FARMSTEAD TELEPHONE GROUP INC
Form 10-Q
August 11, 2005

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 June 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 [X] No [ ]

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

As of July 31, 2005, the registrant had 3,352,730 shares of its $0.001 par value Common Stock outstanding.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED BALANCE SHEETS

(In thousands)	June 30, 2005	December 31 200
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 390	$ 21
Accounts receivable, net	3,467	1,45
Inventories, net	1,429	1,62
Other current assets	101	37

Total Current Assets	5,387	3,67
Property and equipment, net	289	26
Deferred financing costs (Note 7)	407	
Other assets	107	10
Total Assets	$ 6,190	$ 4,05
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 2,674	$ 1,11
Debt maturing within one year (Note 7)	981	18
Accrued expenses and other current liabilities	342	24
Total Current Liabilities	3,997	1,53
Postretirement benefit obligation	656	59
Long-term debt (Note 7)	562	3
Total Liabilities	5,215	2,17
Commitments and contingencies (Note 11)		
Stockholders' Equity:		
Preferred stock, $0.001 par value; 2,000,000 shares authorized; no shares issued and outstanding	-	
Common stock, $0.001 par value; 30,000,000 shares authorized; 3,352,730 and 3,322,182 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively	3	
Additional paid-in capital	12,523	12,32
Accumulated deficit	(11,532)	(10,42
Accumulated other comprehensive loss	(19)	(2
Total Stockholders' Equity	975	1,87
Total Liabilities and Stockholders' Equity	$ 6,190	$ 4,05

See accompanying notes to consolidated financial statements.

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
(In thousands, except loss per share amounts)	2005	2004	2005	2004

Revenues:				
Equipment	$3,723	$2,584	$ 5,688	$5,506
Services and other revenue	760	305	1,204	789
Total revenues	4,483	2,889	6,892	6,295
Cost of Revenues:				
Equipment	2,695	1,970	4,014	4,016
Services and other revenue	321	189	555	461
Other cost of revenues	131	126	233	337
Total cost of revenues	3,147	2,285	4,802	4,814
Gross profit	1,336	604	2,090	1,481
Selling, general and administrative expenses	1,765	1,010	3,148	2,220
Operating loss	(429)	(406)	(1,058)	(739)
Interest expense	(43)	(6)	(51)	(12)
Other income	1	1	4	2
Loss before income taxes	(471)	(411)	(1,105)	(749)
Provision for income taxes	3	3	7	6
Net loss	$ (474)	$ (414)	$(1,112)	$ (755)
Basic and diluted net loss per common share:	$ (.14)	$ (.12)	$ (.33)	$ (.23)
Weighted average common shares outstanding:				
Basic and diluted	3,353	3,316	3,340	3,314

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

(In thousands)	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accum-ulated Deficit	Accumu Comprehe
Balance at December 31, 2004	3,322	$3	$12,320	$(10,420)	
Net loss	-	-	-	(1,112)	
Amortization of pension liability adjustment	-	-	-	-	
Comprehensive loss					
Issuance of warrants	-	-	186	-	
Issuance of common stock	31	-	17	-	
Balance at June 30, 2005	3,353	$3	$12,523	$(11,532)	

See accompanying notes to consolidated financial statements.

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

(In thousands)	2005	2004
Cash flows from operating activities:		
Net loss	$(1,112)	$(755)
Adjustments to reconcile net loss to net cash flows used in operating activities:		
Provision for doubtful accounts receivable	18	18
Provision for losses on inventories	18	68
Depreciation and amortization of property and equipment	53	73
Amortization of deferred financing costs	36	-
Decrease in accumulated other comprehensive loss	5	4
Increase in accrued postretirement benefit obligation	63	57
Changes in operating assets and liabilities:		
Increase in accounts receivable	(2,032)	(119)
Decrease (increase) in inventories	180	(245)
Decrease in other assets	277	7
Increase in accounts payable	1,564	5
Increase in accrued expenses and other current liabilities	100	174
Net cash used in operating activities	(830)	(713)
Cash flows from investing activities:		
Purchases of property and equipment	(18)	(23)
Net cash used in investing activities	(18)	(23)
Cash flows from financing activities:		
Borrowings under revolving credit line and minimum borrowing note	1,271	218
Increase in deferred financing costs	(257)	-
Proceeds from issuance of common stock	17	2
Repayments of long-term debt	(10)	-
Net cash provided by financing activities	1,021	220
Net increase (decrease) in cash and cash equivalents	173	(516)
Cash and cash equivalents at beginning of period	217	827
Cash and cash equivalents at end of period	$ 390	$ 311
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 20	$ 14
Income taxes	2	4
Non-cash financing and investing activities:		
Purchase of equipment under capital lease	56	-
Value of warrant issued 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 June 30, 2005 and for the three and six months ended June 30, 2005 and 2004 have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission for interim financial statements. In the Company's opinion, the unaudited interim consolidated financial statements and accompanying notes reflect all adjustments, consisting of normal and recurring adjustments 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 $474,000 and $1,112,000 for the three and six months ended June 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. The business strategy is to transition to a full communications solutions provider, becoming less dependent on parts sales, and developing more sources of recurring revenues, such as through installation and maintenance services. As a part of the turnaround plan, the Company hired a new President and CEO in October 2004, and two Executive Vice Presidents - one responsible for operations (hired in January 2005) and one responsible for sales (hired in March 2005). In March, the Company significantly expanded its sales infrastructure and opportunities, first by the hiring of twenty three sales and sales support professionals formerly employed by Avaya Inc., and second by entering into a trial agreement with Avaya to provide products and services to the SMB ("small-to-medium sized business") market which commenced in March with the launch of a nationwide SMB sales program. By the end of June 2005, the Company's direct sales and sales support group was 85% larger than June 2004. As a result of these efforts, the Company has been successful in uplifting revenues, as revenues for the three and six months ended June 30, 2005 were 55% and 9% higher than the comparable prior year periods. In fact, the $4,483,000 in revenues for the quarter ended June 30, 2005 was the highest revenue quarter since the second quarter of 2002, and the Company recorded a profit for the month of

June, which was the Company's first profitable month since May 2003.

In May 2005, the Company took steps to further diversify its product offerings, forming a wholly-owned subsidiary named "One IP Voice" which, when operational, will offer carrier-based hosted IP telephony services along with network services. Its primary target will be the SMB market.

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

3. RECLASSIFICATIONS

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

4. ACCOUNTS RECEIVABLE, NET

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

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

5. INVENTORIES, NET

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

Inventories, net	$1,429	$1,627

6. PROPERTY AND EQUIPMENT, NET

(Dollars in Thousands)	Estimated Useful Lives (Yrs.)	June 30, 2005	December 2

Leased equipment under capital lease consists of computer equipment.

7. DEBT OBLIGATIONS

(Dollars In thousands)	June 30, 2005	December 31, 2004
Laurus revolving credit facility note	$ 950	$ -
Laurus Minimum Borrowing Note	500	-
BACC revolving credit facility note	-	179
Installment purchase note	44	47
Leased equipment under capital lease	49	-
	1,543	226
Less: debt maturing within one year	(981)	(187)
Long-term debt obligations	$ 562	$ 39

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 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 $140,000, 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 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 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 Borrowing Note and the Warrant.

As of June 30, 2005, outstanding borrowings with Laurus were $1,450,383, consisting of $950,383 under the revolving credit portion of the facility and a $500,000 Minimum Borrowing Note. The unused portion of the credit facility as of June 30, 2005 was $1,549,617, all of which was available to borrow. The average and highest amounts borrowed under the Laurus credit facility during the three months ended June 30, 2005 were approximately $815,000 and $1,640,000, respectively. The average and highest amounts borrowed under all credit facilities during the six months ended June 30, 2005 were approximately $521,000 and $1,640,000, respectively. The Company was in compliance with the provisions of its loan agreement as of June 30, 2005.

Obligations under Capital Lease:

During 2005, the Company entered into non-cancelable lease agreements to finance $56,000 of computer equipment with payment terms ranging from 24 to 36 months. Monthly lease payments aggregate $1,984 and the agreements

contain a $1.00 purchase option at the end of the lease term. The effective interest rate on the lease obligations is 10.38 to 10.5%. The principal balance of these obligations at June 30, 2005 was $48,809, of which $22,531 was classified under debt maturing within one year.

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

8. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

(Dollars in thousands)	June 30, 2005	December 31, 2004
Salaries, commissions and benefits	$229	$167
Other	113	75
Accrued expenses and other current liabilities	$342	$242

9. RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

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

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4" ("SFAS No. 151"). This statement clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). It also requires that these items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal". This statement also clarifies the circumstances under which fixed overhead costs associated with operating facilities

involved in inventory processing should be capitalized. The provisions of SFAS No. 151 are effective for fiscal years beginning after June 15, 2005 and the Company will adopt this standard in its third quarter of fiscal 2005. The Company has not determined the impact, if any, that this statement will have on its consolidated financial position or results of operations.

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10. STOCK OPTIONS

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

	Three months ended June 30,		Six month June
	2005	2004	2005
Net loss, as reported	$(474)	$(414)	$(1,112)
Add: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(37)	(17)	(239)
Pro forma net loss	(511)	(431)	(1,351)
Pro forma net loss per share:			
Basic and diluted	$(.15)	$(.13)	$ (.40)

The weighted-average fair value of options granted during the three and six months ended June 30, 2005 was $.49 and $.40, respectively, compared to $.37 for the three and six months ended June 30, 2004. The fair value of stock options used to compute pro forma net loss and net loss per share disclosures was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield of 0% for 2005 and 2004; expected volatility of 55% for 2005 and 108% for 2004; average risk-free interest rate of 3.8% for 2005 and 3.30 % for 2004; and an expected option holding period of 3.5 years for 2005 and 4.3 years for 2004.

11. COMMITMENTS AND CONTINGENCIES

Employment agreements:

On January 15, 2005 the Company hired Mr. Alfred G. Stein to the position of Executive Vice President. From September 13, 2004 to his date

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

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

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

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12. EMPLOYEE BENEFIT PLANS

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

	Three months ended June 30,		Six months ended June 30,	
(Dollars in thousands)	2005	2004	2005	2004

Service cost	$21	$20	$43	$40
Interest cost	10	9	20	18
Recognized actuarial losses	3	2	5	4
Net expense	$34	$31	$68	$62

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 June 30, 2005, we reported a net loss of $474,000 or $.14 per share on revenues of $4,483,000. This compares with a net loss of $414,000 or $.12 per share on revenues of $2,889,000 recorded for the three months ended June 30, 2004. For the six months ended June 30, 2005, we reported a net loss of $1,112,000 or $.33 per share on revenues of $6,892,000. This compares with a net loss of $755,000 or $.23 per share on revenues of $6,295,000 recorded for the six months ended June 30, 2004. The net loss for the six month period of 2005 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. The Company has worked to lessen the effects of this trend by increasing its sales force and focusing on developing its systems sales business and, during the second quarter of 2005 has increased its market share of both parts and systems sales.

As further described in the Company's Annual Report on Form 10-K for the year ended December 31, 2004, the Company has taken several measures to turnaround its operating performance. The turnaround strategy is principally based upon building a larger and more highly qualified sales force, and diversifying the Company's product offerings and targeted customers. The business strategy is to transition to a full communications solutions provider, becoming less dependent on parts sales, and developing more sources of recurring revenues, such as through installation and maintenance services. As a first step in the turnaround plan, the Company hired a new President and CEO in October 2004, and two Executive Vice Presidents - one responsible for operations (hired in January 2005) and one responsible for sales (hired in March 2005). In

March, the Company significantly expanded its sales infrastructure and opportunities, first by the hiring of twenty three sales and sales support professionals formerly employed by Avaya Inc., and second by entering into a trial agreement with Avaya to provide products and services to the SMB ("small-to-medium sized business") market which commenced in March with the launch of a nationwide SMB sales program. By the end of June 2005, the Company's direct sales and sales support group was force was 85% larger than June 2004. As a result of these efforts, The Company has been successful in uplifting revenues, as revenues for the three and six months ended June 30, 2005 were 55% and 9% higher than the comparable prior year periods. In fact, the $4,483,000 in revenues for the quarter ended June 30, 2005 was the highest revenue quarter since the second quarter of 2002, and the Company recorded a profit for the month of June, which was the Company's first profitable month since May 2003.

In May 2005, the Company took steps to further diversify its product offerings, forming a wholly-owned subsidiary named "One IP Voice" which, when operational by the end of 2005, will offer carrier-based hosted IP telephony services along with network services. Its primary target will be the SMB market. In order to finance its business expansion plans, effective March 31, 2005 the Company entered into a $3 million credit arrangement with a new lender, replacing a $1.7 million credit facility with Business Alliance Capital Corporation. For additional information on our financial resources, refer to Note 7, "Debt Obligations", and the "Liquidity and Capital Resources" section which follows.

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

Revenues

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2005	2004	2005	2004
Equipment:				
End-user equipment sales	$3,660	$2,272	$5,534	$5,035
Equipment sales to resellers	63	312	154	471

Total equipment sales	3,723	2,584	5,688	5,506
Services:				
Installations	401	189	659	520
Rentals, repair and other	18	35	48	71
Other revenue	341	81	497	198
Total services and other revenue	760	305	1,204	789
Consolidated revenues	$4,483	$2,889	$6,892	$6,295

Equipment Sales. Total equipment sales for the three months ended June 30, 2005, were $3,723,000, an increase of $1,139,000 or 44% from the comparable 2004 period. The increase consisted of a $1,388,000 increase in end-user sales, less a $249,000 decrease in equipment sales to resellers ("wholesale sales"). The increase in end-user sales was attributable to a $1,068,000 or 201% increase in system sales and a $320,000 or 18% increase in parts sales. Total equipment sales for the six months ended June 30, 2005, were $5,688,000, an increase of 182,000 or 3% from the comparable 2004 period. The increase consisted of a $499,000 increase in end-user sales, less a $317,000 decrease in wholesale sales. The increase in end-user sales was attributable to an $845,000 or 52% increase in system sales, partly offset by a $346,000 or 10% 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.

Service revenues for the three months ended June 30, 2005 were $419,000, an increase of $195,000 or 87% from the comparable 2004 period. Service revenues for the six months ended June 30, 2005 were $707,000, an increase of $116,000 or 20% from the comparable 2004 period. The increases in each period were attributable to installation services which have increased due to the significant increase in second quarter 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 June 30, 2005 was $341,000, an increase of $260,000 or 321% from the comparable 2004 period. Other revenue for the six months ended June 30, 2005 was $497,000, an increase of $299,000 or

151% 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.

Cost of Revenues and Gross Profit. Total cost of revenues for the

three months ended June 30, 2005 was $3,147,000, an increase of $862,000 or 38% from the comparable 2004 period. The gross profit for the three months ended June 30, 2005 was $1,336,000, an increase of $732,000 or 121% from the comparable 2004 period. As a percentage of revenue, the overall gross profit margin was 30% for the three months ended June 30, 2005, compared to 21% for the comparable 2004 period.

Total cost of revenues for the six months ended June 30, 2005 was $4,802,000, a decrease of $12,000, or less than one-half percent, from the comparable 2004 period. The gross profit for the six months ended June 30, 2005 was $2,090,000, an increase of $609,000 or 41% from the comparable 2004 period. As a percentage of revenue, the overall gross profit margin was 30% for the six months ended June 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 June 30, 2005, the gross profit margin on equipment sales increased to 28% from 24% in 2004. 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 from a program that terminated in June 2004. Excluding the effects of these items, the gross profit margin on 2004 equipment sales would have also been 27%. For the six months ended June 30, 2005, the gross profit margin on equipment sales increased to 29% from 27% in 2004. The gross profit margin for the 2004 period was also negatively impacted by an increase in obsolescence reserves and by the payment of license fees to Avaya. Excluding the effects of these items, the gross profit margin on 2004 equipment sales would have been 30%. 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 a reduced parts business however, has been offset by significantly higher sales of systems at improved profit margins from 2004. These results can be primarily attributed to increased sales of systems to the SMB marketplace as well as to our larger "Enterprise" customers. We expect continued pressure on our equipment profit margins going forward, particularly in the sale of parts and systems to our larger customers, due to continuing price competition.

Gross Profit Margins on Services and Other Revenue. For the three

months ended June 30, 2005, the Company realized an overall 58% profit margin on its combined service and other revenues, compared to 38% recorded in 2004. The profit margin increase was attributable to significantly higher commission revenues earned from the sale of Avaya maintenance contracts, which generate a 100% profit margin, and to improved margins on installations. For the six months ended June 30, 2005, the Company realized an overall 54% profit margin on its combined service and other revenues, compared to 42% recorded in 2004. The profit margin increase for the six month period was attributable to significantly higher commission revenues earned from the sale of Avaya maintenance contracts.

Other Cost of Revenues. Other cost of revenues consists of product handling, purchasing and facility costs and expenses. For the three months ended June 30, 2005, these expenses were 4% higher than 2004, and represented approximately 4% of 2005 equipment sales revenues, compared to 5% of 2004 equipment sales revenues. For the six months ended June 30, 2005, these expenses were 31% lower than 2004, and represented approximately 4% of 2005 equipment sales revenues, compared to 6% of 2004 equipment sales revenues. The reduction in other cost of revenues primarily resulted from lower personnel levels and other overhead costs.

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Selling, General and Administrative ("SG&A") Expenses. SG&A expenses for the three months ended June 30, 2005 were $1,765,000, an increase of $755,000 or 75% from the comparable 2004 period. SG&A expenses for the three months ended June 30, 2005 were 39% of revenues, compared to 35% of revenues in 2004. Approximately 90% of the increase in SG&A was attributable to increased personnel levels, including compensation and benefits, recruiting fees, and incremental office and travel expenses. SG&A expenses for the six months ended June 30, 2005 were $3,148,000, an increase of $928,000 or 42% from the comparable 2004 period. SG&A expenses for the six months ended June 30, 2005 were 46% of revenues, compared to 35% of revenues in 2004. Approximately 85% of the increase in SG&A 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, by June 30, 2005, the Company's sales and support group was 85% larger than June 2004. The increase in the sales and support group was attributable to the launch of a Company initiative to market its products and services to small to medium-sized business ("SMB") marketplace.

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 June 30, 2005 the Company had incurred $140,000 of direct expenses 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 June 30, 2005 approximately $11,000 has been expensed.

We expect our SG&A expenses to increase as we continue the execution of our turnaround strategy, which has begun to focus on the development and deployment of the hosted VOIP services and products to be marketed through

our newly-formed subsidiary, One IP Voice, Inc.

Interest Expense and Other Income. Interest expense for the three months ended June 30, 2005 was $43,000, compared with $6,000 for 2004. Interest expense for the six months ended June 30, 2005 was $51,000, compared with $12,000 for 2004. Included in interest expense for the three and six months of 2005 is $25,000 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 7. 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 term of the facility. The increase in interest expense was also attributable to higher average borrowing levels and higher borrowing rates. 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 $1,390,000 at June 30, 2005, a decrease of $746,000 or 35% from $2,136,000 at December 31, 2004. The working capital ratio was 1.3 to 1 at June 30, 2005, compared to 2.4 to 1 at December 31, 2004. Operating activities used $830,000 during the six months ended June 30, 2005, compared to the use of $713,000 in the comparable 2004 period. Net cash used by operating activities in 2005 consisted of a net loss of $1,112,000 less non-cash items of $193,000, and net cash generated by changes in operating assets and liabilities of $89,000. Net cash generated by changes in operating assets and liabilities was primarily attributable to an increase in accounts payable and accrued expenses, a decrease in inventories and other assets, partly offset by an increase in accounts receivable resulting from higher sales levels.

Investing activities used $18,000 during the six months ended June 30, 2005, compared to $23,000 in 2004. Net cash used by investing activities in 2005 and 2004 consisted of capital expenditures. Capital expenditures during 2005 were principally for computer and office equipment to support our expanded personnel levels, most of which were financed through lease agreements. 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 $1,021,000 during the six months ended June 30, 2005 principally from borrowings under our revolving credit lines, 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. Our borrowing formulas with Laurus are less restrictive than the

formulas provided under the BACC agreement, thereby increasing our borrowing capacity. Refer to Note 7, "Debt Obligations", of the Notes to Consolidated Financial Statements included herein for further information on the principal terms and conditions of this financing transaction.

Our ability to provide cash to satisfy working capital requirements continues to be dependent upon generating positive cash flow from operations and upon formula borrowings under our revolving credit facility. Historically, our working capital borrowings have increased during periods of revenue growth. This is because our cash receipts cycle is longer than our cash disbursements cycle. As our revenues from systems sales increases, as management expects, the cash receipts cycle may lengthen, unless we can consistently negotiate up-front deposits and progress payments under our systems sales contracts. In addition, our working capital requirements are expected to significantly increase by year end as we continue to buildout the infrastructure of capital equipment, systems and personnel required to deploy our hosted VOIP service offerings through our newly-formed subsidiary One IP Voice, Inc. No assurances can be given that we will have sufficient cash resources to finance all of our future growth plans, and it may become necessary to seek additional financing sources for such purposes. In order to obtain additional financing, we may first need to demonstrate improved operating performance.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

RISKS, UNCERTAINTIES AND OTHER FACTORS THAT MAY AFFECT FUTURE RESULTS

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

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

ITEM 4. CONTROLS AND PROCEDURES.

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

necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

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

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

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PART II. OTHER INFORMATION.

ITEM 1. LEGAL PROCEEDINGS

None.

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

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

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

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:

(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.

SIGNATURES

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

FARMSTEAD TELEPHONE GROUP, INC.

Dated: August 10, 2005

/s/ Jean-Marc Stiegemeier

Jean-Marc Stiegemeier
Chief Executive Officer, President

Dated: August 10, 2005

/s/ Robert G. LaVigne

Robert G. LaVigne
Executive Vice President, Chief Financial Officer