FARMSTEAD TELEPHONE GROUP INC
Form 10-Q
November 12, 2004

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 September 30, 2004

or

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

Commission File Number: 0-15938

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

Delaware	06-1205743
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

22 Prestige Park Circle East Hartford, CT	06108
(Address of principal executive offices)	(Zip Code)

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

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 October 30, 2004, the registrant had 3,322,182 shares of its $0.001 par value Common Stock outstanding.

TABLE OF CONTENTS TO FORM 10-Q

PART I. FINANCIAL INFORMATION

Page

ITEM 1. FINANCIAL STATEMENTS (Unaudited)
Consolidated Balance Sheets - September 30, 2004 and December 31, 2003 3
Consolidated Statements of Operations - Three and Nine Months Ended September 30, 2004 and 2003 4
Consolidated Statements of Cash Flows - Nine Months Ended September 30, 2004 and 2003 5
Notes to Consolidated Financial Statements 6

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS 9

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK 14

ITEM 4. CONTROLS AND PROCEDURES 14

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS 14

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS 14

ITEM 3. DEFAULTS UPON SENIOR SECURITIES 14

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS 14

ITEM 5. OTHER INFORMATION 14

ITEM 6. EXHIBITS 15

SIGNATURES 15

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED BALANCE SHEETS

(In thousands)	September 30, 2004	December 2
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 386	$ 827
Accounts receivable, net	2,007	1,408
Inventories, net	1,840	1,969
Other current assets	343	447
Total Current Assets	4,576	4,651
Property and equipment, net	227	313

Other assets	95	327
Total Assets	$ 4,898	$ 5,291
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,354	$ 1,248
Debt maturing within one year	211	-
Accrued expenses and other current liabilities	399	274
Total Current Liabilities	1,964	1,522
Other liabilities	563	478
Total Liabilities	2,527	2,000
Commitments and contingencies (Note 9)		
Stockholders' Equity:		
Preferred stock, $0.001 par value; 2,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, $0.001 par value; 30,000,000 shares authorized; 3,322,182 and 3,311,601 shares issued and outstanding at September 30, 2004 and December 31, 2003, respectively	3	3
Additional paid-in capital	12,320	12,316
Accumulated deficit	(9,926)	(8,996
Accumulated other comprehensive loss	(26)	(32
Total Stockholders' Equity	2,371	3,291
Total Liabilities and Stockholders' Equity	$ 4,898	$ 5,291

See accompanying notes to consolidated financial statements.

3

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
(In thousands, except loss per share amounts)	2004	2003	2004	2003
Revenues:				
Equipment	$2,967	$2,945	$8,473	$10,025
Services and other revenue	371	350	1,160	1,644
Total revenues	3,338	3,295	9,633	11,669

Cost of Revenues:				
Equipment	2,164	1,990	6,180	6,876
Services and other revenue	257	172	718	1,102
Other cost of revenues	113	187	450	634
Total cost of revenues	2,534	2,349	7,348	8,612
Gross profit	804	946	2,285	3,057
Selling, general and administrative expenses	980	1,080	3,200	3,449
Operating loss	(176)	(134)	(915)	(392)
Interest expense	(7)	(11)	(19)	(21)
Other income	2	3	4	6
Loss before income taxes	(181)	(142)	(930)	(407)
Provision (benefit) for income taxes	(6)	7	-	19
Net loss	$ (175)	$ (149)	$ (930)	$ (426)
Basic and diluted net loss per common share:	$ (.05)	$ (.04)	$ (.28)	$ (.13)
Weighted average common shares outstanding:	3,317	3,306	3,315	3,303

See accompanying notes to consolidated financial statements.

4

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
For the Nine Months Ended September 30, 2004 and 2003

(In thousands)	2004	2003
Cash flows from operating activities:		
Net loss	$(930)	$(426)
Adjustments to reconcile net loss to net cash flows used in operating activities:		
Provision for doubtful accounts receivable	24	25
Provision for losses on inventories	82	25
Depreciation and amortization	111	133
Decrease in accumulated other comprehensive loss	6	-
Changes in operating assets and liabilities:		
Increase in accounts receivable	(623)	(146)
Decrease (increase) in inventories	47	(25)
Decrease (increase) in other assets	61	(352)
Increase (decrease) in accounts payable	106	(6)
Increase (decrease) in accrued expenses and other current liabilities	125	(25)
Increase in other liabilities	85	77
Net cash used in operating activities	(906)	(720)

Cash flows from investing activities:		
Purchases of property and equipment	(25)	(60)
Net cash used in investing activities	(25)	(60)
Cash flows from financing activities:		
Borrowings under revolving credit line	211	135
Borrowing against cash value of insurance policy	275	-
Issuance of common stock	4	2
Net cash provided by financing activities	490	137
Net decrease in cash and cash equivalents	(441)	(643)
Cash and cash equivalents at beginning of period	827	994
Cash and cash equivalents at end of period	$ 386	$ 351
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 20	$ 18
Income taxes	4	5

See accompanying notes to consolidated financial statements.

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

1. BASIS OF PRESENTATION

The consolidated financial statements presented herein consist of the accounts of Farmstead Telephone Group, Inc. and its wholly owned subsidiaries, FTG Venture Corporation (inactive) and InfiNet Systems, LLC (inactive). The accompanying consolidated financial statements as of September 30, 2004 and for the three and nine months ended September 30, 2004 and 2003 have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission for interim financial statements. In the Company's opinion, the unaudited interim consolidated financial statements and accompanying notes reflect all adjustments, consisting of normal and recurring adjustments that are necessary for a fair statement of results for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the results to be experienced for the entire fiscal year. 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, 2003.

2. OPERATIONS

As presented in the consolidated financial statements contained in this report, the Company incurred a net loss of $175,000 for the quarter ended September 30, 2004, a net loss of $930,000 for the nine months ended September 30, 2004, and has incurred substantial losses in each of the past

three fiscal years. These losses have been primarily the result of significant declines in revenues over these periods, with the exception of a 1% increase in revenues in the current year quarter over the comparable 2003 period, and some deterioration in profit margins. There is currently no clear indication that sales levels will significantly increase in the near term and, in fact, they could continue to decline. The Company has been restructuring its operations in order to align its operating expenses with its revenue levels. During 2004, these actions resulted in a reduction of 21% of its workforce, primarily operations and administrative positions. The Company is currently focusing on strategies to increase revenues, which may include a further diversification of its product offerings, and increasing the size of its sales force. The Company is also currently seeking out business partners interested in merging with the Company, as well as investment banking relationships to assist in obtaining capital to finance any mergers/acquisitions. In August, 2004, the Company engaged the services of a business consultant to evaluate the Company's current business model and operating performance, and assist in developing and implementing a strategic redirection. Effective October 1, 2004, the Company hired this individual in the capacity of President and Chief Executive Officer. For additional information refer to Note 12.

On August 2, 2004, the Company received notification from Avaya, Inc. that, effective July 30, 2004, it was terminating the Authorized Remarketing Supplier aftermarket program (the "ARS Program") under which the Company sold "Classic Avaya(TM)" products. The Company will be allowed continued use of the Classic Avaya licensed trade mark for a period of 90 days from the termination date. Avaya is currently developing successor programs to the ARS Program, and the Company expects to be included in these programs. Since the beginning of 2004, in anticipation of the possible termination of the ARS Program, the Company has been selling "Farmstead Certified" refurbished equipment in addition to "Classic Avaya"-labeled equipment. The Company believes that the termination of the ARS Program will not have a material adverse impact on the Company.

3. RECLASSIFICATIONS

Certain amounts in the Consolidated Statement of Operations for the three and nine months ended September 30, 2003 were reclassified to conform to the current period presentation.

4. ACCOUNTS RECEIVABLE, NET

(Dollars in thousands)	September 30, 2004	December 31, 2003
Trade accounts receivable	$2,025	$1,410
Less: allowance for doubtful accounts	(73)	(80)
Trade accounts receivable, net	1,952	1,330
Other receivables	55	78
Accounts receivable, net	$2,007	$1,408

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

5. INVENTORIES, NET

(Dollars in thousands)	September 30, 2004	December 31, 2003
Finished goods and spare parts	$1,484	$1,817
Work in process (a)	403	450
Rental equipment	46	61
	1,933	2,328
Less: reserves for excess and obsolete inventories	(93)	(359)
Inventories, net	$1,840	$1,969

6. DEBT MATURING WITHIN ONE YEAR

On February 19, 2004, the Company's revolving credit facility with Business Alliance Capital Corporation ("BACC") was extended for an additional one-year term with the following modifications: (i) the credit facility advance limit was increased from $1.5 million to $1.7 million; and (ii) the amount that could be advanced against eligible inventory was increased from $200,000 to $400,000. For additional information on the terms and conditions of the BACC credit facility, refer to the Company's Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2003.

As of September 30, 2004, outstanding borrowings with BACC were $210,600. The unused portion of the credit facility as of September 30, 2004 was $1,489,400, of which $1,010,994 was available to borrow. The average and highest amounts borrowed during the three months ended September 30, 2004 were approximately $201,000 and $350,000, respectively. The average and highest amounts borrowed during the nine months ended September 30, 2004 were approximately $173,000 and $401,000, respectively. The Company was in compliance with the provisions of its loan agreement as of September 30, 2004.

7. STOCK OPTIONS

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

	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
Net loss, as reported	$(175)	$(149)	$(930)	$(426)
Add: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(10)	(16)	(38)	(62)
Pro forma net loss	$(185)	$(165)	$(968)	(488)
Pro forma net loss per share:				
Basic and diluted	$(.06)	$(.05)	$(.29)	$(.15)

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 2004 and 2003; expected volatility of 50% for 2004 and 113% for 2003; average risk-free interest rate of 3.1 % for 2004 and 2.78% for 2003; and an expected option holding period of 3.5 years for 2004 and 5.6 years for 2003.

7

8. RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In December 2003, the Financial Accounting Standards Board ("FASB") issued SFAS No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits, an Amendment of FASB Statements No. 87, 88 and 106" ("SFAS No. 132"). SFAS No. 132 requires, for defined benefit pension plans and other defined postretirement benefit plans, additional disclosures regarding plan assets, investment strategy, measurement date, plan obligations, cash flows and components of net periodic benefit cost, effective upon issuance. The Company adopted the annual disclosure requirements for the year ended December 31, 2003. The Company adopted the interim disclosure requirements in the first quarter of 2004, with current quarter disclosures provided in Note 10.

9. COMMITMENTS AND CONTINGENCIES

Lease Agreements. On March 23, 2004, the Company entered into a new lease agreement on its corporate offices and distribution center located at 22 Prestige Park Circle, East Hartford, CT. This agreement replaced the Company's existing lease due to expire in December 2004. Under the new lease agreement, which became effective May 1, 2004, the Company is leasing 25,051 square feet for a 10-year, 8-month period expiring December 31, 2014. The lease contains one five-year renewal option. The lease also allows the Company the one-time option to terminate the lease without penalty on December 31, 2009. Minimum monthly rent will amount to $11,377 for 2004, $13,047 for years 2005 - 2009, and $13,569 for years 2010 - 2014. The Company is additionally obligated to pay the lessor its proportionate share of the property operating costs at an amount equal to $1.20 per

square foot, subject to a 2% annual increase.

On March 31, 2004, the Company terminated, without penalty, its lease agreement on 15,137 square feet of warehouse space that was scheduled to expire December 31, 2004. The lease termination was effective April 1, 2004.

Letter of Credit. In connection with the Company's revolving credit agreement with BACC, the Company issued a $300,000 irrevocable standby letter of credit ("LC") in favor of BACC. The LC can be drawn upon by BACC to satisfy any outstanding obligations under the Company's loan agreement ninety days after an event of default. The LC is secured by cash, and since this cash is restricted from use by the Company during the term of the LC, it has been classified under other current assets in the consolidated balance sheet at September 30, 2004 and December 31, 2003.

10. EMPLOYEE BENEFIT PLANS

The components of the net periodic benefit cost included in the results of operations for the three and nine months ended September 30, 2004 and 2003 are as follows:

	Three months ended September 30,		Nine months ended September 30,	
(Dollars in thousands)	2004	2003	2004	2003
Service cost	$20	$17	$60	$52
Interest cost	9	7	26	22
Recognized actuarial losses	2	-	6	-
Net expense	$31	$24	$92	$74

11. STOCKHOLDERS' EQUITY

On May 7, 2004 the Company received notice from the American Stock Exchange (the "Amex" or the "Exchange") that it did not meet certain of the Exchange's continued listing standards as a result of having stockholders' equity less than $4 million and net losses in three out of its four most recent fiscal years, as set forth in Section 1003 (a) (ii) of the Amex Company Guide. The Company was afforded the opportunity to submit a plan of compliance to the Exchange and on June 15, 2004 presented its plan to the Exchange. On July 19, 2004 the Exchange notified the Company that it accepted its plan of compliance and granted the Company an extension of time to regain compliance with the continued listing standards. The Company will be subject to periodic review by Exchange Staff during the extension period which expires November 7, 2005. Failure to make progress consistent with the plan or to regain compliance with the continued listing standards by the end of the extension period could result in the Company being delisted from the American Stock Exchange.

12. SUBSEQUENT EVENTS

On October 1, 2004, Jean-Marc Stiegemeier was hired as the Company's new President and Chief Executive Officer, succeeding George J. Taylor, Jr., the Company's founder. Mr. Stiegemeier (the "Executive") was also appointed to the Company's Board of Directors. The Executive's employment agreement (the "Agreement") expires December 31, 2009. The Agreement includes the following key provisions: (i) an annual base salary of $300,000, which may be increased by the Board in its discretion or decreased by the Board under certain defined circumstances; (ii) a one-time special bonus of $37,500, $25,000 of which was payable October 1, 2004, with the balance payable in January 2005; (iii) an annual bonus of up to 100% of Executive's base salary based upon the attainment of a Board-approved earnings target for that year; and (iv) as an incentive to reduce the Company's "acquisition" costs, Executive would receive an "acquisition incentive bonus" equal to one percent (1%) of the Purchase Price, as defined in the Agreement, for each acquisition that is concluded during the term of this Agreement without any obligation by the Company to pay any fees, commissions or any other cash or equity-based compensation to any third party(ies) for or in connection with (a) the identification of the entity that is the subject of the acquisition; (b) the valuation of the acquisition or (c) the negotiation of the purchase price and other key business terms of the acquisition with the selling party or its representatives. Concurrent with the effective date of the Agreement, Executive was issued a Warrant to purchase up to Four Hundred Thousand (400,000) shares of common stock at fair market value. The Warrant is exercisable immediately and expires five years from the date of grant. The underlying common stock is unregistered as of the date of issuance of the warrant. The Executive was also granted an option to purchase up to Six Hundred Thousand (600,000) shares of common stock under the 2002 Stock Option Plan at an exercise price equal to the fair market value of the common stock. Three Hundred Thousand (300,000) shares are exercisable one year after the grant date, with the remainder exercisable two years after the grant date. The options expire ten years after the grant date.

The Agreement also provides severance pay for the Executive during the term of the Agreement under certain circumstances. Should the Company terminate the agreement without "cause", or if the Executive terminates the Agreement "for good reason", or in the event the Executive resigns after a "change in control", as all are defined in the Agreement, then severance pay will equal three times the "Executive Compensation Amount" as defined. From August 16, 2004 to October 1, 2004, the Executive provided business consulting services to the Company for which the Executive received $53,714 in fees and expenses.

On October 1, 2004, Mr. Taylor's employment agreement with the Company was modified ("Modified Agreement"), extending his "Active" employment period through December 31, 2007 and eliminating his "Limited" employment period. The Modified Agreement includes the following major provisions: (i) a base salary of $200,000 for 2005, increasing to $250,000 in 2006 and $300,000 in 2007; (ii) an annual bonus of up to 100% of Executive's base salary based upon the attainment of a Board-approved earnings target for that year; and (iii) an "acquisition incentive bonus" as described above for Executive. Mr. Taylor will continue to serve as Chairman of the Board.

13. LOSS PER SHARE

Basic loss per share was computed by dividing net loss by the weighted average number of shares of common stock outstanding during the reporting periods. Options to purchase 1,899,782 shares of common stock at an average exercise price of $1.71, and 1,865,706 shares of common stock at

an average exercise price of $1.73 were not included in the computation of diluted loss per share for the three months ended September 30, 2004 and 2003, respectively, because inclusion of these options would be antidilutive. Options to purchase 1,882,920 shares of common stock at an average exercise price of $1.71, and 1,849,565 shares of common stock at an average exercise price of $1.73 were not included in the computation of diluted loss per share for the nine months ended September 30, 2004 and 2003, respectively, because inclusion of these options would be antidilutive.

On October 1, 2004, a Warrant to purchase up to Four Hundred Thousand (400,000) shares of common stock at fair market value was issued to the Company's new President and CEO. In addition, said individual was also granted an option to purchase up to Six Hundred Thousand (600,000) shares of common stock under the 2002 Stock Option Plan at an exercise price equal to the fair market value of the common stock. See Note 12.

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 September 30, 2004, we recorded a net loss of $175,000 or $.05 per share on revenues of $3,338,000. This compares with a net loss of $149,000 or $.04 per share on revenues of $3,295,000 recorded for the three months ended September 30, 2003. For the nine months ended September 30, 2004, we recorded a net loss of $930,000 or $.28 per share on revenues of $9,633,000. This compares with a net loss of $426,000 or $.13 per share on revenues of $11,669,000 recorded for the nine

months ended September 30, 2003.

Although third quarter 2004 revenues were 1% higher than the prior year period, we experienced a decline in our gross profit margin from 29% in 2003 to 24% in the current year quarter. For the nine months ended September 30, 2004, we experienced a 17% decline in revenues, and our gross profit margin declined to 24%, from 26% in the prior year period. There are several factors which have contributed to these results. First, there is increased competition in the market areas that we serve, and 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 generated incremental revenues, but sales to date have not developed enough to compensate for the decline in parts sales. Second, our sales force has undergone significant turnover in the last two years, and the productivity ramp-up of new salespersons has taken longer than expected. Revenue growth is dependent upon a stable, and highly trained sales force. Third, we continue to believe that corporations are still cautious about capital equipment spending. We believe that equipment sales have been affected by the downsizing of many of our customers over the last few years, which resulted in excess equipment available for re-deployment in their operations. Although there have been some signs of improvement in our industry as evidenced by improved operating results from some of the key manufacturers, and increased sales quotation activities, our overall order flow has been below our expectations.

During these tough times, we have been reorganizing our operations to properly size our business in relation to current revenue run-rates, while trying to preserve our key technical personnel that are critical to maintaining and growing a systems and services business. Our primary focus during 2004 has been on strategies to increase revenues while continuing close controls over operating expenses. However, there is currently no clear indication that sales levels will significantly increase in the near term and, in fact, they could continue to decline. In reaction to lower than expected revenue levels, during the first six months of 2004 we reduced our workforce by 21%, primarily operations and administrative positions, but keeping key technical resources intact. We are currently seeking out business partners interested in merging with the Company, as well as investment banking relationships to assist in obtaining capital to finance any mergers/acquisitions.

In August, 2004, the Company engaged the services of a business consultant to evaluate the Company's current business model and operating performance, and assist in developing and implementing a strategic redirection. Effective October 1, 2004, the Company hired this individual, Mr. Jean-Marc Stiegemeier, in the capacity of President and Chief Executive Officer. Mr. Stiegemeier has extensive executive management experience in the telecommunications industry. From 2002 to 2004 he was a business consultant, advising companies on strategic redirections and turnarounds. He also served on the board of directors for certain of these companies. From 1997-2001, he was associated with Exp@nets Inc., a voice and data solutions provider, serving in various capacities including President and Director. Prior thereto, Mr. Stiegemeier served as Chairman and CEO of Franklin Industries Inc., Lucht, Inc., Ships Entertainment, Inc, California-Telamerica Inc., Morrow Optical, Inc., and Telamerica, Inc. He was also the President of Honeywell-Telamerica.

Additional information on major components of our operating performance for the three and nine months ended September 30, 2004 follows below.

10

REVENUES

(in thousands)	Three months ended September 30, 2004	Three months ended September 30, 2003	Nine months ended September 30, 2004	Nine months ended September 30, 2003
Equipment:				
End-user equipment sales	$2,356	$2,615	$7,391	$ 8,898
Equipment sales to resellers	611	330	1,082	1,127
Total equipment sales	2,967	2,945	8,473	10,025
Services:				
Installations	262	155	782	1,089
Rentals and repair	48	46	119	185
Other revenue	61	149	259	370
Total services and other revenue	371	350	1,160	1,644
Total revenues	$3,338	$3,295	$9,633	$11,669

Equipment Sales

Total equipment sales for the three months ended September 30, 2004, were approximately 1% higher than the comparable 2003 period. The increase consisted of a $281,000 or 85% increase in sales to equipment resellers ("wholesale sales"), partly offset by a $259,000 or 10% decrease in end-user equipment sales. Total equipment sales for the nine months ended September 30, 2004, were 15% below the comparable 2003 period. The decrease consisted of a $1,507,000 or 17% decline in end-user sales, and a $45,000 or 4% decline in wholesale sales. 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 the three and nine months ended September 30, 2004 are also described in the "Overview" section above. Wholesale sales have been impacted by some of these same factors. Although our principal supplier of used equipment for resale into the wholesale market has significantly curtailed operations, thereby limiting our ability to acquire equipment at a low enough cost for profitable resale into the wholesale market, we have been pursuing partnering arrangements with other equipment dealers as a means to bolster equipment revenues. As a marketing tool to help generate future equipment revenues, we have also developed an electronic commerce framework called "ECONNECT". For the nine months ended September 30, 2004, approximately 4% of our equipment sales were processed through this on-line catalog.

Services and Other Revenue

Service revenues for the three months ended September 30, 2004, were approximately 54% higher than the comparable 2003 period. The increase was primarily attributable to higher installation revenues, which in turn is attributable to increased systems sales from the comparable prior year period. Services revenues for the nine months ended September 30, 2004 were 29% below the comparable 2003 period. The decrease was attributable to (i) a 28% decline in installation revenues, although systems sales were approximately 1% higher than the prior year period and (ii) a 36% decline in equipment rental and repair revenues. An increase or decrease in installation revenues 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, and the Company may sell new systems or system upgrades without being contracted to perform the installation. Equipment rental revenues are irregular and difficult to predict, since they tend to be project-oriented.

Other revenue for the three and nine months ended September 30, 2004 and 2003 consisted primarily of freight billed to customers on product shipments, and commissions earned from selling Avaya maintenance contracts. In the sale of Avaya maintenance contracts, we act as a sales agent of Avaya, and the service obligations are borne entirely by Avaya. Other revenue for the three months ended September 30, 2004 was 59% below the comparable 2003 period, attributable to lower commissions earned on Avaya maintenance contracts. Other revenue for the nine months ended September 30, 2004 was 30% below the comparable prior year period due to lower commissions earned on Avaya maintenance contracts and to lower freight revenues.

COST OF REVENUES AND GROSS PROFIT. Total cost of revenues for the three months ended September 30, 2004 was $2,534,000, an increase of 8% from the comparable 2003 period. The gross profit for the three months ended September 30, 2004 was $804,000, a decrease of 15% from the comparable 2003 period. As a percentage of revenue, the gross profit margin was 24% for 2004, compared to 29% for the comparable 2003 period.

Total cost of revenues for the nine months ended September 30, 2004 was $7,348,000, a decrease of 15% from the comparable 2003 period. The gross profit for the nine months ended September 30, 2004 was $2,285,000, a decrease of 25% from the comparable 2003 period. As a percentage of revenue, the gross profit margin was 24% for 2004, compared to 26% for the comparable 2003 period.

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

factors will result in varying gross profit margins from period to period.

Gross Profit on Equipment Sales. For the three months ended September 30, 2004, the gross profit margin on equipment sales revenues was 27%, compared to 32% recorded during the comparable prior year period. For the nine months ended September 30, 2004, the gross profit margin on equipment sales revenues was 27%, compared to 31% recorded during the comparable prior year period. The decrease in each period was attributable to lower profit margins on sales of parts to both end-users and to wholesalers, partly offset by increased profit margins on systems sales. As previously discussed, product demand conditions and increased competition has led to downward pressure on our sales pricing. We expect continued pressure on our profit margins going forward.

Gross Profit on Services and Other Revenues. For the three months ended September 30, 2004, the gross profit margin on services and other revenues was 31%, compared to 51% in the comparable prior year period. The decreased gross profit margin was attributable to lower maintenance contract commissions. For the nine months ended September 30, 2004, the gross profit margin on services and other revenues was 38%, compared to 33% in the comparable prior year period. The increased gross profit margin was primarily attributable to higher profit margins on installation services.

Other Cost of Revenues. Other cost of revenues consists of product handling, purchasing and facility costs and expenses. For the three months ended September 30, 2004, these expenses were 40% lower than the comparable prior year period, and represented approximately 4% of equipment sales revenues during the current period, compared to 6% of equipment sales revenues in 2003. For the nine months ended September 30, 2004, these expenses were 29% lower than the comparable prior year period, representing 5% of equipment sales revenues compared to 6% of equipment sales revenues in 2003. The reduction in other cost of revenues primarily resulted from personnel reductions implemented during 2004 as well as planned reductions in facility costs and expenses. During the nine months ended September 30, 2004, we incurred $25,000 in termination pay expense related to the personnel reductions.

SELLING, GENERAL AND ADMINISTRATIVE ("SG&A") EXPENSES. SG&A expenses for the three months ended September 30, 2004 were $980,000, a decrease of 9% from the comparable 2003 period. SG&A expenses were 29% of revenues for the current three-month period as compared to 33% of revenues in 2003. SG&A expenses for the nine months ended September 30, 2004 were $3,200,000 a decrease of 7% from the comparable 2003 period. SG&A expenses were 33% of revenues for the current nine-month period as compared to 30% of revenues in 2003. The decrease in SG&A expenses in each period was primarily attributable to (i) lower compensation expense from lower personnel levels and lower sales commissions; (ii) lower facility rental and operating costs as a result of a reduction in the number of square feet leased, and (iii) reductions in various other administrative expenses as a result of cost reduction initiatives. The decreases were partly offset by higher marketing expenses, including costs associated with maintaining our ECONNECT on-line catalog, and lower earned Avaya dealer marketing rebates. In addition, we incurred $64,000 in outside business consulting fees and expenses. During the nine months ended September 30, 2004, we also incurred $17,000 in termination pay expense related to personnel reduction initiatives.

INTEREST EXPENSE AND OTHER INCOME. Interest expense for the three months ended September 30, 2004 was $7,000, compared with $11,000 for the comparable 2003 period. Interest expense for the nine months ended September 30, 2004 was $19,000, compared with $21,000 for the comparable 2003 period. The fluctuations in interest expense period-over-

period were attributable to changes in average borrowing levels. Other income consisted of interest earned on invested cash in all reported periods.

PROVISION (BENEFIT) FOR INCOME TAXES. The provision for income taxes represents estimated minimum state taxes in all reported periods. For the three and nine months ended September 30, 2004, these minimum taxes were reduced by an $8,000 overaccrual of prior year state taxes. 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 $2,612,000 at September 30, 2004, a decrease of $517,000 or 17% from $3,129,000 at December 31, 2003. The working capital ratio was 2.3 to 1 at September 30, 2004, compared with 3.1 to 1 at December 31, 2003.

Operating activities used $906,000 during the nine months ended September 30, 2004. Net cash used by operating activities consisted of a net loss of $930,000 adjusted for non-cash expense items of $223,000, and net cash used by changes in operating assets and liabilities of $199,000. Net cash used by changes in operating assets and liabilities was primarily attributable to an increase in accounts receivable, partly offset by an increase in accounts payable and accrued expenses.

Investing activities used $25,000, net of disposals, during the nine months ended September 30, 2004 to fund capital expenditures.

Financing activities provided $490,000 during the nine months ended September 30, 2004, primarily attributable to working capital borrowings under our revolving credit facility with BACC, and borrowings against the cash value of an insurance policy. On February 19, 2004, the BACC credit facility was extended for an additional one-year term with the following modifications: (i) the credit facility advance limit was increased from $1.5 million to $1.7 million; and (ii) the amount that could be advanced against eligible inventory was increased from $200,000 to $400,000. For additional information on the terms and conditions of the BACC credit facility, refer to our Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2003. As of September 30, 2004, outstanding borrowings with BACC were $210,600. The unused portion of the credit facility as of September 30, 2004 was $1,489,400, of which $1,010,994 was available to borrow. The average and highest amounts borrowed during the three months ended September 30, 2004 were approximately $201,000 and $350,000, respectively. The average and highest amounts borrowed during the nine months ended September 30, 2004 were approximately $173,000 and $401,000, respectively. We were in compliance with the provisions of our loan agreement as of September 30, 2004.

As a result of our reduced revenues and employment levels, we early-terminated one building lease agreement covering 15,137 square feet of warehouse space (otherwise scheduled to expire December 31, 2004), and renegotiated the building lease on our main offices and distribution center, reducing our square footage under rent from approximately 35,000

square feet to approximately 25,000 square feet. These actions are estimated to reduce our 2004 building rental and operating costs by approximately $16,000 per month. Refer to Note 9 for further information on the new lease agreement.

We are dependent upon generating positive cash flow from operations and upon our revolving credit facility to provide cash to satisfy working capital requirements. If the trend in operating losses continues, we would most likely not have the financial resources to sustain or fund our current level of operations. Historically, our working capital borrowings have increased during periods of revenue growth. This is because we pay our vendors over a shorter time period than the period in which we collect our accounts receivable. Under the current lending agreement, we are prohibited from borrowing against receivables generated by systems sales until the systems are installed. Under these circumstances, we could run out of availability and/or require a higher credit line. In order to obtain additional financing, we may first need to demonstrate improved operating performance. No assurances can be given that we will have sufficient cash resources to finance possible future growth, and it may become necessary to seek additional financing sources for such purpose.

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, 2003 under the subheading "Critical Accounting Policies and Estimates" is still considered current and is hereby incorporated into this Quarterly Report on Form 10-Q.

13

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, 2003 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, 2003, "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.

ITEMS 1, 2, 3, and 4 have been omitted because there is nothing to report or they are inapplicable.

ITEM 5. OTHER INFORMATION.

On July 23, 2004 the Company filed a report on Form 8-K to report that on July 19, 2004 the Company received approval from the American Stock Exchange (the "Amex") on its plan to get back into compliance with the Amex's continued listing requirements, and to report that it was given an extension to November 7, 2005, subject to certain requirements, to achieve compliance with said listing requirements or be subject to delisting from the Amex.

On August 5, 2004 the Company filed a report on Form 8-K to report that effective July 30, 2004 Avaya terminated the Authorized Remarketing Supplier aftermarket program (the "ARS Program") under which the Company sold "Classic Avaya(TM)" products. The Company will be allowed continued use of the Classic Avaya licensed trade mark for a period of 90 days from the termination date.

On October 6, 2004 the Company filed a report on Form 8-K to report the appointment of Jean-Marc Stiegemeier as the Company's new President and Chief Executive Officer, succeeding George J. Taylor, Jr., the Company's founder. The Company also reported that it had entered into an employment agreement with Mr. Stiegemeier through December 31, 2009, and amended the employment agreement currently in effect with George J. Taylor, Jr. See Note 12, "Subsequent Events", to the consolidated financial statements contained herein for additional information.

14

ITEM 6. EXHIBITS.

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

4(a) Warrant to Purchase common stock of Farmstead Telephone Group, Inc. issued to Jean-Marc Stiegemeier October 1, 2004 [Exhibit 4(a) to the Form 8-K Current Report filed October 6, 2004]

10(a) Employment Agreement dated October 1, 2004 between Farmstead Telephone Group, Inc. and Jean-Marc Stiegemeier. [Exhibit 10(a) to the Form 8-K Current Report filed October 6, 2004]

10(b) Fourth Addendum to that Certain Employment Agreement Between Farmstead Telephone Group, Inc. and George J. Taylor, Jr. Dated as of January 1, 1998 as Amended by that Certain Restated First Addendum Dated as of August 1, 2001; as Further Amended by that Certain Second Addendum Dated as of January 1, 2003; and as Further Amended by that Certain Third Addendum Dated as of January 1, 2004. [Exhibit 10(b) to the Form 8-K Current Report filed October 6, 2004]

10(c) Agreement between Farmstead Telephone Group, Inc. and Jean-Marc Stiegemeier dated August 16, 2004.

31.1 Rule 13a-14(a) or 15d-14(a) Certification of the Chief Executive Officer.

31.2 Rule 13a-14(a) or 15d-14(a) Certification of the Chief Financial Officer.

32.1 Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted 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: November 12, 2004

/s/ George J. Taylor, Jr.

George J. Taylor, Jr.
Chief Executive Officer, President
(through September 30, 2004)

Dated: November 12, 2004

/s/ Robert G. LaVigne

Robert G. LaVigne
Executive Vice President, Chief
Financial Officer