market price - $1.31; exercise price - $1.82; expected term - 5 years; volatility - 65%; interest rate - 4.18%; and dividends - 0. Since there are potential penalties that we may have to pay Laurus under the Registration Rights Agreement, the warrants have been recorded as a derivative instrument liability, rather than as equity. This derivative instrument liability is adjusted to fair value (using the Black-Scholes option pricing model) at the end of each subsequent reporting period, and any changes in the fair value are charged or credited to income in the period of change. Since the nature of the Laurus credit facility is revolving, with continuous advances and repayments expected over its term, and with an indeterminate amount of Minimum Borrowing Notes which can be created and converted, it is not practical to allocate the warrant value to the initial proceeds of the borrowings under the facility or to any one Minimum Borrowing Note. As such, the initial valuation of $335,000 has been recorded as a deferred financing cost, and is being amortized to expense over the term of the facility using an effective interest method. As of June 30, 2005, the unamortized balance was $333,000.

In connection with the Laurus credit facility, the Company also paid

Laurus a $117,000 prepaid facility fee, and incurred other placement fees and expenses totaling $155,000. These amounts, aggregating $272,000, have also been recorded as deferred financing costs on the balance sheet, and as of June 30, 2005 the unamortized balance was $236,000. The facility fee is being amortized to interest expense on a straight-line basis over the term of the facility, while the other fees and expenses are being amortized to SG&A expense on a straight-line basis over the term of the facility.

7. DERIVATIVE FINANCIAL INSTRUMENTS

The following derivative liabilities related to warrants and embedded derivative instruments were outstanding as of June 30, 2005 (in thousands). There were no such instruments or derivative liabilities outstanding as of December 31, 2004.

Instrument:	Issue Date	Expiration Date	Value- Issue date	Va 6/3
Laurus Minimum Borrowing Note (Note 6)	4/4/2005	3/31/2008	$323	$
Laurus Revolving Note (Note 6)	6/13/2005- 6/30/2005	3/31/2008	254	
Fair value of bifurcated embedded derivative instrument liabilities				
500,000 common stock warrants issued to Laurus (Note 6)	3/31/2005	3/31/2010	335	
Total derivative financial instruments				
Less: amount attributable to the Laurus Revolving Note, reported in current liabilities				(
Derivative financial instruments recorded in non-current liabilities				$

The Company uses the Black-Scholes option pricing model to value warrants, and the embedded conversion option components of any bifurcated embedded derivative instruments that are recorded as derivative liabilities. See Note 6 - Convertible Debt. In valuing the warrants and the embedded conversion option components of the bifurcated embedded derivative instruments, at the time they were issued and at June 30, 2005, we used the following assumptions: market price of our common stock on the date of valuation; an expected dividend yield of 0%; an expected life equal to either the remaining period to the expiration date of the warrants or maturity date of the convertible debt instruments; expected volatility of 65%; and a risk-free rate of return ranging from 3.67-4.18%, based on constant maturity rates published by the U.S. Federal Reserve, applicable to the remaining life of the instruments.

8. DEBT OBLIGATIONS

(In thousands)	June 30, 2005	December, 31 2004
BACC revolving credit facility note	$ -	$179
Installment purchase note	44	47
Obligations under capital lease	49	-
	93	226
Less: debt maturing within one year	(31)	(187)
Long-term debt obligations	$62	$ 39

BACC revolving credit facility note:

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. This facility was replaced by the Laurus credit facility as more fully described in Note 6 - Convertible Debt.

Installment Purchase Note:

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 June 30, 2005 was $43,941, of which $8,154 was classified under debt maturing within one year.

Obligations under Capital Lease:

During 2005, the Company entered into non-cancelable lease agreements to finance $56,000 of computer equipment with payment terms ranging from 24 to 36 months. Monthly lease payments aggregate $1,984 and the agreements contain a $1.00 purchase option at the end of the lease term. The effective interest rate on the lease obligations is 10.38 to 10.5%. The principal balance of these obligations at June 30, 2005 was $48,809, of which $22,531 was classified under debt maturing within one year.

9. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

(In thousands)	June 30, 2005	December 31, 2004
Salaries, commissions and benefits	$229	$167
Other	112	75

Accrued expenses and other current liabilities	$341	$242

10. 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 amendment of ARB No. 43, Chapter 4" ("SFAS No. 151"). 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.

11. 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 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 (in thousands except per share amounts):

	Three months ended June 30, 2005	Three months ended June 30, 2004	Six months ended June 30, 2005	Six months ended June 30, 2004
Net income (loss), as reported	$202	$(414)	$ (830)	$(755)
Add: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(37)	(17)	(239)	(38)
Pro forma net income (loss)	165	(431)	(1,069)	(793)
Pro forma net income (loss) per share:				
Basic	$.05	$(.13)	$ (.32)	$(.24)
Diluted	$.04	$(.13)	$ (.32)	$(.24)

The weighted-average fair value of options granted during the three and six months ended June 30, 2005 was $.49 and $.40, respectively, compared to $.37 for the three and six months ended June 30, 2004. 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 2005 and 2004; expected volatility of 55% for 2005 and 108% for 2004; average risk-free interest rate of 3.8% for 2005 and 3.30 % for 2004; and an expected option holding period of 3.5 years for 2005 and 4.3 years for 2004.

12. COMMITMENTS AND CONTINGENCIES

Employment agreements:

On January 15, 2005 the Company hired Mr. Alfred G. Stein to 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 his date of hire. The Company registered 150,000 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 his 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 registered 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.

13. EMPLOYEE BENEFIT PLANS

The components of the net periodic benefit cost included in the results of operations for the three and six months ended June 30, 2005 and 2004 are as follows:

	Three months ended June 30,		Six months ended June 30,	
(In thousands)	2005	2004	2005	2004
Service cost	$21	$20	$43	$40
Interest cost	10	9	20	18
Recognized actuarial losses	3	2	5	4
Net expense	$34	$31	$68	$62

14. INTEREST EXPENSE

	Three months ended June 30		Six months ended June 30	
(In thousands)	2005	2004	2005	2004
Interest expense on outstanding borrowings	$17	$6	$25	$12
Amortization of deferred financing costs (1)	12	-	12	-
Amortization of discounts on convertible notes (2)	19	-	19	-

Total interest expense	$48	$6	$56	$12