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FARMSTEAD TELEPHONE GROUP INC
Form 10-Q
November 14, 2005

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

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005

or

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

Commission File Number: 0-15938

Farmstead Telephone Group, Inc.

(Exact name of registrant as specified in its charter)

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

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

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the 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 No

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of October 27, 2005, the registrant had 3,747,132 shares of its \$0.001 par value Common Stock outstanding.

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PART I - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS.

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED BALANCE SHEETS

| (In thousands) | September 30, 2005 | December 31, 2004 |
|---------------------------|-----------------------|----------------------|
| | ----- | |
| | (Unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 186 | \$ 217 |
| Accounts receivable, net | 3,598 | 1,453 |
| Inventories, net | 1,345 | 1,627 |
| Other current assets | 108 | 378 |
| | ----- | |

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| | | |
|--|----------|----------|
| Total Current Assets | 5,237 | 3,675 |
| Property and equipment, net | 563 | 268 |
| Deferred financing costs (Note 6) | 384 | - |
| Other assets | 107 | 107 |
| Total Assets | \$ 6,291 | \$ 4,050 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 3,123 | \$ 1,110 |
| Debt maturing within one year (Note 6) | 648 | 187 |
| Accrued expenses and other current liabilities | 408 | 242 |
| Total Current Liabilities | 4,179 | 1,539 |
| Postretirement benefit obligation | 688 | 593 |
| Long-term debt (Note 6) | 72 | 39 |
| Total Liabilities | 4,939 | 2,171 |
| Commitments and contingencies (Note 10) | | |
| 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; 3,747,132 and 3,322,182 shares issued and outstanding at September 30, 2005 and December 31, 2004, respectively | 4 | 3 |
| Additional paid-in capital | 13,602 | 12,320 |
| Accumulated deficit | (12,236) | (10,420) |
| Accumulated other comprehensive loss | (18) | (24) |
| Total Stockholders' Equity | 1,352 | 1,879 |
| Total Liabilities and Stockholders' Equity | \$ 6,291 | \$ 4,050 |

See accompanying notes to consolidated financial statements.

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

| (In thousands, except loss per share amounts) | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|--|------|---|------|
| | 2005 | 2004 | 2005 | 2004 |
| | | | | |

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| | | | | |
|--|----------|----------|----------|----------|
| Revenues: | | | | |
| Equipment | \$3,890 | \$2,967 | \$ 9,578 | \$8,473 |
| Services and other revenue | 917 | 371 | 2,121 | 1,160 |
| ----- | | | | |
| Total revenues | 4,807 | 3,338 | 11,699 | 9,633 |
| Cost of Revenues: | | | | |
| Equipment | 2,887 | 2,164 | 6,901 | 6,180 |
| Services and other revenue | 573 | 257 | 1,128 | 718 |
| Other cost of revenues | 108 | 113 | 341 | 450 |
| ----- | | | | |
| Total cost of revenues | 3,568 | 2,534 | 8,370 | 7,348 |
| ----- | | | | |
| Gross profit | 1,239 | 804 | 3,329 | 2,285 |
| Selling, general and administrative expenses | 1,885 | 980 | 5,033 | 3,200 |
| ----- | | | | |
| Operating loss | (646) | (176) | (1,704) | (915) |
| Interest expense | (60) | (7) | (111) | (19) |
| Other income | 3 | 2 | 7 | 4 |
| ----- | | | | |
| Loss before income taxes | (703) | (181) | (1,808) | (930) |
| Provision for income taxes | 1 | (6) | 8 | - |
| ----- | | | | |
| Net loss | (704) | \$ (175) | (1,816) | \$ (930) |
| ===== | | | | |
| Basic and diluted net loss per common share: | \$ (.20) | \$ (.05) | \$ (.53) | \$ (.28) |
| Weighted average common shares outstanding: | | | | |
| Basic and diluted | 3,511 | 3,317 | 3,398 | 3,315 |
| ===== | | | | |

See accompanying notes to consolidated financial statements.

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FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(UNAUDITED)
For the Nine Months ended September 30, 2005

| (In thousands) | Common Stock | | Additional Paid-in Capital | Accum- ulated Deficit | Accumu- Comprehe |
|--|--------------|--------|----------------------------------|-----------------------------|---------------------|
| | Shares | Amount | | | |
| Balance at December 31, 2004 | 3,322 | \$3 | \$12,320 | \$(10,420) | |
| Net loss | - | - | - | (1,816) | |
| Amortization of pension liability adjustment | - | - | - | - | |
| Comprehensive loss | | | | | |
| Warrants issued in connection with convertible debt financing | - | - | 186 | - | |
| Beneficial conversion discount on | | | | | |

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| | | | | |
|---|-------|-----|----------|------------|
| convertible note payable | - | - | 500 | - |
| Common stock issued upon conversion of note payable | 325 | 1 | 499 | - |
| Common stock issued upon exercise of stock options | 55 | - | 67 | - |
| Common stock issued under employee stock purchase plan | 45 | - | 30 | - |
| ----- | | | | |
| Balance at September 30, 2005 | 3,747 | \$4 | \$13,602 | \$(12,236) |
| ===== | | | | |

See accompanying notes to consolidated financial statements.

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

For the Nine Months Ended September 30, 2005 and 2004

| (In thousands) | 2005 | 2004 |
|--|-----------|---------|
| ----- | | |
| Cash flows from operating activities: | | |
| Net loss | \$(1,816) | \$(930) |
| Adjustments to reconcile net loss to net cash flows used in operating activities: | | |
| Provision for doubtful accounts receivable | 27 | 24 |
| Provision for losses on inventories | 30 | 82 |
| Depreciation and amortization of property and equipment | 81 | 111 |
| Amortization of deferred financing costs | 74 | - |
| Amortization of debt discount | 16 | - |
| Decrease in accumulated other comprehensive loss | 6 | 6 |
| Increase in accrued postretirement benefit obligation | 95 | 85 |
| Changes in operating assets and liabilities: | | |
| Increase in accounts receivable | (2,172) | (623) |
| Decrease in inventories | 252 | 47 |
| Decrease in other assets | 270 | 61 |
| Increase in accounts payable | 2,013 | 106 |
| Increase in accrued expenses and other current liabilities | 166 | 125 |
| ----- | | |
| Net cash used in operating activities | (958) | (906) |
| ----- | | |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (320) | (25) |
| ----- | | |
| Net cash used in investing activities | (320) | (25) |
| ----- | | |
| Cash flows from financing activities: | | |
| Net borrowings under revolving credit lines | 939 | 211 |
| Proceeds from convertible note payable | 500 | - |
| Deferred financing costs | (272) | - |
| Borrowing against cash value of insurance policy | - | 275 |
| Proceeds from the issuance of common stock | 97 | 4 |
| Repayments of long-term debt | (17) | - |

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| | | |
|--|--------|--------|
| Net cash provided by financing activities | 1,247 | 490 |
| Net decrease in cash and cash equivalents | (31) | (441) |
| Cash and cash equivalents at beginning of period | 217 | 827 |
| Cash and cash equivalents at end of period | \$ 186 | \$ 386 |

Supplemental disclosure of cash flow information:

Cash paid during the period for:

| | | |
|--|-------|-------|
| Interest | \$ 46 | \$ 20 |
| Income taxes | 2 | 4 |
| Non-cash financing and investing activities: | | |
| Purchase of equipment under capital lease | 56 | - |
| Debt discount recorded on issuance of note payable | 500 | - |

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| | | |
|--|-----|---|
| Fair value of warrant recorded as deferred financing cost in connection with revolving credit facility | 186 | - |
|--|-----|---|

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. The accompanying consolidated financial statements as of September 30, 2005 and for the three and nine months ended September 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 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, 2004.

2. OPERATIONS

As presented in the consolidated financial statements contained in this report, the Company incurred net losses of \$704,000 and \$1,816,000 for the three and nine months ended September 30, 2005, respectively. In addition, the Company has incurred substantial losses in each of the past four fiscal years. 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. By the end of September 2005, the Company's direct

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sales and sales support group was significantly larger than September 2004, and revenues for the three and nine months ended September 30, 2005 were 44% and 21% higher than the comparable prior year periods.

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 in the first quarter of 2006, will offer carrier-based hosted IP telephony services along with network services. Its primary target will be the SMB ("small-to-medium sized business") market.

In order to finance its business expansion plans, effective March 31, 2005 the Company entered into a \$3 million credit arrangement with a new lender, replacing a \$1.7 million credit facility with Business Alliance Capital Corporation. For additional information, refer to Note 6, Debt Obligations contained herein. Additionally, in October 2005, the Company engaged the services of an investment banking firm, and intends to raise additional capital through one or a series of private offerings of securities, as more fully described in Note 14, Subsequent Events, contained herein.

3. ACCOUNTS RECEIVABLE, NET

| (In thousands) | September 30, 2005 | December 31, 2004 |
|---------------------------------------|-----------------------|----------------------|
| | | |
| Trade accounts receivable | \$3,246 | \$1,379 |
| Less: allowance for doubtful accounts | (87) | (60) |
| | | |
| Trade accounts receivable, net | 3,159 | 1,319 |
| Other receivables | 439 | 134 |
| | | |
| Accounts receivable, net | \$3,598 | \$1,453 |
| | | |

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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) | September 30, 2005 | December 31, 2004 |
|--------------------------------|-----------------------|----------------------|
| | | |
| Finished goods and spare parts | \$1,167 | \$1,341 |
| Work in process * | 244 | 352 |
| Rental equipment | 12 | 52 |
| | | |

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| | | |
|---|---------|---------|
| | 1,423 | 1,745 |
| Less: reserves for excess and obsolete inventories | (78) | (118) |
| ----- | | |
| Inventories, net | \$1,345 | \$1,627 |
| ===== | | |

* Consists of used equipment requiring repair or refurbishing.

5. PROPERTY AND EQUIPMENT, NET

| (In thousands) | Estimated Useful Lives (Yrs.) | September 30, 2005 | Decem |
|---|-------------------------------------|-----------------------|-------|
| ----- | | | |
| Computer and office equipment | 3 - 5 | \$ 1,062 | \$ |
| IP network equipment and licenses | 5 | 301 | |
| Furniture and fixtures | 5 - 10 | 288 | |
| Leasehold improvements | 10 | 171 | |
| Capitalized software development costs | 5 | 98 | |
| Automobile | 5 | 50 | |
| Leased equipment under capital lease * | 3 | 56 | |
| | | 2,026 | |
| Less: accumulated depreciation and amortization | | (1,463) | |
| | | ----- | |
| Property and equipment, net | | \$ 563 | \$ |
| ===== | | | |

* Consists of computer equipment.

6. DEBT OBLIGATIONS

| (In thousands) | September 30, 2005 | December 31, 2004 |
|---|-----------------------|----------------------|
| ----- | | |
| Laurus revolving credit facility note | \$ 618 | \$ - |
| Laurus convertible minimum borrowing note | 500 | - |
| Unamortized debt discount on minimum borrowing note | (484) | - |
| BACC revolving credit facility note | - | 179 |
| Installment purchase note | 42 | 47 |
| Leased equipment under capital lease | 44 | - |
| | | ----- |
| | 720 | 226 |
| Less: debt maturing within one year | (648) | (187) |
| | | ----- |
| Long-term debt obligations | \$ 72 | \$ 39 |
| ===== | | |

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Credit Arrangements:

On March 31, 2005, the Company terminated its \$1.7 million revolving credit facility with Business Alliance Capital Corporation ("BACC"), repaying the outstanding balance and an early-termination fee of \$68,000 on April 1, 2005. On March 31, 2005, the Company entered into a financing transaction with Laurus Master Fund, Ltd., ("Laurus"), providing for a three-year, \$3 million ("Capital Availability Amount") revolving loan credit facility which includes a Secured Revolving Note (the "Revolving Note") and a Secured Convertible Minimum Borrowing Note (together with the Revolving Note, the "Laurus Notes"). The initial Minimum Borrowing Note was set at \$500,000, the proceeds of which were advanced to the Company on April 4, 2005. Amounts outstanding under the Laurus Notes will either be paid in cash at their March 31, 2008

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

The fair value of the Warrant was estimated using the Black-Scholes pricing model with the following assumptions: fair market value of the underlying common stock of \$1.08 per share (which amount represents the closing price of the common stock on the date that the principal terms and conditions of the financing were approved by both parties); zero dividends; expected volatility of 55%; a risk-free interest rate of 3.9% and an expected holding period of 4.5 years. The resulting value of \$186,299, along with a \$117,000 prepaid facility fee, have been recorded in deferred financing costs, and are being amortized to interest expense over the term of the facility. Other direct costs incurred by the Company in the execution of the agreements with Laurus, approximating \$155,000, have also been recorded on the balance sheet under deferred financing costs, and are being amortized to SG&A expense over the term of the facility.

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

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

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Company is additionally 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

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

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Borrowing Note and the Warrant.

As of September 30, 2005, outstanding borrowings with Laurus consisted of \$618,186 under the revolving loan portion of the credit facility and a \$500,000 convertible Minimum Borrowing Note ("MBN"), issued September 2, 2005. The Company has recorded a beneficial conversion premium on the issuance of the MBN in the amount of \$500,000, calculated as the difference between the fixed conversion price of the note (\$1.54) and the market value of the Company's common stock on the date of issuance (\$3.08) times the number of convertible shares (324,675). The beneficial conversion premium has been recorded on the balance sheet as a debt discount and an increase in additional paid-in capital. The debt discount will be amortized to interest expense over the life of the MBN or as the debt is converted to common stock. The unused portion of the credit facility as of September 30, 2005 was \$1,881,814, of which \$1,572,061 was available to borrow. The average and highest amounts borrowed under the Laurus credit facility during the three months ended September 30, 2005 were approximately \$1,124,000 and \$1,606,000, respectively. The average and highest amounts borrowed under all credit facilities during the nine months ended September 30, 2005 were approximately \$721,000 and \$1,640,000, respectively. The Company was in compliance with the provisions of its loan agreement as of September 30, 2005.

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 September 30, 2005 was \$43,855, of which \$21,681 was classified under debt maturing within one year.

Note Payable:

The Company is financing an automobile through a \$50,056, 3.75% note payable to a finance company. The note is payable in 38 monthly installments of \$799, with a final payment of \$24,236 on January 7, 2008. The note balance at September 30, 2005 was \$41,903, of which \$8,154 was classified under debt maturing within one year.

7. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

| (In thousands) | September 30, 2005 | December 31, 2004 |
|--|-----------------------|----------------------|
| Salaries, commissions and benefits | \$316 | \$167 |
| Other | 92 | 75 |
| Accrued expenses and other current liabilities | \$408 | \$242 |

8. RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 123 (revised 2004),

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"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

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to expense the fair value of all share based payments; 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 be required to adopt this standard in its 2006 fiscal year. The Company has not determined the impact, if any, that this statement will have on its consolidated financial position or results of operations.

9. 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 (dollars in thousands except per share amounts):

| | Three months ended September 30, | | Nine months end September 30, | |
|-------|-------------------------------------|------|----------------------------------|------|
| | 2005 | 2004 | 2005 | 2004 |
| ----- | | | | |

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| | | | | |
|--|----------|----------|------------|-------|
| Net loss, as reported | \$ (704) | \$ (175) | \$ (1,816) | \$ (9 |
| Add: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (202) | (10) | (441) | (|
| ----- | ----- | ----- | ----- | ----- |
| Pro forma net loss | (906) | (185) | (2,257) | (9 |
| Pro forma net loss per share: | | | | |
| Basic and diluted | \$ (.26) | \$ (.06) | \$ (.66) | \$ (. |
| ===== | ===== | ===== | ===== | ===== |

The weighted-average fair value of options granted during the three and nine months ended September 30, 2005 was \$1.04 and \$.80, respectively, compared to \$.13 and \$.24, respectively, for the three and nine months ended September 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 50% for 2004; average risk-free interest rate of 3.8% -4.2% for 2005 and 3.1-3.3 % for 2004; and an expected option holding period of 3.5 years for 2005 and 2004.

10. 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

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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

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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.

On October 13, 2005, the Company and Mr. Jean-Marc Stiegemeier, the Company's Chairman, Chief Executive Officer and President executed an agreement modifying the following terms of Mr. Stiegemeier's employment agreement with the Company: (i) the vesting date of 300,000 of the 600,000 options granted in October 2004 was changed to October 1, 2005; and (ii) the use of a Company-leased residential house was extended for an additional year. In addition, Mr. Stiegemeier's Base Salary, as defined, was increased to \$500,000 per annum. These changes were approved by the Company's Compensation Committee and the full Board of Directors, and are effective as of October 1, 2005.

11. 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, 2005 and 2004 are as follows:

| | Three months ended September 30, | | Nine months ended September 30, | |
|-----------------------------|-------------------------------------|------|------------------------------------|------|
| (In thousands) | 2005 | 2004 | 2005 | 2004 |
| Service cost | \$21 | \$20 | \$ 64 | \$60 |
| Interest cost | 12 | 9 | 32 | 26 |
| Recognized actuarial losses | 1 | 2 | 6 | 6 |
| Net expense | \$34 | \$31 | \$102 | \$92 |
| | | | | |

12. SEGMENT INFORMATION

Historically, the Company has operated in a single business segment, selling telecommunications equipment to businesses. During 2005, the Company commenced activities related to the development of a new business segment which, when operational, will provide hosted carrier-based Voice over IP products and related network services to the small-to-medium business marketplace. The hosted VoIP business is currently in the development stage and, accordingly, has not yet generated reportable revenues. Summarized financial information for the Company's reportable business segments for the three and nine months ended September 30, 2005 is presented below. Geographic information is not presented because the Company does not operate outside of the United States. Corporate operating expenses consist primarily of compensation and benefits, costs associated

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with corporate governance and compliance, investor relations, and other shared general expenses not allocated to the business segments.

Business segment information as of and for the three months ended September 30, 2005 is as follows:

| (In thousands) | Telecom- munication Equipment | IP Telephony Services | Corporate | Consol. |
|-------------------------------|-------------------------------------|-----------------------------|-----------|---------|
| Revenues | \$4,807 | \$ - | \$ - | \$4,807 |
| Operating loss | (145) | (243) | (258) | (646) |
| Depreciation and amortization | 24 | 1 | 3 | 28 |
| Property and equipment, net | 236 | 301 | 26 | 563 |
| Capital expenditures | 1 | 301 | - | 302 |

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Business segment information as of and for the nine months ended September 30, 2005 is as follows:

| (In thousands) | Telecom- munication Equipment | IP Telephony Services | Corporate | Consol. |
|-------------------------------|-------------------------------------|-----------------------------|-----------|----------|
| Revenues | \$11,699 | \$ - | \$ - | \$11,699 |
| Operating loss | (469) | (486) | (749) | (1,704) |
| Depreciation and amortization | 69 | 4 | 8 | 81 |
| Property and equipment, net | 236 | 301 | 26 | 563 |
| Capital expenditures | 19 | 301 | - | 320 |

The following table reconciles the totals reported for the operating loss of the segments to the Company's reported loss before income taxes:

| (In thousands) | Three months ended September 30, 2005 | Nine months ended September 30, 2005 |
|--------------------------------|---|--|
| Total segment operating losses | \$ (388) | \$ (955) |
| Unallocated amounts: | | |
| Corporate expenses | (258) | (749) |
| Interest expense | (60) | (111) |

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| | | |
|---------------------------------------|---------|-----------|
| Other income | 3 | 7 |
| | | |
| Consolidated loss before income taxes | \$(703) | \$(1,808) |
| | | |

13. LOSS PER SHARE

Basic loss per share was computed by dividing net loss (the numerator) by the weighted average number of shares of common stock outstanding (the denominator) during the reporting periods. Weighted average outstanding options and warrants to purchase 1,705,576 and 19,385 shares of common stock were not included in the computation of diluted loss per share for the three months ended September 30, 2005 and 2004, respectively, because their inclusion would be antidilutive. Weighted average outstanding options and warrants to purchase 1,159,742 and 36,123 shares of common stock were not included in the computation of diluted loss per share for the nine months ended September 30, 2005 and 2004, respectively, because their inclusion would be antidilutive.

14. SUBSEQUENT EVENTS

On November 2, 2005 the Company filed a Notice of Special meeting and Proxy Statement with the SEC, seeking shareholder approval on the proposed issuance of more than 20% of the Company's outstanding shares of Common Stock in connection with any one or series or combinations of private offerings to investors of the Company's securities, and a secondary offering to the public of Common Stock, in an approximate aggregate amount in the range of \$6,000,000 to \$26,000,000 (exclusive of any securities which may be sold upon exercise of any overallotment options). In connection therewith, on October 31, 2005 the Company entered into an agreement with a leading New York-based investment banking firm, which has agreed on a "best efforts" basis to immediately place private offerings with investors, and to act as the principal underwriter on a "firm commitment" basis for a possible secondary offering to the public of the Company's common stock sometime in 2006. Funds raised will be primarily used to finance the continuing buildout of One IP Voice's IP telephony business.

On November 8, 2005, the Company received notice from the American Stock Exchange ("AMEX") that the Company no longer complies with the AMEX's continued listing standards due to its failure to maintain stockholders' equity of at least \$4 million, which minimum level is required due to its history of losses in three out of its four most recent fiscal years, as set forth in Section 1003 (a) (ii) of the AMEX Company Guide, and that its securities are, therefore, subject to being delisted from the AMEX. The Company was previously granted an eighteen month period to regain compliance with this standard, and such compliance period ended as of November 7, 2005.

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The foregoing determination by the AMEX staff was made subsequent to the Company's update and submission of the Company's plan for upcoming private offerings of its securities to investors for which the Company had requested a ninety (90) day extension from November 7, 2005 in order to complete the offerings and regain compliance with the AMEX continued listing requirements. Such update and submission to AMEX included the Notice of the Special Meeting of the Stockholders and Proxy Statement to approve such transactions which have been filed with the SEC as Schedule 14A on November 2, 2005, an engagement agreement dated October 31, 2005

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with an investment banking firm, which agreed to be the lead placement agent for the private offerings on a "best efforts" basis and to be the managing underwriter for a possible secondary public offering of common stock on a "firm-commitment" basis planned for sometime in 2006, and a detailed timetable to consummate the private offerings and regain compliance.

According to the AMEX notice, the Company must appeal by November 16, 2005, or the AMEX staff determination will become final. AMEX staff will suspend trading in the Company's securities and submit an application to the SEC to strike the Company's common stock from listing and registration on the AMEX in accordance with the Securities Exchange Act of 1934, as amended, and the rules promulgated thereunder.

The Company plans to appeal this determination by the AMEX staff and to request a hearing before an AMEX panel (the "Panel"). The time and place of such a hearing will be determined by the Panel. There can be no assurance that the Panel would grant the relief sought by the Company or, even if it does, the Company will be able to implement its plan of compliance consistent with the relief sought. If the Panel does not grant the relief sought by the Company, its securities would be de-listed from the AMEX. In that event, the Company would also seek quotation of its securities on the OTC Bulletin Board.

The Company fully intends to pursue stockholders' approval and complete the transactions contemplated in the filed Schedule 14A. The Company believes that the completion of the private offerings described in the Schedule 14A will put the Company back in compliance with the AMEX continued listing requirement for stockholders' equity. If the Company is able to regain compliance anytime between now and the hearing with AMEX staff, the de-listing process would be withdrawn. The contemplated private and secondary public offerings are also intended to raise additional capital for the Company to use in the continuing buildout of its One IP Voice, Inc. IP telephony business.

The Company disclosed its previous AMEX notice and circumstances relating to its current listing deficiency in its previous filings with the SEC starting with Current Report on Form 8-K filed with the SEC on July 23, 2004 and last disclosed on the Proxy Statement on Schedule 14A filed with the SEC on November 2, 2005.

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

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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.

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RESULTS OF OPERATIONS

Overview

For the three months ended September 30, 2005, we reported a net loss of \$704,000 or \$.20 per share on revenues of \$4,807,000. This compares with a net loss of \$175,000 or \$.05 per share on revenues of \$3,338,000 recorded for the three months ended September 30, 2004. For the nine months ended September 30, 2005, we reported a net loss of \$1,816,000 or \$.53 per share on revenues of \$11,699,000. This compares with a net loss of \$930,000 or \$.28 per share on revenues of \$9,633,000 recorded for the nine months ended September 30, 2004. The operating results for the three and nine month periods of 2005 include losses of approximately \$243,000 and \$486,000, respectively, attributed to our new business entity One IP Voice, Inc. as further described below. The net loss for the nine month period of 2005 also includes one-time expenses aggregating \$84,000 incurred in connection with the termination of our credit facility with Business Alliance Capital Corporation.

There continues to be intense competition in the market areas that we serve, particularly with our larger, "Enterprise" customers. This has particularly been the case in the aftermarket parts business in which, over the last several years, the Company has experienced significant sales price erosion, as aftermarket parts have become more of a commodity and subject to "price shopping" by customers. 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 current business strategy is to transition to a full communications solutions provider, becoming less dependent on equipment sales, and developing more sources of recurring revenues, such as through installation and maintenance services. These efforts to date have resulted in increased revenues in 2005 as compared to 2004.

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 by the beginning of 2006, will offer carrier-based hosted IP telephony services along with network services. Its primary target will be the small-to-medium size business ("SMB") market. In order to finance its business expansion plans, effective March 31, 2005 the Company entered into a \$3 million credit arrangement with a new lender, replacing a \$1.7 million credit facility with Business Alliance Capital Corporation. The Company has also engaged the services of an investment banking firm to assist the Company in raising additional capital needed to continue the build out and national deployment of its IP telephony products and services. For additional information on our financial resources, refer to Note 6, "Debt Obligations", Note 14, "Subsequent Events" and the "Liquidity

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and Capital Resources" section which follows.

Additional information on our results of operations and financial condition for the three and nine months ended September 30, 2005 follows below.

Revenues

| (In thousands) | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|---------|------------------------------------|---------|
| | 2005 | 2004 | 2005 | 2004 |
| <hr style="border-top: 1px dashed black;"/> | | | | |
| Equipment: | | | | |
| End-user equipment sales | \$3,739 | \$2,356 | \$ 9,273 | \$7,391 |
| Equipment sales to resellers | 151 | 611 | 305 | 1,082 |
| <hr style="border-top: 1px dashed black;"/> | | | | |
| Total equipment sales | 3,890 | 2,967 | 9,578 | 8,473 |
| <hr style="border-top: 1px dashed black;"/> | | | | |
| Services: | | | | |
| Installations | 652 | 262 | 1,311 | 782 |
| Rentals, repair and other | 12 | 48 | 60 | 119 |
| Other revenue | 253 | 61 | 750 | 259 |
| <hr style="border-top: 1px dashed black;"/> | | | | |
| Total services and other revenue | 917 | 371 | 2,121 | 1,160 |
| <hr style="border-top: 1px dashed black;"/> | | | | |
| Consolidated revenues | \$4,807 | \$3,338 | \$11,699 | \$9,633 |
| <hr style="border-top: 1px solid black;"/> | | | | |

Equipment Sales. Total equipment sales for the three months ended September 30, 2005, were \$3,890,000, an increase of \$923,000 or 31% from the comparable 2004 period. The increase consisted of a \$1,383,000 increase in end-user sales, less a \$460,000 decrease in equipment sales to resellers ("wholesale sales"). The increase in end-user sales was attributable to a \$2,029,000 or 308% increase in system sales less a \$646,000 or 38% decrease in parts sales. Total equipment sales for

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the nine months ended September 30, 2005, were \$9,578,000, an increase of \$1,105,000 or 13% from the comparable 2004 period. The increase consisted of a \$1,882,000 increase in end-user sales, less a \$777,000 decrease in wholesale sales. The increase in end-user sales was attributable to a \$2,875,000 or 125% increase in system sales, partly offset by a \$993,000 or 20% decline in parts sales. During 2005, we continued a strategy of diversifying our product offerings by marketing the sale of complete telecommunications systems to our customer base. In March 2005, we significantly expanded our sales force and began targeting the SMB marketplace, which is primarily oriented towards systems sales. Other factors affecting end-user equipment sales for 2005 have previously been described in the "Overview" section above. Wholesale sales have been impacted by some of the same factors which affected end user sales and our shift in emphasis to new system sales.

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Service revenues for the three months ended September 30, 2005 were \$664,000, an increase of \$354,000 or 114% from the comparable 2004 period. Service revenues for the nine months ended September 30, 2005 were \$1,371,000, an increase of \$470,000 or 52% from the comparable 2004 period. The increases in each period were attributable to installation services which have increased due to the increases in system sales. An increase or decrease in installation revenues, however, does not always coincide with the reported increase or decrease in system sales since installations may occur in different periods than the related system sale.

Other revenue for the three months ended September 30, 2005 was \$253,000, an increase of \$192,000 or 315% from the comparable 2004 period. Other revenue for the nine months ended September 30, 2005 was \$750,000, an increase of \$491,000 or 190% from the comparable 2004 period. The increase in each period was attributable to higher commissions earned on Avaya maintenance contract sales. In the sale of Avaya maintenance contracts, the Company receives a one-time commission, and all of the equipment service obligations are borne entirely by Avaya.

The Company expects to begin marketing its One IP Voice product offerings to businesses in the first quarter of 2006.

Cost of Revenues and Gross Profit. Total cost of revenues for the three months ended September 30, 2005 was \$3,568,000, an increase of \$1,034,000 or 41% from the comparable 2004 period. The gross profit for the three months ended September 30, 2005 was \$1,239,000, an increase of \$435,000 or 54% from the comparable 2004 period. As a percentage of revenue, the overall gross profit margin was 26% for the three months ended September 30, 2005, compared to 24% for the comparable 2004 period.

Total cost of revenues for the nine months ended September 30, 2005 was \$8,370,000, an increase of \$1,022,000, or 14% from the comparable 2004 period. The gross profit for the nine months ended September 30, 2005 was \$3,329,000 an increase of \$1,044,000 or 46% from the comparable 2004 period. As a percentage of revenue, the overall gross profit margin was 29% for the nine months ended September 30, 2005, compared to 24% for the comparable 2004 period.

In general, our gross profit margins are dependent upon a variety of factors including (1) product mix - gross margins can vary significantly among parts sales, system sales and our various service offerings. The parts business, for example, involves hundreds of parts that generate significantly varying gross profit margins depending upon their availability, competition, and demand conditions in the marketplace; (2) customer mix - we sell parts to both end-users and to other equipment resellers. Our larger "Enterprise" companies often receive significant purchase discounts from Avaya, which could cause us to accept lower gross margins as we compete against Avaya directly for this business; (3) the level and amount of vendor discounts and purchase rebates available to us from Avaya and its master distributors; (4) capacity - as sales volume rises or falls, overhead costs, consisting primarily of product handling, purchasing, and facility costs, can become a lower or higher percentage of sales dollars; (5) competitive pressures - as a result of the slowdown in capital equipment spending in our industry, and the large number of Avaya dealers nationwide, we have been faced with increased price competition; and (6) obsolescence charges. The combined effect of all of these factors could result in varying gross profit margins from period to period.

Gross Profit Margins on Equipment Sales. For the three months ended September 30, 2005, the gross profit margin on equipment sales decreased to 26% from 27% in 2004. For the nine months ended September 30, 2005, the gross profit margin on equipment sales increased to 28% from 27% in 2004.

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The gross profit margin for the 2004 period was negatively impacted by an increase in obsolescence reserves, and by the payment of license fees to Avaya, under a program which terminated in June 2004. Excluding the effects of these items, the gross profit margin on equipment sales for the nine months ended September 30, 2004 would have been 29%. As compared to the prior year periods, the Company experienced a decline in the gross profit margins generated by the sale of aftermarket parts. This is attributable to the fact that the parts business has become more of a "commodity" business and less of a "value-added" business. It has therefore become more prone to price-shopping by customers, who are tending more towards awarding contracts to the lowest bidder. The impact of

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a reduced parts business however, has been offset by significantly higher sales of systems at improved profit margins from 2004. We expect continued pressure on our equipment profit margins going forward, particularly in the sale of aftermarket parts, due to continuing price competition.

Gross Profit Margins on Services and Other Revenue. For the three months ended September 30, 2005, the Company realized an overall 38% profit margin on its combined service and other revenues, compared to 31% recorded in 2004. For the nine months ended September 30, 2005, the Company realized an overall 47% profit margin on its combined service and other revenues, compared to 38% recorded in 2004. The profit margin increase in each period was attributable to significantly higher commission revenues earned from the sale of Avaya maintenance contracts, which generate a 100% profit margin.

Other Cost of Revenues. Other cost of revenues consists of product handling, purchasing and facility costs and expenses. For the three months ended September 30, 2005, these expenses were 4% lower than 2004, and represented approximately 3% of 2005 equipment sales revenues, compared to 4% of 2004 equipment sales revenues. For the nine months ended September 30, 2005, these expenses were 24% lower than 2004, and represented approximately 4% of 2005 equipment sales revenues, compared to 5% of 2004 equipment sales revenues. The reduction in other cost of revenues primarily resulted from lower personnel levels and other overhead costs.

Selling, General and Administrative ("SG&A") Expenses. SG&A expenses for the three months ended September 30, 2005 were \$1,885,000, an increase of \$905,000 or 92% from the comparable 2004 period. SG&A expenses for the three months ended September 30, 2005 were 39% of revenues, compared to 29% of revenues in 2004. SG&A expenses for the nine months ended September 30, 2005 were \$5,033,000, an increase of \$1,833,000 or 57% from the comparable 2004 period. SG&A expenses for the nine months ended September 30, 2005 were 43% of revenues, compared to 33% of revenues in 2004. Approximately 90% of the increase in SG&A in each period was attributable to increased personnel levels, including compensation and benefits, recruiting fees, and incremental office and travel expenses.

As a part of the Company's turnaround plan, it hired a new President and CEO in October 2004, and two Executive Vice Presidents - one responsible for operations (hired in January 2005) and one responsible for sales (hired in March 2005). In addition, during March 2005 the Company significantly increased its sales and sales support group and launched an initiative to market its products and services to the SMB marketplace.

Included in SG&A expense for the three and nine months ended

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September 30, 2005 were \$243,000 and \$486,000 of expenses related to the formation of One IP Voice, Inc. and the development of an IP telephony services business segment. The expenses consisted primarily of compensation, consulting, marketing, training and office expenses, as the Company began the process of hiring its management and support teams and developing its product offerings and marketing materials.

In connection with the replacement of the BACC credit facility with the Laurus credit facility, the Company incurred in March 2005 one-time expenses totaling \$84,000, consisting of a \$68,000 early termination fee, and a \$16,000 charge to write-off of the remaining balance of its annual loan commitment fee with BACC. In addition, as of September 30, 2005 the Company had incurred \$155,000 of direct costs associated with the acquisition of the Laurus credit facility. These costs are included in deferred financing costs on the balance sheet and are being amortized to SG&A expense over the term of the facility. As of September 30, 2005 approximately \$23,000 has been amortized.

We expect our SG&A expenses to increase as we continue the infrastructure development and deployment of our One IP Voice product offerings.

Interest Expense. Interest expense for the three months ended September 30, 2005 was \$60,000, compared with \$7,000 for 2004. Interest expense for the nine months ended September 30, 2005 was \$111,000, compared with \$19,000 for 2004. Included in interest expense for the three and nine months of 2005 is \$25,000 and \$51,000 respectively, representing the amortization of a portion of deferred financing costs incurred in connection with the acquisition of the Laurus credit facility, as further described in Note 6. These costs, consisting of a \$117,000 facility fee and a \$186,299 value ascribed to the warrants issued to Laurus, are being amortized to interest expense over the three-year term of the facility. Interest expense for the three and nine months of 2005 also includes \$16,000 from the amortization of the \$500,000 beneficial conversion feature, recorded as debt discount on the balance sheet, in connection with the September issuance of a \$500,000 convertible note payable to Laurus. The debt discount will be amortized to interest expense over the life of the note or on a more accelerated basis as the debt is converted to common stock. The increase in interest expense was also attributable to higher average borrowing levels and higher borrowing rates.

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Other Income. Other income for all periods presented consisted of interest earned on invested cash.

Provision for Income Taxes. The provision for income taxes represents estimated minimum state taxes in all reported periods. We maintain a full valuation allowance against our net deferred tax assets, which consist primarily of net operating loss and capital loss carryforwards, and timing differences between the book and tax treatment of inventory and other asset valuations. Realization of these net deferred tax assets is dependent upon our ability to generate future taxable income.

LIQUIDITY AND CAPITAL RESOURCES

Working capital, defined as current assets less current liabilities, was \$1,058,000 at September 30, 2005, compared to \$2,136,000 at December 31, 2004. The working capital ratio was 1.3 to 1 at September 30, 2005, compared to 2.4 to 1 at December 31, 2004. Operating activities used

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\$958,000 during the nine months ended September 30, 2005, compared to the use of \$906,000 in the comparable 2004 period. Net cash used by operating activities in 2005 consisted of a net loss of \$1,816,000 less non-cash items of \$329,000, and net cash generated by changes in operating assets and liabilities of \$529,000. The increase in our accounts receivable was primarily attributable to significant growth in our systems sales revenues over the prior year period, for which the cash receipts cycle is longer than for parts sales since there is typically an installation requirement to be completed prior to full payment.

Investing activities used \$320,000 during the nine months ended September 30, 2005, compared to \$25,000 in 2004. Net cash used by investing activities in 2005 and 2004 consisted of capital expenditures. Capital expenditures during 2005 were principally for the purchase of network equipment and licenses in connection with the build out of an IP telephony platform for our One IP Voice ("OIPV") subsidiary, and computer and office equipment to support our expanded personnel levels. Pursuant to our loan agreement with Laurus, we may obtain external financing on capital expenditures up to \$500,000 in any fiscal year period before requiring Laurus's prior approval.

Financing activities provided \$1,247,000 during the nine months ended September 30, 2005 principally from borrowings under our revolving credit lines and a convertible note, net of related costs incurred. On March 31, 2005, we terminated our \$1.7 million revolving credit facility with BACC, repaying the outstanding balance on April 1, 2005, and entered into a financing transaction with Laurus Master Fund, Ltd., ("Laurus"), providing for a three-year, \$3 million revolving loan credit facility. Refer to Note 6, "Debt Obligations", of the Notes to Consolidated Financial Statements included herein for further information on the principal terms and conditions of this financing transaction.

Our ability to provide cash to satisfy working capital requirements continues to be dependent upon generating positive cash flow from operations and upon formula borrowings under our revolving credit facility. Historically, our working capital borrowings have increased during periods of revenue growth. This is because our cash receipts cycle is longer than our cash disbursements cycle. As our revenues from systems sales increases, the cash receipts cycle may lengthen, unless we can consistently negotiate up-front deposits and progress payments under our systems sales contracts. In addition, our working capital requirements are expected to significantly increase as we continue the build out of the infrastructure of capital equipment, systems and personnel required to deploy our hosted VoIP service offerings through OIPV.

On October 31, 2005, we engaged the services of an investment banking firm to assist the Company in raising additional capital. In order to raise the capital required for the continuing buildout of OIPV and regain compliance with the AMEX's minimum stockholders' equity requirement so as to maintain the Company's listing on AMEX, the board of directors of the Company has approved, subject to stockholders' approval, one or a series or combination of private offerings to investors of the Company's Securities, and a secondary offering to the public of Common Stock, said shares currently intended to be offered to the public in a firm commitment underwriting sometime during 2006. The aggregate amount sought out by the Company is anticipated to be in range of approximately \$6,000,000 to \$26,000,000 (exclusive of any securities which may be sold upon exercise of any overallotment options).

No assurances can be given that we will be successful in completing the above-referenced financing transactions, since they are dependent upon, among other factors, obtaining shareholder approval and the market

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conditions prevailing during the offering periods. In order to obtain such additional financing, we may also need to demonstrate improved operating performance.

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CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

RISKS, UNCERTAINTIES AND OTHER FACTORS THAT MAY AFFECT FUTURE RESULTS

The discussion included in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2004 under the subheading "Risks, Uncertainties and Other Factors That May Affect Future Results" is still considered current and applicable, and is hereby incorporated into this Quarterly Report on Form 10-Q, along with the following update:

We could be delisted by the American Stock Exchange.

As previously stated in prior filings, on May 7, 2004 we received notice from the Amex that we did not meet certain of the Amex's continued listing standards as a result of having stockholders' equity less than \$4 million and net losses in three out of our four most recent fiscal years, as set forth in Section 1003 (a) (ii) of the Amex Company Guide. We were afforded the opportunity to submit a plan of compliance to the Amex and, on June 15, 2004, presented our plan. On July 19, 2004 the Amex notified us that it accepted our plan of compliance and granted us an extension until November 7, 2005 to regain compliance with the continued listing standard related to minimum stockholders' equity.

On November 8, 2005, the Company received notice from the American Stock Exchange ("AMEX") that the Company no longer complies with the AMEX's continued listing standards due to its failure to maintain stockholders' equity of at least \$4 million, as set forth in Section 1003 (a) (ii) of the AMEX Company Guide, and that its securities are, therefore, subject to being delisted from the AMEX

The Company plans to appeal this determination by the AMEX staff and to request a hearing before an AMEX panel (the "Panel"). The time and place of such a hearing will be determined by the Panel. There can be no assurance that the Panel would grant a relief sought by the Company or, even if it does, the Company will be able to implement its plan of compliance consistent with the relief sought. If the Panel does not grant the relief sought by the Company, its securities would be de-listed from the AMEX. In that event, the Company would seek quotation of its securities on the OTC Bulletin Board.

Whether or not the Amex grants us an extension, if we are unable to close one or more financing transactions prior to the end of any applicable appeal period or extension period, we will be delisted. Additionally, if we fail to receive stockholder approval of our financing proposals at our December 16, 2005 Special Meeting of Stockholders, we would be unable to list any of the shares of common stock potentially issuable pursuant to those proposals, which may affect our ability to attract investors. For further information related to our delisting notification and our financing

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plans, please refer to Note 14, Subsequent Events, contained herein.

The following additional risk factors are attributable to the business activities of the Company's newly-formed subsidiary, One IP Voice ("OIPV"):

WE INTEND TO PURSUE A NEW BUSINESS DIRECTION - THE MARKETING OF CARRIER-BASED, HOSTED VOIP PRODUCTS AND RELATED NETWORK SERVICES - WHICH MAY NOT BE PROFITABLE.

Since the beginning of 2005, we have been devoting significant management and capital resources to the development of this business, and we expect to continue to do so; however we cannot provide assurance that this new business venture will be profitable. Our business model is still being developed, and it has not yet been proven out. There is also no guarantee that we will be successful in generating significant revenues from future sales of our planned IP products and services. If we are not able to generate significant revenues selling into the VoIP telephony market, our business and operating results would be seriously harmed.

WE CURRENTLY HAVE LIMITED CASH RESOURCES, AND WE MAY NOT BE SUCCESSFUL IN FINANCING THE BUILDOUT OF OUR NEW BUSINESS VENTURE

Please refer to the discussion above under Liquidity and Capital Resources. As discussed in this section, our cash needs are expected to significantly increase as we continue the buildout of OIPV and the deployment of its products. It has become necessary to seek out external financing sources in order to raise capital, since our core business does not generate sufficient

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cash to meet the projected short-term cash requirements of OIPV. In the event that we are unable to obtain sufficient external funding for this project, we may be unable to complete the buildout of the OIPV business as currently planned.

THE SUCCESS OF OUR NEW BUSINESS VENTURE IS DEPENDENT ON THE GROWTH AND PUBLIC ACCEPTANCE OF VOIP TELEPHONY PRODUCTS AND SERVICES.

As we enter this emerging marketplace, we will be dependent upon future demand for VoIP telephony systems and services. In order for the IP telephony market to continue to grow, several things need to occur. Telephony service providers must continue to invest in the deployment of high speed broadband networks to residential and business customers. VoIP networks must improve quality of service for real-time communications, managing effects such as packet jitter, packet loss, and unreliable bandwidth, so that toll-quality service can be provided. VoIP telephony equipment and services must achieve a similar level of reliability that users of the public switched telephone network have come to expect from their telephone service. VoIP telephony service providers such as ourselves must offer cost and feature benefits that are sufficient to cause customers to switch away from traditional telephony service providers. Furthermore, end users in markets serviced by recently deregulated telecommunications providers are not familiar with obtaining services from competitors of these providers and may be reluctant to use new providers, such as ourselves. We will need to devote substantial resources to educate customers and end users about the benefits of VoIP telephony solutions in general and our services in particular. If any or all of these factors fail to occur, our business may decline.

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THE VoIP TELEPHONY MARKET IS SUBJECT TO RAPID TECHNOLOGICAL CHANGE AND WE WILL DEPEND ON NEW PRODUCT AND SERVICE INTRODUCTIONS IN ORDER TO ESTABLISH, MAINTAIN AND GROW OUR BUSINESS.

VoIP telephony is an emerging market that is characterized by rapid changes in customer requirements, frequent introductions of new and enhanced products, and continuing and rapid technological advancement. To compete successfully in this emerging market, we will have to offer VoIP telephony products and services that will incorporate the latest technological advancements in features, performance and cost-effectiveness, and respond to changing customer requirements.

DECREASING TELECOMMUNICATIONS RATES MAY DIMINISH OR ELIMINATE OUR PLANNED COMPETITIVE PRICING STRUCTURE.

Decreasing telecommunications rates may diminish or eliminate the competitive pricing structure of our services. Telecommunications rates have decreased significantly over the last few years in most of the markets in which we intend to operate, and we anticipate that rates will continue to be reduced. Users who select our services to take advantage of the current pricing differential between traditional telecommunications rates and our rates may switch to traditional telecommunications carriers as such pricing differentials diminish or disappear, and we will be unable to use such pricing differentials to attract new customers in the future. Continued rate decreases would require us to lower our rates to remain competitive and adversely impact our profit margins.

OUR SUCCESS WILL DEPEND ON THIRD PARTIES IN OUR PLANNED DISTRIBUTION CHANNELS.

We plan to sell our products primarily through resellers, and we are focusing our business development efforts on establishing distribution channels. Our planned revenues and future growth will depend in large part on sales of our products through reseller and other distribution relationships. We may not be successful in developing distribution relationships. Agreements with distribution partners may not require minimum purchases or restrict development or distribution of competitive products. In addition, distributors and resellers may not dedicate sufficient resources or give sufficient priority to selling our products. Our failure to develop distribution channels, the loss of a distribution relationship or a decline in the efforts of a material reseller or distributor could have a material adverse effect on our business, financial condition or results of operations.

WE WILL NEED TO ATTRACT AND RETAIN KEY PERSONNEL TO SUPPORT OUR PRODUCTS AND ONGOING OPERATIONS.

To date, we have been successful in hiring certain key business development and technical management personnel; however the continuing build out of our business plan requires the hiring of other key marketing, engineering, customer service and administrative personnel. Our future success depends upon the continued services of our executive officers and other key employees who have critical industry experience and relationships that we rely on to implement our business plan. The loss of the services of any of our officers or key employees could delay the development of OIPV and its products and services, and negatively impact our financial results and impair our growth.

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WE WILL RELY ON THIRD PARTY NETWORK SERVICE PROVIDERS TO ORIGINATE AND TERMINATE SUBSTANTIALLY ALL OF OUR PUBLIC SWITCHED TELEPHONE NETWORK CALLS.

We will depend on the availability of third party network service providers that provide telephone numbers and public switched telephone network (PSTN) call termination and origination services for our future IP telephony customers. Many of these network service providers have been affected by the downturn in the telecommunications industry and may be forced to terminate the services that we will depend on. The time to interface our technology to another network service provider, if available, and qualify this new service could have a material adverse effect on our business, operating results or financial condition.

THE FAILURE OF IP NETWORKS TO MEET THE RELIABILITY AND QUALITY STANDARDS REQUIRED FOR VOICE AND VIDEO COMMUNICATIONS COULD RENDER OUR PRODUCTS OBSOLETE.

Circuit-switched telephony networks feature very high reliability, with a guaranteed quality of service. In addition, such networks have imperceptible delay and consistently satisfactory audio quality. Emerging broadband IP networks, such as LANs, WANs, and the Internet, or emerging last mile technologies such as cable, digital subscriber lines, and wireless local loop, may not be suitable for telephony unless such networks and technologies can provide reliability and quality consistent with these standards.

FUTURE LEGISLATION OR REGULATION OF THE INTERNET AND/OR VOICE AND VIDEO OVER IP SERVICES COULD RESTRICT OUR BUSINESS, PREVENT US FROM OFFERING SERVICE OR INCREASE OUR COST OF DOING BUSINESS.

At present there are few laws, regulations or rulings that specifically address access to commerce and communications services on the Internet, including IP telephony. We are unable to predict the impact, if any, that future legislation, legal decisions or regulations concerning the Internet may have on our business, financial condition, and results of operations. Regulation may be targeted towards, among other things, assessing access or settlement charges, imposing taxes related to internet communications and imposing tariffs or regulations based on encryption concerns or the characteristics and quality of products and services, any of which could restrict our business or increase our cost of doing business. The increasing growth of the broadband IP telephony market and popularity of broadband IP telephony products and services heighten the risk that governments or other legislative bodies will seek to regulate broadband IP telephony and the Internet. In addition, large, established telecommunication companies may devote substantial lobbying efforts to influence the regulation of the broadband IP telephony market, which may be contrary to our interests.

POTENTIAL REGULATION OF INTERNET SERVICE PROVIDERS COULD ADVERSELY AFFECT OUR OPERATIONS.

To date, the FCC has treated Internet service providers as information service providers. Information service providers are currently exempt from federal and state regulations governing common carriers, including the obligation to pay access charges and contribute to the universal service fund. The FCC is currently examining the status of Internet service providers and the services they provide. If the FCC were to determine that Internet service providers, or the services they provide, are subject to FCC regulation, including the payment of access charges and contribution to the universal service funds, it could have a material

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adverse effect on our business, financial condition and operating results.

THERE MAY BE RISKS ASSOCIATED WITH 911 EMERGENCY DIALING.

On June 3, 2005 the Commission released the VoIP 911 Order adopting rules that require interconnected VoIP providers to provide their new and existing subscribers with 911 service no later than November 28, 2005. Specifically, as a condition of providing interconnected VoIP service, each interconnected VoIP provider must, in addition to satisfying the subscriber notification, acknowledgment, and labeling requirements set forth in section 9.5(e) of the Commission's rules:

* Transmit all 911 calls to the public safety answering point (PSAP), designated statewide default answering point, or appropriate local emergency authority that serves the caller's "Registered Location (An end-user's "Registered Location" is the most recent information obtained by an interconnected VoIP service provider that identifies the physical location of the end-user)." Such transmissions must include the caller's Automatic Numbering Information ("ANI", which is a system that identifies the billing account for a call and, for 911 systems, identifies the calling party and may be used as a call back number) and Registered Location to the extent that the PSAP, designated statewide default answering point, or appropriate local emergency authority is capable of receiving and processing such information;

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* Route all 911 calls through the use of ANI and, if necessary, pseudo-ANI (a "pseudo-ANI" is a number, consisting of the same number of digits as ANI, that is not a North American Numbering Plan telephone directory number and may be used in place of an ANI to convey special meaning. The special meaning assigned to the pseudo-ANI is determined by agreements, as necessary, between the system originating the call, intermediate systems handling and routing the call, and the destination system) via the Wireline E911 Network (The "Wireline E911 Network" is a dedicated wireline network that: (1) is interconnected with but largely separate from the public switched telephone network; (2) includes a selective router; and (3) is utilized to route designated statewide default answering point or appropriate local emergency authority from or through the appropriate Automatic Location Identification database), and make a caller's Registered Location available to the appropriate PSAP;

* Obtain from each of its existing and new customers, prior to the initiation of service, a Registered Location; and

* Provide all of their end users one or more methods of updating their Registered Location at will and in a timely manner. At least one method must allow end users to use only the same equipment (such as the Internet telephone) that they use to access their interconnected VoIP service.

We currently have no subscribers, as we are still in the process of developing and deploying our VoIP platform. However, we intend to comply with all current rules and regulations provided by the FCC in regards to 911/E911 services prior to the initiation of service to subscribers.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The discussion included in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2004, "Quantitative and Qualitative Disclosures

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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 Securities 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 Securities and Exchange Commission's rules and forms.

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

PART II. OTHER INFORMATION.

ITEM 1. LEGAL PROCEEDINGS

None.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

The proposals voted upon at the Company's Annual Meeting of Stockholders, held July 14, 2005, along with the voting results, were as follows:

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

| Nominees | Votes For | Votes Withheld |
|-----------------------|--------------|-------------------|
| ----- | ----- | ----- |
| Jean-Marc Stiegemeier | 3,208,981 | 41,071 |
| George J. Taylor, Jr. | 3,188,401 | 61,651 |
| Harold L. Hanson | 3,207,714 | 42,338 |
| Hugh M Taylor | 3,205,551 | 44,501 |
| Joseph J. Kelley | 3,208,534 | 41,518 |
| Ronald P. Pettirossi | 3,212,658 | 37,394 |

- (2) Ratification of the appointment of Carlin, Charron & Rosen LLP as independent auditors of the Company for the year ending December 31, 2005: The proposal was approved with 3,197,907 votes for, 40,840 votes against and 11,305 abstentions.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS:

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

- 31.1 Certification of the Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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 14, 2005

/s/ Jean-Marc Stiegemeier

Jean-Marc Stiegemeier

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Chief Executive Officer, President

Dated: November 14, 2005

/s/ Robert G. LaVigne

Robert G. LaVigne
Executive Vice President,
Chief Financial Officer