

FRANKLIN ELECTRONIC PUBLISHERS INC
Form 10-Q
November 15, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 2004

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File No. 0-14841

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

(Exact Name of Registrant as Specified in Its Charter)

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Pennsylvania
(State or other Jurisdiction of

22-2476703
(I.R.S. Employer

Incorporation or Organization)

Identification No.)

One Franklin Plaza, Burlington, New Jersey 08016-4907

(Address of Principal Executive Office)

(609) 386-2500

(Registrant's Telephone Number)

Indicate by check mark whether 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 Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

COMMON STOCK OUTSTANDING AS OF NOVEMBER 5, 2004: **8,056,408 SHARES**

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

| | September 30, 2004 | March 31, 2004 |
|--|-----------------------|-------------------|
| | (Unaudited) | (Audited) |
| <u>ASSETS</u> | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 2,530 | \$ 2,217 |
| Accounts receivable, less allowance for doubtful accounts of \$703 and \$802 | 9,490 | 7,110 |
| Inventories | 13,084 | 8,407 |
| Prepays and other assets | 2,364 | 2,398 |
| TOTAL CURRENT ASSETS | 27,468 | 20,132 |
| PROPERTY AND EQUIPMENT | 6,733 | 6,587 |
| OTHER ASSETS: | | |
| Deferred income tax asset | 5,700 | 5,700 |
| Trademark and goodwill | 3,796 | 3,796 |
| Software development costs | 2,676 | 2,531 |
| Other assets | 4,222 | 4,369 |
| TOTAL OTHER ASSETS | 16,394 | 16,396 |
| TOTAL ASSETS | \$ 50,595 | \$ 43,115 |
| <u>LIABILITIES AND SHAREHOLDERS' EQUITY</u> | | |
| CURRENT LIABILITIES: | | |
| Accounts payable and accrued expenses | \$ 13,801 | \$ 10,766 |
| Revolving credit facility | 5,146 | 2,375 |
| Current portion of long-term liabilities - Other | 133 | 48 |
| TOTAL CURRENT LIABILITIES | 19,080 | 13,189 |
| LONG-TERM LIABILITIES: | | |
| Other liabilities | 1,169 | 1,258 |
| SHAREHOLDERS' EQUITY: | 4,557 | 4,557 |

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| | | |
|---|------------------|------------------|
| Preferred stock, \$2.50 par value, authorized 10,000,000 shares, issued and outstanding 4,579 (\$4,579 liquidation value) | | |
| Common stock, \$0.01 par value, authorized 50,000,000 shares, issued and outstanding, 8,053,033 and 7,944,232 shares | 81 | 80 |
| Additional paid in capital | 50,168 | 50,047 |
| Retained earnings (deficit) | (23,619) | (25,114) |
| Foreign currency translation adjustment | (841) | (902) |
| TOTAL SHAREHOLDERS EQUITY | <u>30,346</u> | <u>28,668</u> |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | <u>\$ 50,595</u> | <u>\$ 43,115</u> |

See notes to consolidated statements.

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except for per share data)

(unaudited)

| | Three Months Ended September 30, | | Six Months Ended September 30, | |
|---|-------------------------------------|-----------|-----------------------------------|-----------|
| | 2004 | 2003 | 2004 | 2003 |
| SALES | \$ 16,246 | \$ 15,671 | \$ 32,236 | \$ 30,654 |
| COST OF SALES | 8,463 | 8,138 | 16,526 | 16,138 |
| GROSS MARGIN | 7,783 | 7,533 | 15,710 | 14,516 |
| EXPENSES: | | | | |
| Sales and marketing | 3,873 | 4,194 | 8,145 | 8,324 |
| Research and development | 873 | 681 | 1,755 | 1,403 |
| General and administrative | 1,769 | 1,732 | 3,704 | 3,244 |
| Total operating expenses | 6,515 | 6,607 | 13,604 | 12,971 |
| OPERATING INCOME | 1,268 | 926 | 2,106 | 1,545 |
| Interest expense, net | (99) | (138) | (166) | (249) |
| Other, net | (145) | (36) | (110) | (248) |
| INCOME BEFORE INCOME TAXES | 1,024 | 752 | 1,830 | 1,048 |
| INCOME TAX PROVISION | 79 | 5 | 106 | 21 |
| NET INCOME | 945 | 747 | 1,724 | 1,027 |
| PREFERRED STOCK DIVIDEND | | | 229 | 208 |
| INCOME APPLICABLE TO COMMON SHAREHOLDERS | \$ 945 | \$ 747 | \$ 1,495 | \$ 819 |
| INCOME PER COMMON SHARE: | | | | |
| Basic | \$ 0.12 | \$ 0.09 | \$ 0.19 | \$ 0.10 |
| Diluted | \$ 0.11 | \$ 0.09 | \$ 0.18 | \$ 0.10 |
| WEIGHTED AVERAGE COMMON SHARES: | | | | |
| Basic | 8,036 | 7,970 | 8,019 | 7,955 |
| Diluted | 8,494 | 8,341 | 8,472 | 8,287 |

See notes to consolidated statements.

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(in thousands, except for share data)

| | Common Stock | | | Preferred Stock | | Retained Earnings | Accumulated Other Comprehensive Income * | Total Shareholders Equity |
|--|--------------|--------|----------------------------|-----------------|----------|-------------------|--|---------------------------|
| | Shares | Amount | Additional Paid in Capital | Shares | Amount | | | |
| BALANCE - MARCH 31, 2004 | 7,994,232 | \$ 80 | \$ 50,047 | 4,579 | \$ 4,557 | \$ (25,114) | \$ (902) | \$ 28,668 |
| Amortization of deferred compensation expense for shares issued for services | | | 4 | | | | | 4 |
| Issuance of common shares under employee stock option plan | 58,801 | 1 | 117 | | | | | 118 |
| Preferred stock dividend | | | | | | (229) | | (229) |
| Income for the period | | | | | | 1,724 | | 1,724 |
| Foreign currency translation adjustment | | | | | | | 61 | 61 |
| BALANCE - SEPTEMBER 30, 2004 (unaudited) | 8,053,033 | \$ 81 | \$ 50,168 | 4,579 | \$ 4,557 | \$ (23,619) | \$ (841) | \$ 30,346 |

* Comprehensive income, i.e., net income (loss), plus, or less, the change in foreign currency balance sheet translation adjustments, totaled \$1,785 for the six months ended September 30, 2004.

See notes to consolidated statements.

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

(unaudited)

| | Six Months Ended September 30, | |
|---|-----------------------------------|-----------------|
| | 2004 | 2003 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| NET INCOME | \$ 1,724 | \$ 1,027 |
| ADJUSTMENTS TO RECONCILE NET INCOME TO | | |
| NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES | | |
| Depreciation and amortization | 1,480 | 1,587 |
| Provision for losses on accounts receivable | 87 | 76 |
| Loss (gain) on disposal of property and equipment | (8) | (4) |
| Source (use) of cash from change in operating assets and liabilities: | | |
| Accounts receivable | (2,467) | (5,366) |
| Inventories | (4,676) | (1,129) |
| Prepays and other assets | 33 | (53) |
| Accounts payable and accrued expenses | 3,041 | 2,903 |
| Other, net | 3 | (16) |
| NET CASH USED IN OPERATING ACTIVITIES | (783) | (975) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (648) | (682) |
| Proceeds from sale of property and equipment | 10 | 24 |
| Software development costs | (679) | (911) |
| Investment in MobiPocket | | (527) |
| Change in other assets | (299) | (240) |
| NET CASH USED IN INVESTING ACTIVITIES | (1,616) | (2,336) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from revolving credit facility | 2,772 | 3,374 |
| Cash dividends on preferred stock | (229) | |
| Proceeds from issuance of common shares | 118 | 35 |
| Other liabilities | (10) | (31) |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 2,651 | 3,378 |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH | 61 | 182 |
| INCREASE IN CASH AND CASH EQUIVALENTS | 313 | 249 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 2,217 | 1,459 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 2,530 | \$ 1,708 |

See notes to consolidated statements.

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited, in thousands)

Reference is made to the financial statements included in the Company's Annual Report (Form 10-K) filed with the Securities and Exchange Commission for the year ended March 31, 2004.

The financial statements for the periods ended September 30, 2004 and 2003 are unaudited and include all adjustments necessary to a fair presentation of the results of operations for the periods then ended. All such adjustments are of a normal recurring nature. The results of the Company's operations for any interim period are not necessarily indicative of the results of the Company's operations for a full year.

OPERATIONS

Under Statement of Financial Accounting Standards No. 131, Disclosure about Segments of an Enterprise and Related Information, the Company's operations are treated as one operating segment as it only reports profit and loss information on an aggregate basis to the chief operating decision maker of the Company. Information about the Company's product sales are as follows:

| Product Sales | Three Months Ended | | Six Months Ended | |
|----------------------|--------------------|------------------|------------------|------------------|
| | September 30, | | September 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| Reference | \$ 13,897 | \$ 13,191 | \$ 28,559 | \$ 25,524 |
| ROLODEX® Electronics | 949 | 945 | 1,431 | 2,458 |
| Seiko | 872 | 1,183 | 1,539 | 1,987 |
| eBookMan | 374 | 115 | 422 | 209 |
| Other | 154 | 237 | 285 | 476 |
| Total Sales | \$ 16,246 | \$ 15,671 | \$ 32,236 | \$ 30,654 |

Approximate foreign sources of revenues including export sales were as follows:

| Product Sales | Three Months Ended | | Six Months Ended | |
|---------------|--------------------|------|------------------|------|
| | September 30, | | September 30, | |
| | 2004 | 2003 | 2004 | 2003 |

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| | | | | |
|---------------------|----------|----------|----------|----------|
| Europe | \$ 3,206 | \$ 3,015 | \$ 6,073 | \$ 5,190 |
| Other International | 1,554 | 1,511 | 2,323 | 2,787 |

For the three month period ended September 30, 2004 one customer accounted for more than 10% of the Company's revenue. Sales to the customer were approximately \$1,838 and consisted of reference and Seiko products. For the three months ended September 30, 2003, and the six month periods ended September 2004 and 2003, no customer accounted for more than 10% of the Company's revenues.

For the quarter ended September 30, 2004, three suppliers accounted for more than 10% of the Company's purchases of its inventory. The three suppliers individually accounted for 13%, 17%

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited, in thousands)

and 20% of inventory purchases. For the six months ended September 30, 2004, three suppliers accounted for more than 10% of the Company's purchases of its inventory. The three suppliers individually accounted for 11%, 16% and 22% of inventory purchases.

For the quarter ended September 30, 2003, four suppliers accounted for more than 10% of the Company's purchases of its inventory. The four suppliers individually accounted for 20%, 19%, 16% and 12% of inventory purchases. For the six months ended September 30, 2003, three suppliers accounted for more than 10% of the Company's purchases of its inventory. Individually two suppliers each accounted for 18% of inventory purchases and the third supplier accounted for 14% of the Company's inventory purchases.

The Company has multiple sources for all major reference products. During the six month period ended September 30, 2004, the Company used twelve different vendors to supply its reference products.

MOBIPOCKET

In April 2003, the Company purchased 25% of the outstanding shares of MobiPocket.com S.A. for approximately \$525 including expenses. MobiPocket, through its software reader application, enables the reading and secured distribution of electronic content across all the major OS platforms, including Palm OS, Pocket PC OS, Symbian OS, Windows OS and the Company's proprietary operating systems.

This transaction was accounted for by the purchase method of accounting. The Company accounts for the ongoing results of MobiPocket by the equity method of accounting.

STOCK OPTIONS

At September 30, 2004, the Company had two stock-based employee compensation plans, Franklin's 1988 Stock Option Plan, as amended, and Franklin's 1998 Stock Option Plan, as amended. The Company accounts for these plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, under which the Company has elected to follow the disclosure only alternative to accounting for its stock based compensation. Accordingly, no compensation is reflected in net income on the issuance of employee stock options at market value on the date of grant.

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited, in thousands)

The following table illustrates the effect on net income and earnings per share if the company had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock Based Compensation*, to stock-based employee compensation:

| | Three months ended | | Six months ended | |
|--|--------------------|---------|------------------|----------|
| | September 30, | | September 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| Reported net income | \$ 945 | \$ 747 | \$ 1,724 | \$ 1,027 |
| Deduct: | | | | |
| Total stock-based employee compensation expense determined under the fair value based method | (215) | (358) | (430) | (716) |
| Pro forma net income | \$ 730 | \$ 389 | \$ 1,294 | \$ 311 |
| (a) Earnings per share: | | | | |
| Basic-as reported | \$ 0.12 | \$ 0.09 | \$ 0.19 | \$ 0.10 |
| Basic- pro forma | \$ 0.09 | \$ 0.05 | \$ 0.16 | \$ 0.04 |
| Diluted as reported | \$ 0.11 | \$ 0.09 | \$ 0.18 | \$ 0.10 |
| Diluted pro forma | \$ 0.09 | \$ 0.05 | \$ 0.15 | \$ 0.04 |

(a) After preferred stock dividends of \$229 and \$208 for the six-month periods ended June 30, 2004 and 2003 respectively.

LEGAL PROCEEDINGS

In July 2004 E-Data Corporation (E-Data) filed an action against the Company in the United States District Court for the Eastern District of Texas alleging that the Company sold articles over the internet via a system, process, and method that infringed E-Data s United States Patent No. 4, 528, 643 (the 643 Patent) and asked for monetary damages in connection therewith. The 643 Patent expired in January 2003. As a result, E-Data has not asked for, nor is E-Data entitled to, injunctive relief as against the Company. The Company believes that the action is without merit and that the resolution of this matter will not have a material adverse effect on its financial condition or results of operations.

The Company is subject to other litigation from time to time arising in the ordinary course of its business. The Company does not believe that any such litigation is likely, individually or in the aggregate, to have a material adverse effect on the financial condition of the Company.

RECLASSIFICATIONS

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Certain reclassifications have been made to the prior period's financial statements to conform to the current period presentation. These reclassifications had no effect on previously reported results of operations or retained earnings.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (in thousands)

This 2004 Quarterly Report on Form 10-Q may contain statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended. Those statements include statements regarding the intent and belief or current expectations of Franklin and its management team. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those projected in the forward-looking statements. Such risks and uncertainties include, among other things, the timely availability and acceptance of new electronic books, organizers, and other electronic products, changes in technology, the impact of competitive electronic products, the management of inventories, Franklin's dependence on key licenses, titles and products, Franklin's dependence on third party component suppliers and manufacturers, including those that provide Franklin-specific parts, international sales and currency fluctuations and other risks and uncertainties that may be detailed herein, and from time-to-time, in Franklin's reports filed with the Securities and Exchange Commission. Franklin undertakes no obligation to publicly update any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

RESULTS OF OPERATIONS

Three months ended September 30, 2004 compared with three months ended September 30, 2003:

Net Sales

Sales of \$16,246 for the quarter ended September 30, 2004, increased by \$575 from sales of \$15,671 for the same quarter last year. The higher sales in the quarter were primarily attributable to increased reference product sales of \$706 and higher eBookMan closeout sales of \$259 which were offset in part by a decline in Seiko product sales of \$311. The increase in reference product sales was mainly due to higher sales in the US Consumer and European markets of \$800 and \$245 respectively. These increases were partially offset by a decline in OEM reference sales of \$242 and a reduction of \$74 in US direct reference sales. The decline in sales of Seiko products was due to lower sales to US retailers.

Gross Margin

The gross margin percentage for the quarter ended September 30, 2004 was approximately equivalent to the gross margin percentage in the same period last year while gross margin dollars increased by \$250 due to higher sales. The Company's sales mix was comparable to the prior year period with the lower margin ROLODEX[®] Electronics products accounting for 6% of sales in both the current and prior year quarters. The margin percentage benefited from the results of the Company's European subsidiaries, as their revenues were helped by the strengthening Euro and British pound while their cost of sales remained fixed in US dollars. These gains were offset by a shift in divisional sales mix as the US Direct, OEM and Medical divisions, which typically enjoy higher margins, accounted for only 13% of domestic sales in the current year compared with 17% last year.

Operating Expenses

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Total operating expenses decreased to \$6,515 in the current quarter from \$6,607 in the same period last year. Sales and marketing expense decreased to \$3,873 (24% of sales) from \$4,194 (27% of sales) last year due primarily to a decrease in trade advertising and promotions of \$269. Research and development expense increased by \$192 to \$873 (5% of sales) from \$681 (4% of sales) last year as increased consulting and outside engineering costs of \$320 and \$57 respectively were partially offset by the deferral of \$233 of costs related to work on specific contracts for which the revenue and related expenses will be recognized in future periods. General and administrative expense increased by \$37 to \$1,769 (11% of sales) compared with \$1,732 (11% of sales) in the prior year.

Interest Expense, net

Interest expense, net declined to \$99 in the current period from \$138 last year because of lower levels of debt outstanding.

Other, net

Other, net was a loss of \$145 for the quarter ended September 30, 2004 compared with a loss of \$36 in the same period last year. The change is due primarily to a loss on the Company's hedging program of \$126 in the quarter ended September 30, 2004 as a result of the weakening dollar, as compared to a loss of \$44 in the same quarter last year and loss of \$60 on the repatriation of funds from the Company's foreign subsidiaries in the quarter ended September 30, 2004. The losses were partially offset by equity income of \$46 on the Company's 25% investment in MobiPocket.

The Company maintains a program of selling Euros at current rates for future settlement in order to protect the dollar value of sales generated by foreign subsidiaries. Gains or losses on these contracts are offset by the effect of the foreign exchange rate changes on the underlying transactions, primarily the revenue generated and expenses incurred by the Company's European subsidiaries.

Net Income

For the quarter ended September 30, 2004, net income increased by \$198 to \$945 from \$747 in the same period last year. The increase is primarily due to increased sales of \$575 which resulted in higher gross margin dollars of \$250, reduced operating expenses of \$92 and lower interest expense of \$39 resulting from reduced debt levels. These gains were partly offset by higher foreign exchange losses of \$126 on the Company's hedging program and higher income tax accruals of \$74.

Six months ended September 30, 2004 compared with six months ended September 30, 2003:

Net Sales

Sales of \$32,236 for the six months ended September 30, 2004, increased by \$1,582 from sales of \$30,654 for the same period last year. The higher sales in the period were primarily attributable to increased reference product sales of \$3,035 which were offset in part by a decline in sales of Seiko and ROLODEX[®] Electronics products of \$448 and \$1,027 respectively. The increase in reference product sales was mainly due to higher sales in the US Consumer and European markets of \$3,110 and \$1,021 respectively. These increases were partially offset by a decline in OEM sales of \$494, a reduction of \$323 in US direct sales and a decline in Medical and export sales of \$73 and \$181 respectively. The decline in Seiko and ROLODEX[®] Electronics products occurred mainly in the US Consumer division where sales of these product lines decreased by \$458 and \$848 respectively.

Gross Margin

The gross margin percentage for the six months ended September 30, 2004 was 49% of sales compared with 47% sales in the same period last year while gross margin dollars increased by \$1,194. Of the increase in the gross margin dollar amount, \$445 is attributable to the higher margin percentage while \$749 is due to higher year-over-year sales. The margin percentage benefited from the results of the Company's European subsidiaries, as their revenues were helped by the strengthening Euro and British pound while their cost of sales remained fixed in US dollars. In addition, the margin was helped by a shift in the Company's sales mix with lower margin ROLODEX® Electronics products accounting for only 4% of sales in the six months ended September 30, 2004 compared with 8% in the same period last year. As discussed above, these gains were partly offset by a shift in divisional sales mix as the higher margin US Direct, OEM and Medical divisions accounted for only 12% of domestic sales in the current year compared with 17% last year.

Operating Expenses

Total operating expenses increased to \$13,604 in the current period from \$12,971 in the same period last year. Sales and marketing expense decreased to \$8,145 (25% of sales) from \$8,324 (27% of sales) last year. The decrease in sales and marketing expense was due primarily to a decrease in trade advertising and promotions of \$181. Research and development expense increased by \$352 to \$1,755 (5% of sales) from \$1,403 (5% of sales) last year due primarily to increased personnel costs of \$86 and higher consulting and outside engineering costs of \$317 and \$44 respectively. General and administrative expense increased by \$460 to \$3,704 (11% of sales) compared with \$3,244 (11% of sales) in the prior year due primarily to higher personnel costs of \$276, increased bad debt provisions of \$70 and higher travel and entertainment expense of \$75. The increased personnel costs are primarily due to increased medical benefits expense of \$92 and higher incentive bonus accruals of \$206 directly related to the year-over-year increase in the Company's pre-tax income.

Interest Expense, net

Interest expense, net declined to \$166 in the current period from \$249 last year because of lower levels of debt outstanding.

Other, net

Other, net was a loss of \$110 for the six months ended September 30, 2004 compared with a loss of \$248 in the same period last year. The change is due primarily to reduced losses on the Company's hedging program which were \$87 in the six months ended September 30, 2004 compared with \$286 in the same period last year and equity income in the current year of \$46 on the Company's 25% investment in MobiPocket. These improvements were partially offset by losses of \$58 on the repatriation of funds from the Company's foreign subsidiaries in the six months ended September 30, 2004 compared with a gain of \$30 last year.

The Company maintains a program of selling Euros at current rates for future settlement in order to protect the dollar value of sales generated by foreign subsidiaries. Gains or losses on these contracts are offset by the effect of the foreign exchange rate changes on the underlying transactions, primarily the revenue generated and expenses incurred by the Company's European subsidiaries.

Net Income

For the six months ended September 30, 2004, net income increased by \$697 to \$1,724 from \$1,027 in the same period last year. The increase is primarily due to improved gross margin, on a higher revenue base, of \$1,582 and reduced losses on the Company's hedging program of \$199, and lower interest expense of \$83 resulting from reduced debt levels. These improvements were partly offset by increased operating expenses of \$633 and higher income tax accruals of \$85.

Changes in Financial Condition

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Accounts receivable increased by \$2,380 to \$9,490 at September 30, 2004 from \$7,110 at March 31, 2004 primarily because of a seasonal increase in sales of \$3,937 during the September 2004 quarter compared with the March 2004 quarter. Inventory increased by \$4,677 to \$13,084 on September 30, 2004 from \$8,407 on March 31, 2004 due to normal seasonal increases as the Company builds inventory for the holiday selling season. Accounts payable and the balance of the Company's borrowings under its credit facility increased by \$3,035 and \$2,771 respectively, from March 31, 2004 because of seasonal inventory and cash requirements.

Liquidity and Capital Resources

The Company has a \$25,000 secured financing facility with a commercial lender which expires on December 7, 2004. Borrowings under the revolving credit facility bear interest at the bank's prime rate (4.75% at September 30, 2004) plus 3/4% and real property and equipment advances under the facility bear interest at the rate of prime plus 1½%. As of September 30, 2004 the Company had real property advances outstanding of \$2,995 and no equipment advances. The facility contains certain financial covenants and restrictions on indebtedness, dividend payments, business combinations and other related items. On June 9, 2004, the Company received a waiver from its lender allowing the Company to pay the preferred stock dividend due June 30, 2004 in cash. As of September 30, 2004 no other amounts were available for payment of dividends. On November 12, 2004, the Board of Directors approved a dividend of \$229 on the Preferred Stock payable on December 31, 2004, and the redemption prior to December 31, 2004 of 1,145 shares of the Preferred Stock at a cost of \$1,145. Borrowings are collateralized by substantially all assets of the Company. On September 30, 2004 the Company had an aggregate outstanding balance of \$5,146 under the facility and remains in compliance with all covenants. As the current facility expires on December 7, 2004, amounts outstanding under the facility as of September 30, 2004 and March 31, 2004 are classified as current liabilities.

The Company relies primarily on its revolving credit facility to supplement operating cash flow to meet its financing needs. The amount of credit available under the facility at any time is based upon a formula applied to the Company's accounts receivable, inventory, real estate, and certain capital equipment. As of September 30, 2004, there was credit available of \$13,277, of which \$5,146 was drawn down and \$8,131 remained available. The Company's credit availability and borrowings under the facility fluctuate during the year because of the seasonal nature of the business. During the year ended March 31, 2004, maximum availability and borrowings under the facility approximated \$16,800 and \$10,500 respectively. The Company does not have any significant capital leases and anticipates that depreciation and amortization for fiscal 2005 will exceed planned capital expenditures.

The Company has signed a commitment letter from another commercial lender under which the new lender will provide a three year secured credit facility in the amount of \$20,000 to replace the existing facility on December 7, 2004, subject to due diligence and documentation of the facility. Interest under the new facility is determined by a pricing grid based on certain financial ratios of the Company. The initial interest rate under this grid will be the bank's prime rate less 1/2% for both the revolving credit and real estate advance portions of the facility. The amount of credit available under the facility at any time will be based upon a formula applied to the Company's accounts receivable, inventory and real estate. The facility will be secured by all of the Company's assets.

Management believes that cash flow from operations and the new secured financing facility will be adequate to provide for the Company's liquidity and capital needs for the foreseeable future.

The Company has no material commitments for capital expenditures in the next twenty-four months.

Seasonality

The Christmas selling season (October, November and December) and the back to school season (August to mid-September) are the strongest selling periods at retail for the Company's products.

Future Income Tax Benefits

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Because of net operating loss carryforwards, no federal income taxes have been provided during the quarter ending September 30, 2004. The Company's deferred tax asset of \$5,700 represents the amount that the Company believes that it can reasonably expect to utilize in the foreseeable future.

Contractual Obligations

In April 2003, the Company began to distribute handheld reference products in North America under the Seiko® trademark. In June 2004, the Company entered into cross-distribution agreements with Seiko Instruments, Inc. (SII), which provide for Franklin to continue purchasing Seiko® reference products for distribution in North America for the five years ending March 31, 2009 with a minimum purchase guarantee of approximately \$14,042 during the period.

The minimum purchase guarantee by fiscal year is as follows:

| | |
|-------------|----------|
| Fiscal 2005 | \$ 2,300 |
| Fiscal 2006 | 2,530 |
| Fiscal 2007 | 2,783 |
| Fiscal 2008 | 3,061 |
| Fiscal 2009 | 3,368 |

Critical Accounting Policies and Estimates

Management's discussion and analysis of financial condition and results of operations are based upon the Company's consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures. On an ongoing basis, the Company evaluates its estimates and judgments based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. The Company annually reviews its financial reporting and disclosure practices and accounting policies to ensure that its financial reporting and disclosures provide accurate and transparent information relative to the current economic and business environment. The Company believes that of its significant accounting policies, the following policy involves a higher degree of judgment and/or complexity:

Asset Impairment In assessing the recoverability of the Company's fixed assets, goodwill and other non-current assets, the Company considers changes in economic conditions and makes assumptions regarding estimated future cash flows and other factors.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

There were no material changes from the information presented in Item 7A of the Company's Annual Report on Form 10-K for the year ended March 31, 2004, which is hereby incorporated by reference, with respect to the Company's quantitative and qualitative disclosures about market risks.

ITEM 4. CONTROLS AND PROCEDURES

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As of September 30, 2004 (the end of the period covered by this report), the Company's management carried out an evaluation, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including the Company's subsidiaries) required to be included in periodic reports filed under the Securities Exchange Act of 1934.

In designing and evaluating the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934), management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. We believe that our disclosure controls and procedures provide such reasonable assurance.

No change occurred in the Company's internal controls concerning financial reporting during the quarter ended September 30, 2004 that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In July 2004 E-Data Corporation (E-Data) filed an action against the Company in the United States District Court for the Eastern District of Texas alleging that the Company sold articles over the internet via a system, process, and method that infringed E-Data's United States Patent No. 4, 528, 643 (the 643 Patent) and asked for monetary damages in connection therewith. The 643 Patent expired in January 2003. As a result, E-Data has not asked for, nor is E-Data entitled to, injunctive relief as against the Company. The Company believes that the action is without merit and that the resolution of this matter will not have a material adverse effect on its financial condition or results of operations.

The Company is subject to other litigation from time to time arising in the ordinary course of its business. The Company does not believe that any such litigation is likely, individually or in the aggregate, to have a material adverse effect on the financial condition of the Company.

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

The Company has a \$25 million secured financing facility with a commercial lender which expires on December 7, 2004. The facility contains certain financial covenants and restrictions on indebtedness, dividend payments, business combinations and other related items. As of September 30, 2004 no amounts were available for payment of dividends.

The Company awarded approximately 8,250 shares of common stock to certain employees of the Company on November 9, 2003. These shares were awarded pursuant to the Company's Restricted Stock Plan, as Amended and Restated (the Restricted Stock Plan). Exemption from the registration requirements of the Securities Act of 1933, as amended (the Securities Act), for the issuance of such shares is claimed under Section 4(2) of the Securities Act. Employees vest in their unrestricted ownership of these shares after three years in accordance with the Restricted Stock Plan vesting provisions. Employees will forfeit all non vested shares upon departure from the Company. The value of these shares at the grant date was approximately \$26 and the related compensation charge is being expensed over the vesting period. As of September 30, 2004, approximately 4,000 additional shares remain reserved for future issuance under the Restricted Stock Plan.

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

The Annual Meeting of Shareholders of the Company was held on August 25, 2004. Reference is made to the Company's Proxy Statement furnished to shareholders in connection with the solicitation of proxies in connection with that Annual Meeting. In connection with the annual election of directors, eight incumbent directors were re-elected with Edward H. Cohen receiving 8,020,899 votes with 68,547 votes withheld; Barry Lipsky receiving 8,082,899 with 6,547 votes withheld; Leonard M. Lodish receiving 8,048,799 with 40,647 votes withheld; William H. Turner receiving 8,046,799 votes with 42,647 votes withheld; Howard L. Morgan receiving 7,798,356 with 291,090 votes withheld; James Meister receiving 7,796,256 votes with 293,190 votes withheld; Jerry R. Schubel receiving 8,048,599 votes with 40,847 votes withheld; and James H. Simons receiving 7,798,156 votes with 291,290 votes withheld. Shareholders ratified the appointment of Radin, Glass & Co. as auditors for the Company's 2005 fiscal year by vote of 8,048,954 in favor, 35,200 votes against, and 5,292 abstentions.

ITEM 5. OTHER INFORMATION

ROLODEX® is a registered trademark of Berol Corporation, a subsidiary of Newell Rubbermaid, Inc. Seiko® is registered trademark of Seiko, Inc.

ITEM 6. EXHIBITS

(a) Exhibits

- 31.1* Chief Executive Officer's Certificate, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2* Chief Financial Officer's Certificate, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1* Chief Executive Officer's Certificate, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2* Chief Financial Officer's Certificate, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith

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.

FRANKLIN ELECTRONIC PUBLISHERS,

INCORPORATED

Date: November 15, 2004

/s/ Barry J. Lipsky

Barry J. Lipsky
President and Chief Executive Officer
(Duly Authorized Officer)

Date: November 15, 2004

/s/ Arnold D. Levitt

Arnold D. Levitt
Senior Vice President,
Chief Financial Officer, and Treasurer
(Principal Financial and Accounting Officer)