FARMSTEAD TELEPHONE GROUP INC
Form 10-Q
May 13, 2004

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)
[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the quarterly period ended March 31, 2004

or

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

Commission File Number: 0-15938

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

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

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

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

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the proceeding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

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

As of April 30, 2004, the registrant had 3,315,638 shares of its $0.001 par value Common Stock outstanding.

TABLE OF CONTENTS TO FORM 10-Q

PART I. FINANCIAL INFORMATION

2

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED BALANCE SHEETS

(In thousands)	March 31, 2004	December 31, 2003
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 349	$ 827
Accounts receivable, net	1,884	1,408
Inventories, net	2,340	1,969
Other current assets	428	447

Total Current Assets	5,001	4,651
Property and equipment, net	289	313
Other assets	382	327
Total Assets	$ 5,672	$ 5,291
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,513	$ 1,248
Debt maturing within one year	305	-
Accrued expenses and other current liabilities	393	274
Total Current Liabilities	2,211	1,522
Other liabilities	507	478
Total Liabilities	2,718	2,000
Commitments and contingencies (Note 9)		
Stockholders' Equity:		
Preferred stock, $0.001 par value; 2,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, $0.001 par value; 30,000,000 shares authorized; 3,315,638 and 3,311,601 shares issued and outstanding at March 31, 2004 and December 31, 2003, respectively	3	3
Additional paid-in capital	12,318	12,316
Accumulated deficit	(9,337)	(8,996)
Accumulated other comprehensive loss	(30)	(32)
Total Stockholders' Equity	2,954	3,291
Total Liabilities and Stockholders' Equity	$ 5,672	$ 5,291

See accompanying notes to consolidated financial statements.

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

(In thousands, except per share amounts)	Three Months Ended March 31, 2004	2003
Revenues:		
Equipment	$ 2,922	$ 4,027
Services and other revenue	484	477
Net revenues	3,406	4,504
Cost of revenues:		
Equipment	2,046	2,777
Services and other revenue	272	333
Other cost of revenues	211	258
Total cost of revenues	2,529	3,368
Gross profit	877	1,136
Selling, general and administrative expenses	1,210	1,275
Operating loss	(333)	(139)
Interest expense	(6)	(2)
Other income	1	2
Loss before income taxes	(338)	(139)
Provision for income taxes	3	6
Net loss	$ (341)	$ (145)
Basic and diluted net loss per common share	$ (.10)	$ (.04)
Weighted average common shares outstanding:		
Basic and diluted	3,313	3,299

See accompanying notes to consolidated financial statements.

4

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

(In thousands)	Three Months Ended March 31, 2004	2003

Cash flows from operating activities:		
Net loss	$(341)	$ (145)
Adjustments to reconcile net loss to net cash flows used in operating activities:		
Provision for doubtful accounts receivable	9	9
Provision for losses on inventories	9	-
Depreciation and amortization	36	45
Decrease in accumulated other comprehensive loss	2	-
Changes in operating assets and liabilities:		
Increase in accounts receivable	(485)	(1,063)
(Increase) decrease in inventories	(380)	92
Increase in other assets	(36)	(335)
Increase in accounts payable	265	869
Increase (decrease) in accrued expenses and other current liabilities	119	(125)
Increase in other liabilities	29	24
Net cash used in operating activities	(773)	(629)
Cash flows from investing activities:		
Purchases of property and equipment	(12)	(20)
Net cash used in investing activities	(12)	(20)
Cash flows from financing activities:		
Borrowings under revolving credit line	305	373
Issuance of common stock	2	-
Net cash provided by financing activities	307	373
Net decrease in cash and cash equivalents	(478)	(276)
Cash and cash equivalents at beginning of period	827	994
Cash and cash equivalents at end of period	$ 349	$ 718
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 6	$ 1
Income taxes	4	4

See accompanying notes to consolidated financial statements.

5

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

1. BASIS OF PRESENTATION

The consolidated financial statements presented herein consist of the accounts of Farmstead Telephone Group, Inc. and its wholly owned subsidiaries, FTG Venture Corporation (inactive) and InfiNet Systems, LLC (inactive). The accompanying consolidated financial statements as of and for the three months ended March 31, 2004 and 2003 have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission for interim financial statements. In the Company's opinion, the unaudited interim consolidated financial statements and accompanying notes reflect all adjustments, consisting of normal and recurring adjustments, that are necessary for a fair statement of results for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the results to be experienced for the entire fiscal year. This Form 10-Q should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

2. OPERATIONS

As presented in the consolidated financial statements contained in this report, the Company incurred a net loss of $341,000 for the quarter ended March 31, 2004, and has incurred substantial losses in each of the past three fiscal years. These losses have been primarily the result of significant declines in revenues over these periods. There is currently no clear indication that sales levels will significantly increase in the near term and, in fact, they could continue to decline. The Company is currently in the process of developing and implementing a plan to further restructure its operations in order to align its operating expenses with its revenue levels. The plan may include curtailing certain planned business generation strategies and pursuing other strategic alternatives.

3. RECLASSIFICATIONS

Certain amounts in the Consolidated Statement of Operations for the three months ended March 31, 2003 were reclassified to conform to the current period presentation.

4. ACCOUNTS RECEIVABLE, NET

(Dollars in thousands)	March 31, 2004	December 31, 2003
Trade accounts receivable	$1,832	$1,410
Less: allowance for doubtful accounts	(58)	(80)
Trade accounts receivable, net	1,774	1,330
Other receivables	110	78
Accounts receivable, net	$1,884	$1,408

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

5. INVENTORIES, NET

(Dollars in thousands)	March 31, 2004	December 31, 2003
Finished goods and spare parts	$2,071	$1,817
Work in process (a)	511	450
Rental equipment	73	61
	2,655	2,328
Less: reserves for excess and obsolete		

inventories	(315)	(359)
Inventories, net	$2,340	$1,969

(a) Work in process inventories consist of used equipment requiring repair or refurbishing.

6. DEBT MATURING WITHIN ONE YEAR

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

As of March 31, 2004, outstanding borrowings with BACC amounted to $304,679. The unused portion of the credit facility as of March 31, 2004 was $1,395,321, of which $877,828 was available to borrow. The average and highest amounts borrowed during the three months ended March 31, 2004 were approximately $152,000 and $361,000, respectively. The Company was in compliance with the provisions of its loan agreement as of March 31, 2004.

7. RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

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

8. 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 awards. Had compensation cost for the Company's stock option plan been determined in accordance with the fair value-based method prescribed under SFAS 123, the Company's net loss and basic and diluted net loss per share would have approximated the pro forma amounts indicated below (dollars in thousands except per share amounts):

	Three Months Ended March 31,	
	2002	2003

Net loss, as reported	$(341)	$(145)
Add: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(21)	(23)
Pro forma net loss	$(362)	$(168)
Pro forma net loss per share:		
Basic and diluted	$(.11)	$(.05)

The weighted-average fair value of options granted during the three months ended March 31, 2004 and 2003 was $.56 and $.22, respectively. The fair value of stock options used to compute pro forma net loss and net loss per share disclosures was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions: dividend yield of 0% for 2004 and 2003; expected volatility of 109% for 2004 and 113% for 2003; average risk-free interest rate of 3.02 % for 2004 and 2.78% for 2003; and an expected option holding period of 4.7 years for 2004 and 5.6 years for 2003.

9. COMMITMENTS AND CONTINGENCIES

Lease Agreements. On March 23, 2004, the Company entered into a new lease agreement on its corporate offices and distribution center located at 22 Prestige Park Circle, East Hartford, CT. This agreement replaced the Company's existing lease due to expire in December 2004. Under the new lease agreement, which becomes effective May 1, 2004, the Company will be leasing 25,051 square feet for a 10-year, 8-month period expiring December 31, 2014. The lease contains one five-year renewal option. The lease also allows the Company the one-time option to terminate the lease without penalty on

7

December 31, 2009. Minimum monthly rent will amount to $11,377 for 2004, $13,047 for years 2005 - 2009, and $13,569 for years 2010 - 2014. The Company is additionally obligated to pay the lessor its proportionate share of the property operating costs at an amount equal to $1.20 per square foot, subject to a 2% annual increase.

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

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

10. EMPLOYEE BENEFIT PLANS

The components of the net periodic benefit cost included in the results of operations for the three months ended March 31, 2004 and 2003 are as follows:

(Dollars in thousands)	2004	2003
Service cost	$20	$18
Interest cost	9	8
Recognized actuarial losses	2	-
Net expense	$31	$26

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

The discussions set forth below and elsewhere in this Quarterly Report on Form 10-Q contain certain statements, based on current expectations, estimates, forecasts and projections about the industry in which we operate and management's beliefs and assumptions, which are not historical facts and are considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 ("the Act"). Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate, or imply future results, performance, or achievements, and may contain the words "believe," "will be," "will continue," "will likely result," "anticipates," "seeks to," "estimates," "expects," "intends," "plans," "predicts," "projects," and similar words, expressions or phrases of similar meaning. Our actual results could differ materially from those projected in the forward-looking statements as a result of certain risks, uncertainties and assumptions, which are difficult to predict. Many of these risks and uncertainties are described under the heading "Risks, Uncertainties and Other Factors That May Affect Future Results" below. All forward-looking statements included in this document are based upon information available to us on the date hereof. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. In addition, other written or oral statements made or incorporated by reference from time to time by us or our representatives in this report, other reports, filings with the Securities and Exchange Commission ("SEC"), press releases, conferences, or otherwise may be forward-looking statements within the meaning of the Act.

RESULTS OF OPERATIONS

OVERVIEW. For the three months ended March 31, 2004, we recorded a net loss of $341,000 or $.10 per share on revenues of $3,406,000. This compares with a net loss of $145,000 or $.04 per share on revenues of $4,504,000 recorded for the three months ended March 31, 2003. The operating results for 2004, as compared to the comparable prior year period, are the product of several dynamics affecting the industry in general and Farmstead in particular. First, there is a continuing softness in corporate buying in the telecommunications equipment sector. We believe that corporations are still cautious about capital equipment spending. As a result, we have experienced a decrease in both the number of orders received and their average order size. Although there have been some signs of improvement in our industry as evidenced by improved operating results from some of the key manufacturers, and increased sales quotation activities, customer spending for new telecommunication systems has been below our expectations. Second, there is increased competition in our marketplace, and coupled with the soft economic conditions, has led to continued sales price erosion. Third, our sales force has undergone significant turnover in the last two years, and the productivity ramp-up of new salespersons has taken longer than expected.

Our overall strategy during these tough economic times has been to properly size our business in relation to current revenue run-rates, while preserving our key technical personnel that are critical to maintaining and growing a systems and services business. Our primary focus during the first quarter of 2004 had been on strategies to increase revenues while continuing close controls over operating expenses. However, there is currently no clear indication that sales levels will significantly increase in the near term and, in fact, they could continue to decline. Accordingly, we are currently in the process of developing and implementing a plan to further restructure operations in order to align our operating expenses with our revenue levels. The plan may include curtailing certain planned business generation strategies and pursuing other strategic alternatives. Additional information on major components of our operating performance for the three months ended March 31, 2004 follows below.

REVENUES

	Three Months Ended March 31,			
(Dollars in thousands)	2004	%	2003	%
End-user equipment sales	$2,763	81	$3,622	80
Equipment sales to resellers	159	5	405	9
Services and other revenues	484	14	477	11
Consolidated revenues	$3,406	100	$4,504	100

Equipment Sales

During the three months ended March 31, 2004, end-user equipment sales revenues, consisting of sales of both new and refurbished parts and systems sales, decreased by $859,000 or 24% from the comparable 2003 period. The decrease consisted of a 24% decline in parts sales and a 23% decline in systems sales. We attribute these sales declines primarily to (i) continuing softness in corporate spending for telecommunications products, including both parts and systems and (ii) sales price erosion due to increased competition in the marketplace. In addition, last year's first quarter revenues included two large system sales that comprised 23% of that period's equipment sales. We believe that our parts sales business has been affected by the downsizing of many of our customers over the last few years, which resulted in excess equipment available for re-deployment in their operations. As a marketing tool to help generate future equipment revenues, we have developed an electronic commerce framework called "ECONNECT". Although revenues to date have not been significant, we have recently signed agreements with two large aftermarket customers whom we will service through ECONNECT. We will be monitoring the effectiveness and leverage of this type of program as the year progresses.

Equipment sales to resellers ("wholesale sales") decreased by $246,000 or 61% from the comparable 2003 period. Wholesale sales have been impacted by the same factors noted above that have impacted end-user sales. In addition, our principal supplier of used equipment for resell into the wholesale market has significantly curtailed operations, thereby limiting our ability to acquire equipment for profitable resale into the wholesale market. We expect this trend to continue over at least the short-term.

Services and Other Revenues

(Dollars in thousands)	Three Months Ended March 31, 2004	2003
Services:		
Installations	$331	$283
Rentals and repair	36	107
Other revenues	117	87
Services and other revenues	$484	$477

During the three months ended March 31, 2004, services and other revenues increased overall by $7,000 or 2% from the comparable 2003 period. The increase was attributable to (i) 35% growth in other revenues due to an increase in commissions earned from Avaya for selling Avaya maintenance contracts, partly offset by a decrease in freight billed to customers as a result of lower sales volume, and (ii) 17% growth in installation revenues. These results were partly offset by a 66% decrease in equipment rentals and customer repair revenues. Revenues from these sources are erratic and difficult to predict, since they tend to be project-oriented. An increase or decrease in installation revenues does not always coincide with the reported increase or decrease in system sales since installations may occur in different periods than the related system sale, and the Company may sell new systems or system upgrades without being contracted to perform the installation.

COST OF REVENUES AND GROSS PROFIT. Total cost of revenues for the three months ended March 31, 2004 was $2,529,000, a decrease of $839,000 or 25% from the comparable 2003 period. The gross profit for the three months ended March 31, 2004 was $877,000, a decrease of $259,000 or 23% from the comparable 2003 period. As a percentage of revenue, the gross profit margin was 26.1% for 2004, compared to 25.6% for the comparable 2003 period.

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

Gross profit on Equipment Sales. For the three months ended March 31, 2004, the gross profit margin on equipment sales revenues decreased slightly to 30%, from 31% recorded during the comparable prior year period. The decrease was attributable to sales of parts to both end-users and to wholesalers, partly offset by increased profit margins on systems sales. Although we have experienced downward pressure on our sales pricing, as noted above, we have been focusing on lowering our product acquisition costs in order to maintain our gross margin levels. We expect continued pressure on our profit margins going forward.

Gross profit on Services and Other Revenues. For the three months ended March 31, 2004, the gross profit margin on services and other revenues increased to 44%, from 30%. The increase was primarily attributable to higher profit margins on installations, and higher commissions earned on sales 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 March 31, 2004, these expenses were $47,000 or 18% lower than the comparable prior year period, however represented 7% of equipment sales revenues during the current period, compared to 6% of equipment sales revenues in 2003. The dollar reduction primarily resulted from personnel reductions implemented in January 2004.

SELLING, GENERAL AND ADMINISTRATIVE ("SG&A") EXPENSES. SG&A expenses for the three months ended March 31, 2004 were $1,210,000, a decrease of $65,000 or 5% from the comparable 2003 period. SG&A expenses, however, were 36% of revenues in 2004 as compared to 28% of revenues in 2003, which is attributable to the "fixed" nature of a significant portion of our SG&A. The decrease was attributable to lower depreciation and bad debt expenses, and lower office and other administrative expenses. In response to lower sales levels, we have been more tightly controlling expenses, and deferring expenditures where possible. The reduction in SG&A expenses was partly offset by a 9% increase in sales and marketing compensation, as we increased the size of our sales force in an effort to increase sales. Given the unpredictability of the direction of future revenues, we will continue to monitor SG&A expenses and where possible, make certain expenses more variable in relation to sales volume.

INTEREST EXPENSE AND OTHER INCOME. Interest expense for the three months ended March 31, 2004 was $6,000, compared with $2,000 for the comparable 2003 period. The increase was attributable to higher average borrowings. Other income for the three months ended March 31, 2004 was $1,000, compared with $2,000 for 2003, and consisted of interest earned on invested cash .

PROVISION FOR INCOME TAXES. The provision for income taxes for the three months ended March 31, 2004 was $3,000, compared with $6,000 for the comparable 2003 period. The provision for income taxes represented estimated minimum state taxes in each period. We maintain a full valuation allowance against our net deferred tax assets, which consist primarily of net operating loss and capital loss carryforwards, and timing differences between the book and tax treatment of inventory and other asset valuations. Realization of these net deferred tax assets is dependent upon our ability to generate future taxable income.

LIQUIDITY AND CAPITAL RESOURCES

Working capital, defined as current assets less current liabilities, was $2,790,000 at March 31, 2004, a decrease of $339,000 or 11% from $3,129,000 at December 31, 2003. The working capital ratio was 2.3 to 1 at March 31, 2004, compared with 3.1 to 1 at December 31, 2003.

Operating activities used $773,000 during the three months ended

March 31, 2004. Net cash used by operating activities consisted of a net loss of $341,000 adjusted for non-cash items of $56,000, and net cash used by changes in operating assets and liabilities of $488,000. Net cash used by changes in operating assets and liabilities was primarily attributable to an increase in accounts receivable and inventories, partly offset by an increase in accounts payable and accrued expenses.

Investing activities used $12,000 during the three months ended March 31, 2004 to fund capital expenditures.

Financing activities provided $307,000 during the three months ended March 31, 2004, attributable to working capital borrowings under our revolving credit facility with BACC. On February 19, 2004, the BACC credit facility was extended for an additional one-year term with the following modifications: (i) the credit facility advance limit was increased from $1.5 million to $1.7 million; and (ii) the amount that could be advanced against eligible inventory was increased from $200,000 to $400,000. For additional information on the terms and conditions of the BACC credit facility, refer to our Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2003.

As of March 31, 2004, our outstanding borrowings with BACC amounted to $304,679. The unused portion of the credit facility as of March 31, 2004 was $1,395,321, of which $877,828 was available to borrow. The average and highest amounts borrowed during the three months ended March 31, 2004 were approximately $152,000 and $361,000, respectively. We were in compliance with the provisions of our loan agreement as of March 31, 2004.

As a result of our reduced revenues and employment levels, we early-terminated one building lease agreement covering 15,137 square feet of warehouse space (otherwise scheduled to expire December 31, 2004), and renegotiated the building lease on our main offices and distribution center, reducing our square footage under rent from approximately 35,000 square feet to approximately 25,000 square feet. These actions are estimated to reduce our 2004 building rental and operating costs by approximately $16,000 per month. Refer to Note 9, for further information on the new lease agreement.

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The discussion included in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2003 under the subheading "Critical Accounting Policies and Estimates" is still considered current and is hereby incorporated into this Quarterly Report on Form 10-Q.

RISKS, UNCERTAINTIES AND OTHER FACTORS THAT MAY AFFECT FUTURE RESULTS

The discussion included in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2003 under the subheading "Risks, Uncertainties and Other Factors That May Affect Future Results" is still considered current and applicable, and is hereby incorporated into this Quarterly Report on Form 10-Q.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The discussion included in Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2003, "Quantitative and Qualitative Disclosures About Market Risk", is still considered current and applicable, and is hereby incorporated into this Quarterly Report on Form 10-Q.

ITEM 4. CONTROLS AND PROCEDURES.

(a) Evaluation of Disclosure Controls and Procedures. Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-14(c) and 15d-

14(c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of a date within 90 days prior to the filing date of this Quarterly Report on Form 10-Q. Based on such evaluation, such officers have concluded that our disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to our Company required to be included in our reports filed or submitted under the Exchange Act.

(b) Changes in Internal Controls. There were no significant changes in our internal controls or in other factors that could significantly affect such controls subsequent to the date of their most recent evaluation.

PART II. OTHER INFORMATION.

ITEMS 1-5 have been omitted because there is nothing to report.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K:

(a) Exhibits:

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

10 (a) Agreement of Lease By and Between Fremont Prestige Park, LLC (Landlord) and Farmstead Telephone Group, Inc. (Tenant), dated March 23, 2004

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.

(b) Reports on Form 8-K: No reports on Form 8-K were filed during the quarter for which this report is filed.

SIGNATURES

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

FARMSTEAD TELEPHONE GROUP, INC.

Dated: May 12, 2004

/s/ George J. Taylor, Jr.

George J. Taylor, Jr.
Chief Executive Officer, President

Dated: May 12, 2004

/s/ Robert G. LaVigne

Robert G. LaVigne
Executive Vice President,
Chief Financial Officer