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

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

Form 10-Q/A

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

For the quarterly period ended September 30, 2005

or

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

Commission File Number: 001-12155

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

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

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

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

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

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

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

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

EXPLANATORY NOTE:

This Form 10-Q/A to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005, initially filed with the

Securities and Exchange Commission on November 14, 2005, amends Part I, Items 1 and 2 for the three and nine months ended September 30, 2005. This Form 10-Q/A continues to reflect circumstances as of the date of the original filing of the Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005 and we have not updated the disclosures contained herein to reflect events that occurred at a later date, except for items related to the restatement or where otherwise indicated.

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

We have filed amended reports on Form 10-Q/A for the quarterly periods ended March 31, 2005 and June 30, 2005 which reflect the corrections in the accounting for convertible notes and warrants issued to Laurus during 2005. The consolidated financial statements for the years ended December 31, 2005, 2004 and 2003 included in our Annual Report on Form 10-K for the year ended December 31, 2005 should be relied upon.

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

		Page
ITEM 1.	FINANCIAL STATEMENTS (Unaudited)	
	Consolidated Balance Sheets - September 30, 2005 and December 31, 2004	3
	Consolidated Statements of Operations - For the Three and Nine Months Ended September 30, 2005 and 2004	4
	Consolidated Statement of Changes in Stockholders' Equity (Deficiency) - For the Nine Months Ended September 30, 2005	5
	Consolidated Statements of Cash Flows - For the Nine Months Ended September 30, 2005 and 2004	6
	Notes to Consolidated Financial Statements	7
ITEM 2.	MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	17
ITEM 3.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	26
ITEM 4.	CONTROLS AND PROCEDURES	26
PART II.	OTHER INFORMATION	
ITEM 1.	LEGAL PROCEEDINGS	26
ITEM 2.	UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS	26
ITEM 3.	DEFAULTS UPON SENIOR SECURITIES	26
ITEM 4.	SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS	26

ITEM 5. OTHER INFORMATION 27

ITEM 6. EXHIBITS 27

SIGNATURES 27

2

PART I - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS.

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED BALANCE SHEETS

(In thousands)	September 30, 2005	December 31 2004
	(Unaudited) (As Restated)	
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
Total Current Assets	5,237	3,675
Property and equipment, net	563	268
Deferred financing costs (Note 6)	560	-
Other assets	107	107
Total Assets	$ 6,467	$ 4,050
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIENCY)		
Current liabilities:		
Accounts payable	$ 3,123	$ 1,110
Accrued expenses and other current liabilities	410	242
Current portion of convertible debt, net of unamortized discount of $592 (Note 6)	26	-
Revolving credit facility note (Note 6)	-	179
Derivative financial instruments (Note 7)	762	-
Current portion of long-term debt (Note 8)	30	8
Total Current Liabilities	4,351	1,539
Postretirement benefit obligation	688	593
Convertible debt, net of unamortized discount of $494 (Note 6)	6	
Derivative financial instruments (Note 7)	2,130	-
Long-term debt (Note 8)	56	39
Total Liabilities	7,231	2,171

Commitments and contingencies (Note 12)		
Stockholders' Equity (Deficiency):		
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	13,148	12,320
Accumulated deficit	(13,898)	(10,420)
Accumulated other comprehensive loss	(18)	(24)
Total Stockholders' Equity (Deficiency)	(764)	1,879
Total Liabilities and Stockholders' Equity (Deficiency)	$ 6,467	$ 4,050

See accompanying notes to consolidated financial statements.

3

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
(In thousands, except loss per share amounts)	2005	2004	2005	2004
	(As Restated)		(As Restated)	
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)
Other income (expense):				
Interest expense (Note 17)	(55)	(7)	(111)	(19)
Derivative instrument expense	(1,949)	-	(1,662)	-

Other Income	3	2	7	4
Total other income (expense)	(2,001)	(5)	(1,766)	(15)
Loss before income taxes	(2,647)	(181)	(3,470)	(930)
Provision (benefit) for income taxes	1	(6)	8	-
Net loss	(2,648)	$ (175)	(3,478)	$ (930)
Basic and diluted net loss per common share:	$ (.75)	$ (.05)	$ (1.02)	$ (.28)
Weighted average common shares outstanding:				
Basic and diluted	3,511	3,317	3,398	3,315

See accompanying notes to consolidated financial statements.

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

(In thousands)	Common Stock		Additional Paid-in Capital	Accum-ulated Deficit	Accumulate Other Comprehensi Loss
	Shares	Amount			
Balance at December 31, 2004	3,322	$3	$12,320	$(10,420)	$(24)
Net loss	-	-	-	(3,478)	-
Amortization of pension liability adjustment	-	-	-	-	6
Comprehensive loss					
Common stock issued upon conversion of Laurus debt	325	1	731	-	-
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	$13,148	$(13,898)	$(18)

See accompanying notes to consolidated financial statements.

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)
For the Nine Months Ended September 30, 2005 and 2004

(In thousands)	2005	2004
	(As Restated)	
Cash flows from operating activities:		
Net loss	$(3,478)	$(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	47	-
Amortization of discount on convertible debt	43	-
Derivative instrument expense	1,662	
Decrease in accumulated other comprehensive loss	6	6
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 postretirement benefit obligation	95	85
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:		
(Repayments) borrowings under BACC credit facility	(179)	211
Borrowings under convertible debt facility	1,618	-
Deferred financing costs	(272)	-
Borrowing against cash value of insurance policy	-	275
Proceeds from exercise of stock options and employee stock purchases	97	4
Repayments of long-term debt and capital lease obligations	(17)	-
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	-
Common stock issued on conversion of debt	732	-

Discounts on warrants issued to Laurus	335	
Discounts on issuance of convertible debt	1,094	-

See accompanying notes to consolidated financial statements.

6

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

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

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/A should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

Restatement

The accompanying consolidated financial statements as of September 30, 2005 and for the three and nine months ended September 30, 2005 (the "2005 Financial Statements") have been restated to correct an error pertaining to the accounting for warrants and outstanding borrowings under convertible notes issued to the Laurus Master Fund Ltd. ("Laurus") in connection with a three-year Secured Revolving Note agreement dated March 31, 2005. Specifically, the Company has adjusted its 2005 Financial Statements in order to apply the accounting methodology required under EITF Issue 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock". Applying this methodology resulted in the recording of derivative financial instrument liabilities attributable to borrowings under the credit agreement and to the freestanding warrants issued to Laurus, and non-cash derivative instrument expense of $1,949,000 and $1,662,000 for the three and nine months ended September 30, 2005, respectively. The effect of the foregoing on the 2005 Financial Statements is as follows (in thousands, except per share amounts):

Consolidated Balance Sheet:	September 30, 2005	
	As Previously Reported	As Restated

Total assets	$6,291	$6,467
Total liabilities	4,939	7,231
Stockholders' equity (deficiency)	1,352	(764)

Consolidated Results of Operations:	Three Months Ended September 30, 2005		Nine Months Ended September 30, 2005	
	As Previously Reported	As Restated	As Previously Reported	As Restated
Operating loss	$(646)	$ (646)	$(1,704)	$(1,704)
Net loss	(704)	(2,648)	(1,816)	(3,478)
Net loss per common share:				
Basic and diluted	$(.20)	$ (.75)	$ (.53)	$ (1.02)

Business Operations

As presented in the consolidated financial statements contained in this report, the Company incurred net losses of $2,648,000 and $3,478,000 for the three and nine months ended September 30, 2005, respectively. These results include non-cash derivative instrument expense of $1,949,000 for the three-month period, and $1,662,000 for the nine-month period, arising from borrowings under a three-year convertible revolving credit facility entered into with Laurus effective March 31, 2006, and the issuance of freestanding warrants in connection therewith, as more fully described in Note 6 - Convertible Debt. The derivative instrument expense was primarily attributable to increases in the calculated market value of the

7

conversion options embedded in the convertible borrowings and the free-standing warrants since their initial valuations, resulting from increases in the market value of the Company's common stock during the reported periods. Excluding the non-cash derivative instrument expense, the Company's net losses would have been $699,000 and $816,000 for the respective three and nine months ended September 30, 2005.

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 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, 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 Laurus, replacing a $1.7 million credit facility with Business Alliance Capital Corporation. For additional information, refer to Note 6 - Convertible Debt 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 16 - Subsequent Events, contained herein.

Significant Accounting Policies

Derivative financial instruments

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

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

Certain instruments, including convertible debt and equity instruments and the freestanding options and warrants issued in connection with those convertible instruments, may be subject to registration rights agreements, which impose penalties for failure to register the underlying common stock by a defined date. The existence of the potential cash penalties under the related registration rights agreement requires that the embedded conversion option be accounted for as a derivative instrument liability. Similarly, the potential cash penalties under the related registration rights agreement may require us to account for the freestanding options and warrants as derivative financial instrument liabilities, rather than as equity. In addition, when the ability to physical or net-share settle the conversion option or the exercise of the freestanding options or warrants is deemed to not be within the control of the Company, the embedded conversion option or freestanding options or warrants may be required to be accounted for as a derivative financial instrument liability.

Derivative financial instruments are measured at their fair value. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then revalued at each reporting date, with changes in the fair value reported as charges or credits to income. For option-based derivative financial instruments, we use the Black-Scholes option pricing model to value the derivative instruments. When the convertible debt or equity

instruments contain embedded derivative instruments that are to be bifurcated and accounted for as liabilities, the total proceeds allocated to the convertible host instruments are first allocated to the fair value of all the bifurcated derivative instruments. The remaining proceeds, if any, are then allocated to the convertible instruments themselves, usually resulting in those instruments being recorded at a discount from their face amount.

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

8

instrument, is amortized over the life of the instrument through periodic charges to income, usually using the effective interest method.

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

2. RECLASSIFICATIONS

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

3. ACCOUNTS RECEIVABLE, NET

(In thousands)	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

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

5. PROPERTY AND EQUIPMENT, NET

(In thousands)	Estimated Useful Lives (Yrs.)	September 30, 2005	December 31, 2004
Computer and office equipment	3 - 5	$ 1,062	$ 1,071
IP network equipment and licenses	5	301	-
Furniture and fixtures	5 - 10	288	288
Leasehold improvements	10	171	171
Capitalized software development costs	5	98	98
Automobile	5	50	50
Leased equipment under capital lease *	3	56	-
		2,026	1,678
Less: accumulated depreciation and amortization		(1,463)	(1,410)
Property and equipment, net		$ 563	$ 268

9

6. CONVERTIBLE DEBT

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

Borrowing under secured revolving credit facility note	$ 618	$ -
Secured convertible Minimum Borrowing Note	500	-
Less: unamortized discount attributable to the revolving credit facility note	(592)	-
Less: unamortized discount attributable to the Minimum Borrowing Note	(494)	-
Convertible Debt, net of unamortized discounts	32	
Less: current portion	(26)	
Convertible Debt, net of unamortized discounts	$ 6	$ -

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

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

Principal Borrowing Terms and Prepayment: Borrowings are advanced pursuant to a formula consisting of (i) 90% of eligible accounts receivable, as defined (primarily receivables that are less than 90 days old), and (ii) 30% of eligible inventory, as defined (primarily inventory classified as "finished goods"), up to a maximum inventory advance of $600,000, less any reserves required by Laurus. Interest on the outstanding borrowings is charged at the per annum rate of two percentage points (2%) above the prime rate, but not less than 6%. The interest rate charged, however, will be decreased by 2% (or 200 basis points) for every 25% increase in the market price of the Company's common stock above the fixed conversion price, down to a minimum interest charge of 0.0%. The Company will additionally be charged a fee equal to 0.25% of the unused portion of the facility. Should the Company terminate the financing agreement with Laurus prior to the maturity date, the Company will incur an early payment fee equal to 4%, 3% and 2% of the Capital Availability Amount if terminated in the first, second or third year, respectively, of the term.

Security and Events of Default. Borrowings under the Laurus Notes are secured by a lien on substantially all of the Company's assets. The Security Agreement contains no specific financial covenants; however, it defines certain circumstances under which the agreement can be declared in default and subject to termination, including among others if (i) there is a material adverse change in the Company's business or financial condition; (ii) an insolvency proceeding is commenced; (iii) the Company defaults on any of its material agreements with third parties or there are material liens or attachments levied against the Company's assets; (iv) the Company's common stock ceases to be publicly traded; and (v) the Company fails to comply with the terms, representations and conditions of the agreement. Upon the occurrence of an Event of Default, the interest rate charged will be increased by 1-1/2 % per month until the default is cured; should the default continue beyond any applicable grace period, Laurus could require the Company to repay 120% of any principal and interest outstanding under the agreement.

Conversion Rights and Limitation. All or a portion of the outstanding principal and interest due under the Laurus Notes may be converted, at the option of the Holder, into shares of the Company's common stock, at the Fixed Conversion Price ("FCP") of $1.54. The FCP was originally set at 110% of the average closing price of the Company's common stock over the ten trading days preceding the execution of the agreement, and is subject to anti-dilution protection adjustments. The

10

FCP will be reset once $1.5 million of debt has been converted. The Laurus Notes contain a mandatory conversion feature such that, if the average closing price of the common stock as reported by Bloomberg, L.P. on the Principal Market for five (5) consecutive trading days in any calendar month shall be greater than 115% of the FCP, the Holder shall convert into shares of common stock such portion of the principal amount outstanding under any Minimum Borrowing Note (together with accrued interest and fees in respect thereof) on such date equal to ten percent (10%) of the aggregate dollar trading volume of the common stock for the period of twenty-two (22) trading days preceding the date of the mandatory conversion. The Holder shall not be required under any circumstances to make more than one (1) mandatory conversion in any calendar month. By agreement between the parties, Laurus will not own greater than 4.99% of the outstanding shares of the Company's common stock except that (i) upon the occurrence and during the continuance of an Event of Default, or (ii) upon 75 days prior notice to the Company, their ownership could increase to 19.99%. Upon receipt of a conversion notice from the Holder, the Company can elect to pay cash to the Holder in lieu of issuing shares of common stock, at a price per share equal to the intraday high price of the stock.

Registration Rights. Pursuant to the terms of a Registration Rights Agreement, the Company is obligated to file and obtain effectiveness for a registration statement registering the resale of shares of the Company's common stock issuable upon conversion of the Laurus Notes and the exercise of the Warrant. If the registration statement is not timely filed, or declared effective the Company will be subject to certain penalties. On June 24, 2005, the Company completed the registration of the common stock issuable upon conversion of the initial Minimum Borrowing Note and the Warrant. On October 11, 2005, the Company completed the registration of the common stock issuable upon conversion of the second Minimum Borrowing Note.

During the three months ended September 30, 2005, the initial

$500,000 Minimum Borrowing Note was fully converted to 324,675 shares of common stock, resulting in a $732,000 credit to Additional Paid-in Capital consisting of a $210,000 net carrying value converted and $522,000 of extinguished derivative liability.

As of September 30, 2005, the amount of available borrowings under the Laurus credit facility, pursuant to borrowing formulas, was as follows (in thousands):

Available borrowings supported by collateral base	$2,690
Less: amount borrowed under revolving credit facility	(618)
Less: amount borrowed under Minimum Borrowing Note	(500)
Available to borrow	$1,572

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.

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

The proceeds received from Laurus under the two Minimum Borrowing Notes ("MBNs") issued during 2005 were first allocated to the fair value of the bifurcated embedded derivative instruments included in the convertible notes, with the remaining proceeds allocated to the MBN, resulting in these notes being recorded at a significant discount from their face amounts. This discount, together with the stated interest on the MBN, is being amortized using an effective interest method over the term of the MBN. Since there are frequent borrowings and repayments under the revolving note, the value of the embedded derivative instruments is calculated upon advances, and the discount is recognized as the advances are repaid, with the stated interest recognized currently.

The 500,000 warrants issued to Laurus were initially valued at $335,000, using the Black-Scholes option pricing model and the following assumptions: market price - $1.31; exercise price - $1.82; expected term - 5 years; volatility - 65%; interest rate - 4.18%; and dividends - 0. Since there are potential penalties that we may have to pay Laurus under the Registration Rights Agreement, the warrants have been recorded as a derivative instrument liability, rather than as equity. This derivative instrument liability is adjusted to fair value (using the Black-Scholes option pricing model) at the end of each subsequent reporting period, and any changes in the fair value are charged or credited to income in the period of change. Since the nature of the Laurus credit facility is revolving, with continuous advances and repayments expected over its term, and with an indeterminate amount of Minimum Borrowing Notes which can be created and converted, it is not practical to allocate the warrant value to the initial proceeds of the borrowings under the facility to any one Minimum Borrowing Note. As such, the initial valuation of $335,000 has been recorded as a deferred financing cost, and is being amortized to expense over the term of the facility using an effective interest method. As of September 30, 2005, the unamortized balance was $331,000.

In connection with the Laurus credit facility, the Company also paid Laurus a $117,000 prepaid facility fee, and incurred other placement fees and expenses totaling $155,000. These amounts, aggregating $272,000, have also been recorded as deferred financing costs on the balance sheet, and as of September 30, 2005 the unamortized balance was $229,000. The facility fee is being amortized to interest expense on a straight-line basis over the term of the facility, while the other fees and expenses are being amortized to SG&A expense on a straight-line basis over the term of the facility.

7. DERIVATIVE FINANCIAL INSTRUMENTS

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

Instrument:	Issue Date	Expiration Date	Value- Issue date	Val 9/30
Laurus Minimum Borrowing Note (Note 6)	4/4/2005	3/31/2008	$323	$
Laurus Minimum Borrowing Note (Note 6)	9/2/2005	3/31/2008	773	
Laurus Revolving Note (Note 6)	9/21/2005- 9/30/2005	3/31/2008	594	
Fair value of bifurcated embedded derivative instrument liabilities				1,
500,000 common stock warrants issued to Laurus (Note 6)	3/31/2005	3/31/2010	335	1,
Total derivative financial instruments				2,

Less: amount attributable to the Laurus Revolving Note, reported in current liabilities	(
Derivative financial instruments recorded in non-current liabilities	$2,

The Company uses the Black-Scholes option pricing model to value warrants, and the embedded conversion option components of any bifurcated embedded derivative instruments that are recorded as derivative liabilities. See Note 6 - Convertible Debt. In valuing the warrants and the embedded conversion option components of the bifurcated embedded derivative instruments, at the time they were issued and at September 30, 2005, we used the following assumptions: market price of our common stock on the date of valuation; an expected dividend yield of 0%; an expected life equal to either the remaining period to the expiration date of the warrants or maturity date of the convertible debt instruments; expected volatility of 65%; and a risk-free rate of return ranging from 3.79-4.18%, based on constant maturity rates published by the U.S. Federal Reserve, applicable to the remaining life of the instruments.

12

8. LONG-TERM DEBT

(In thousands)	September 30, 2005	December 31, 2004
Installment purchase note	$ 42	$47
Obligations under capital lease	44	-
	86	47
Less: debt maturing within one year	(30)	(8)
Long-term debt obligations	$ 56	$39

Installment Purchase Note:

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

Obligations under Capital Lease:

During 2005, the Company entered into non-cancelable lease agreements to finance $56,000 of computer equipment with payment terms ranging from 24 to 36 months. Monthly lease payments aggregate $1,984 and the agreements contain a $1.00 purchase option at the end of the lease term. The effective

interest rate on the lease obligations is 10.38 to 10.5%. The principal balance of these obligations at September 30, 2005 was $43,855, of which $21,681 was classified under debt maturing within one year.

9. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

(In thousands)	September 30, 2005	December 31, 2004
Salaries, commissions and benefits	$316	$167
Other	94	75
Accrued expenses and other current liabilities	$410	$242

10. RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS No. 123 (revised 2004)"), revising FASB Statement 123, "Accounting for Stock-Based Compensation" and superseding APB Opinion No. 25, "Accounting for Stock Issued to Employees,". This Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, focusing primarily on transactions in which an entity obtains employee services in share-based payment transactions. SFAS No. 123 (revised 2004) requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award. Accounting for share-based compensation transactions using the intrinsic method supplemented by pro forma disclosures will no longer be permissible. This statement is effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005 and the Company will adopt the standard in the first quarter of fiscal 2006. The adoption of this standard will have an impact on the Company's results of operations as it will be required to expense the fair value of all share based 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.

11. STOCK OPTIONS

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

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Net loss, as reported	$(2,648)	$(175)	$(3,478)	$(930)
Add: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(202)	(10)	(441)	(38)
Pro forma net loss	$(2,850)	$(185)	$(3,919)	$(968)
Pro forma net loss per share:				
Basic and diluted	$ (.81)	$(.06)	$ (1.15)	$(.29)

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.

12. COMMITMENTS AND CONTINGENCIES

Employment agreements:

On January 15, 2005 the Company hired Mr. Alfred G. Stein to the position of Executive Vice President. From September 13, 2004 to his date of hire, Mr. Stein was a consultant to the Company, assisting management in the development of a strategic re-direction of the Company's sales organization and product offerings, for which he earned $40,000 in consulting fees. Mr. Stein has an employment agreement expiring December 31, 2007 which includes the following key provisions: (i) an annual base salary of $175,000, (ii) an annual bonus of up to 100% of base salary based upon the attainment of a Board-approved annual business plan which includes revenue and operating profit targets and (iii) the grant of a five-year warrant to purchase up to 250,000 shares of common stock at an exercise

price of $0.67 per share, which was equal to the closing price of the common stock on his date of hire. The Company registered 150,000 shares underlying the warrant, and has agreed to register the remaining 100,000 shares by January 15, 2007.

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

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

14

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.

13. 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

14. 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 expenses consist primarily of compensation and benefits, costs associated 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

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:

15

(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	(55)	(111)
Derivative instrument expense	(1,949)	(1,662)
Other income	3	7
Consolidated loss before income taxes	$(2,647)	$(3,470)

15. 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.

16. 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 over-allotment 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.

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 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.

16

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.

17. INTEREST EXPENSE

Interest expense for the three and nine months ended September 30, 2005 and 2004 consisted of the following:

(In thousands)	Three months ended September 30		Nine months ended September 30	
	2005	2004	2005	2004
Interest expense on outstanding borrowings	$19	$7	$ 44	$19
Amortization of deferred financing costs (1)	11	-	23	-
Amortization of discounts on convertible notes (2)	25	-	44	-
Total interest expense	$55	$7	$111	$19