

TROY GROUP INC
Form 10-Q
March 19, 2003

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended August 31, 2002.

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

For the transition period from to

Commission File Number: 000-24413

TROY GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

33-0807798

(I.R.S. Employer Identification No.)

2331 South Pullman Street

Santa Ana, California

(Address of principal executive offices)

92705

(Zip code)

(949) 250-3280

(Registrant's telephone number, including area code)

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

As of October 11, 2002, there were 10,649,092 shares of our common stock outstanding.

TROY GROUP, INC.

Quarterly Report on Form 10-Q for the

Quarterly Period Ended August 31, 2002

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PART I: FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TROY GROUP, INC.
CONSOLIDATED BALANCE SHEETS

(in thousands, except share amounts)

Assets	August 31, 2002 (Unaudited)	November 30, 2001
Current assets:		
Cash and cash equivalents	\$ 5,459	\$ 1,210
Investment in available-for-sale securities	1,323	5,181
Accounts receivable, less allowance for doubtful accounts of \$706 and \$1,130, respectively	7,399	9,713
Income tax refund receivable	1,373	1,059
Inventories	7,135	9,251
Prepaid expenses and other	807	358
Deferred tax assets	2,480	2,480
Total current assets	25,976	29,252
Equipment and leasehold improvements, net	2,186	2,529
Other assets, including receivable from stockholders of \$2,123 at August 31, 2002 and \$1,666 at November 30, 2002	5,210	5,226
Total assets	\$ 33,372	\$ 37,007
Liabilities and Stockholders Equity		
Current liabilities:		
Current portion of long-term debt	\$ 72	\$ 70
Accounts payable	2,492	4,418
Accrued expenses	2,353	2,456
Deferred revenue	972	1,138
Total current liabilities	5,889	8,082
Long-term debt, net of current portion	139	193
Stockholders equity:		
Preferred stock, par value \$.01 per share, authorized 5,000,000 shares, issued none		
Common stock, par value \$.01 per share; authorized 50,000,000 shares, issued 2002 10,969,657 shares; and 2001 10,921,032 shares	110	109
Additional paid-in capital	21,113	20,966
Retained earnings	7,296	8,753
	28,519	29,828
Less cost of treasury stock 320,565 common shares in 2002 and 295,320 in 2001	1,175	1,096

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Total stockholders' equity		27,344		28,732
Total liabilities and stockholders' equity	\$	33,372	\$	37,007

See Notes to Consolidated Financial Statements.

TROY GROUP, INC.
CONSOLIDATED STATEMENTS
OF OPERATIONS
(Unaudited)
(in thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	August 31, 2002	August 31, 2001	August 31, 2002	August 31, 2001
Net sales	\$ 13,649	\$ 13,674	\$ 41,245	\$ 34,783
Cost of goods sold	10,214	8,161	26,658	21,243
Gross profit	3,435	5,513	14,587	13,540
Operating expenses:				
Selling, general and administrative	3,415	3,584	11,282	11,533
Research and development	1,696	1,379	5,221	4,400
Amortization of intangible assets	130	320	390	960
Operating income (loss)	(1,806)	230	(2,306)	(3,353)
Interest income	17	102	96	468
Interest expense	(3)	(28)	(33)	(92)
Income (loss) before income taxes	(1,792)	304	(2,243)	(2,977)
Provision for (benefit from) income taxes	(627)	84	(786)	(1,031)
Net income (loss)	\$ (1,165)	\$ 220	\$ (1,457)	\$ (1,946)
Net income (loss) per share:				
Basic	\$ (.11)	\$.02	\$ (.14)	\$ (.18)
Diluted	\$ (.11)	\$.02	\$ (.14)	\$ (.18)
Weighted-average shares outstanding:				
Basic	10,649	10,667	10,646	10,816
Diluted	10,649	10,803	10,646	10,816

See Notes to Consolidated Financial Statements.

TROY GROUP, INC.

CONSOLIDATED STATEMENTS

OF CASH FLOWS

(Unaudited)

(in thousands)

	Nine Months Ended	
	August 31, 2002	August 31, 2001
Cash flows from operating activities:		
Net loss	\$ (1,457)	\$ (1,946)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	980	1,538
Recovery of doubtful accounts	(212)	308
Deferred taxes		(88)
Accrued interest on available for sale securities	(85)	(314)
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	2,526	398
Income tax refund receivable	(314)	241
Inventories	2,116	2
Prepaid expenses and other	(449)	(60)
Accounts payable	(1,927)	538
Accrued expenses	(103)	86
Deferred revenue	(167)	57
Net cash provided by operating activities	908	760
Cash flows from investing activities:		
Acquisition of businesses		(1,980)
Purchase of equipment and leasehold improvements	(302)	(866)
Purchase of available-for-sale securities	(1,449)	(3,363)
Maturities of available-for-sale securities	5,393	9,148
Capitalization of software development costs		814
Increase in other assets, net	(319)	(1,835)
Net cash provided by investing activities	3,323	1,918
Cash flows from financing activities:		
Net borrowings on revolving line of credit		
Payments on notes payable	(52)	(50)
Proceeds from issuance of common stock	149	158
Purchase of treasury stock	(79)	(918)
Net cash provided by (used in) financing activities	18	(810)
Net increase in cash and cash equivalents	4,249	1,868
Cash and cash equivalents, beginning of period	1,210	1,235
Cash and cash equivalents, end of period	\$ 5,459	\$ 3,103

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See Notes to Consolidated Financial Statements.

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

Note 1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals and adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended August 31, 2002 are not necessarily indicative of the results that may be expected for the year ended November 30, 2002. For further information, refer to the financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for its fiscal year ended November 30, 2001 (File No. 000-24413).

Note 2. Inventories

Inventories consisted of the following as of August 31, 2002 and November 30, 2001 (amounts in thousands):

	August 31, 2002	November 30, 2001
Raw materials	\$ 4,904	\$ 6,997
Work-in-process	766	455
Finished goods	3,631	4,306
Reserve for slow moving and obsolete inventories	(2,166)	(2,507)
Total	\$ 7,135	\$ 9,251

Note 3. Investment in Available-for-sale Securities

As of August 31, 2002, the Company had approximately \$1.3 million in corporate debt securities with contractual maturity dates of up to one year, which management has determined should be classified as available-for-sale. Market values approximated carrying values. Accordingly, no unrealized gains or losses were recorded at August 31, 2002. There were no gains or loss recognized for the nine months ended August 31, 2002 or August 31, 2001.

Note 4. Stock Option and Stock Warrant Plans

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During the nine months ended August 31, 2002, the Company granted options to employees to acquire 350,000 shares of common stock at a weighted-average exercise price of \$4.03 per share, 10,000 options were exercised at a weighted-average exercise price of \$2.94 per share, and 703,000 options were forfeited at a weighted-average exercise price of \$6.21 per share. The following is a summary of total outstanding options and stock warrants at August 31, 2002:

Range of Exercise Prices		Options and Warrants Outstanding				Options and Warrants Exercisable			
		Number of Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life	Number of Options	Weighted-Average Exercise Price			
\$2.94	4.51	857,666	\$ 3.88	8.1 years	211,665	\$ 2.99			
\$6.31	8.75	740,000	\$ 7.35	7.1 years	425,500	\$ 7.25			
\$13.16	14.25	25,000	\$ 13.38	7.3 years					
		1,622,666			637,165				

At August 31, 2002, there were 1,209,000 shares remaining available for grant under the Company's option plans.

Note 5. Net Income (Loss) Per Share

The following table sets forth the computation of basic and diluted net income (loss) per share:

	Three months ended (amounts in thousands, except per share data)		Nine months ended (amounts in thousands, except per share data)	
	August 31, 2002	August 31, 2001	August 31, 2002	August 31, 2001
<u>Numerator for basic and diluted net income (loss) per share:</u>				
Net income (loss)	\$ (1,165)	\$ 220	\$ (1,457)	\$ (1,946)
Denominator for basic net income (loss) per share				
weighted-average shares outstanding	10,649	10,667	10,646	10,816
Effect of employee stock options and warrants		136		
Denominator for diluted net income (loss) per share				
	10,649	10,803	10,646	10,816
<u>Net income (loss) per share:</u>				
Basic	\$ (.11)	\$.02	\$ (.14)	\$ (.18)
Diluted	\$ (.11)	\$.02	\$ (.14)	\$ (.18)

The dilutive effect of incremental shares of employee stock options and warrants for the periods ended August 31, 2002 and 2001 would have been 53,000 and 68,000 for the three and nine months ended August 31, 2002, respectively, and 136,000 and 77,000 for the three and nine months ended August 31, 2001, respectively.

Note 6. Business Combination*Extended Systems Incorporated*

On May 31, 2001, the Company acquired in a purchase transaction certain assets and assumed certain liabilities of Extended Systems Incorporated, a print server manufacturer, in exchange for \$1,672,000 in cash and \$504,000 in direct expenses. The total acquisition cost was \$2,051,000 and was allocated as follows:

Inventories	\$	1,600,000
Equipment		46,000
Goodwill		530,000
Current liabilities assumed		(125,000)
	\$	2,051,000

Unaudited pro forma information

Unaudited pro forma consolidated results of operations for the nine months ended August 31, 2001 as though Extended Systems Incorporated had been acquired as of December 1, 2000 are as follows (amounts in thousands, except per share data):

	Nine Months Ended	
	August 31, 2001	
Pro forma net sales	\$	41,879
Pro forma net loss	\$	(1,788)
Pro forma net loss per share: basic and diluted	\$	(.17)

The above amounts reflect pro forma adjustments for amortization of intangibles and number of shares outstanding. This pro forma financial information does not purport to be indicative of the results of operations had the Extended Systems Incorporated acquisition actually taken place at the earlier date.

Note 7. Segment Information

The following tables summarize revenues and net income (loss) by operating segment and unallocated corporate for the three and nine months ended August 31, 2002 and August 31, 2001:

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	Three months ended		Nine months ended	
	(amounts in thousands)		(amounts in thousands)	
	August 31, 2002	August 31, 2001	August 31, 2002	August 31, 2001
Revenues:				
Troy Systems	\$ 10,547	\$ 10,096	\$ 32,134	\$ 27,793
Troy Wireless	3,157	3,684	9,314	7,212
Less intersegment revenue	(55)	(106)	(203)	(222)
	\$ 13,649	\$ 13,674	\$ 41,245	\$ 34,783
Net income (loss):				
Troy Systems	\$ 379	\$ 1,285	\$ 2,914	\$ 1,754
Troy Wireless	(813)	(384)	(2,068)	(1,455)
Unallocated Corporate	(731)	(681)	(2,303)	(2,245)
	\$ (1,165)	\$ 220	\$ (1,457)	\$ (1,946)

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Certain reclassifications have been made to the August 31, 2001 segment information to conform to the August 31, 2002 presentation.

	August 31, 2002	November 30, 2001
Segment Assets:		
Troy Systems	\$ 11,842	\$ 13,395
Troy Wireless	11,040	10,259
Unallocated Corporate	41,661	28,663
	\$ 64,543	\$ 52,317

The following schedule is presented to reconcile August 31, 2002 and November 30, 2001 segment assets to the amounts reported in the Company's consolidated financial statements (amounts in thousands).

	August 31, 2002	November 30, 2001
Total Assets of Reportable Segments	\$ 64,543	\$ 52,317
Intersegment Receivables	(30,789)	(14,928)
Investment in Subsidiaries	(382)	(382)
Consolidated assets	\$ 33,372	\$ 37,007

Note 8. Cash Flow Information

Supplemental disclosure of cash flow information

	Nine months ended (amounts in thousands)	
	August 31, 2002	August 31, 2001
Cash paid during the period for:		
Interest	\$ 46	\$ 92
Income taxes	\$ 13	\$ 81

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

The following discussion and analysis should be read in conjunction with our Condensed Consolidated Financial Statements and related Notes included in this report. This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The statements contained in this report that are not historical in nature, particularly those that utilize terminology such as may, will, should, expects, anticipates, estimates, believes or plans, or comparable terminology, are forward-looking statements based on expectations and assumptions.

Various risks and uncertainties could cause actual results to differ materially from those expressed in forward-looking statements. These risks and uncertainties include our ability to consolidate operations and reduce costs; the continued demand for printed financial documents; our ability to offset declining sales of our wired connectivity products; the success of the measures we implemented to address inventory accounting controls; the market acceptance of products incorporating wireless printing technologies; the impact of the delisting of our common stock from the Nasdaq National Market; our ability to hire and retain qualified management, technology and other personnel; the impact of competition from existing and new technologies and companies; and the other factors set forth below under the heading "Certain Important Factors" and in our other periodic reports and other documents that we file from time to time with the Securities and Exchange Commission.

We own or have rights to trademarks that we use in connection with the sale of our products. TROY®, eCheck Secure, PrintraNet, TROYmark, StarACH, Etherwind, Windconnect, Windport, EtherSync, Exact MICR Technology (ExMT) and Exact Positioning Technology (ExPT) are among the trademarks that we own. This report also makes reference to trademarks and trade names of other companies.

Background

TROY Group, Inc. is a worldwide provider of enterprise output solutions. For the past three years we have been expanding beyond our core business in digital check printing systems and related consumables by developing electronic payment systems and wired and wireless networking solutions. Most of this new product expansion was accomplished through the acquisition and further investment in five small technology companies. These acquisitions have been organized under two primary business segments: TROY Systems and TROY Wireless.

TROY Systems provides state-of-the-art payment systems ranging from high security digital check printing systems to electronic payment and funds transfer solutions. Our systems are used to transfer monies between bank accounts using paper checks or electronic ACH (Automated Clearing House) processes. Our products provide our customers with payment solutions that offer security, speed, flexibility and efficiency. Ameritrade, Inc., AT&T Corporation, Bank of America Corporation, Eastman Kodak Company, Farmers Group, Inc. (Farmers Insurance), Fidelity Investments, Ford Motor Company, IBM, Manpower Inc., Morgan Stanley Dean Witter & Co., CSFBdirect, Track Data, Mr. Stock, Wal-Mart Stores, Inc., Wells Fargo & Company, Comerica Bank, Red Cross, G.E. Capital Ireland and Ford Credit Europe are among the TROY customers that purchased payment products during the last 12 months.

TROY Wireless provides hardware and software solutions that enable enterprises to share intelligent devices like printers either wirelessly or using traditional networks. We have been a supplier

of hardwired network printing solutions since 1991. Our wireless products allow a wide range of devices to exchange information via *Bluetooth* and 802.11b short-range radio connections. Brother Industries, Ltd., Sony Corporation, Seiko Epson Corporation and DaimlerChrysler AG are among the TROY Wireless customers that have purchased these products during the last 12 months.

We serve a wide variety of industries including financial services, insurance, telecommunications, computer hardware, automotive, personnel, government and others. We distribute our solutions around the world and market our products through a direct sales force and a network of distributors and value-added resellers. More than 5,000 customers have purchased our products and services during the last 12 months.

Results of Operations

On October 15, 2002, we issued a press release announcing that the filing of our Form 10-Q for the fiscal quarter ended August 31, 2002 would be delayed. We had conducted physical inventory counts and discovered certain inventory shortfalls and other adjustments, which we preliminarily estimated to be approximately \$1.5 million. We delayed the filing of our Form 10-Q for the fiscal quarter ended August 31, 2002 in order to give us sufficient time to review the causes of such inventory adjustments and to determine if any of the financial statements for prior periods would need to be restated. Following completion of this review, we determined that the final adjustments totaled approximately \$1.2 million, and that it would be necessary to restate our consolidated financial statements as of and for the periods ended February 28, 2002 and May 31, 2002 and to make conforming changes to Management's Discussion and Analysis of Financial Condition and Results of Operations to reflect such restatement.

The following table sets forth, for the periods indicated, certain information derived from our consolidated statements of operations expressed as a percentage of net sales:

	Three Months Ended		Nine Months Ended	
	August 31, 2002	August 31, 2001	August 31, 2002	August 31, 2001
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	74.8	59.7	64.6	61.1
Gross Profit	25.2	40.3	35.4	38.9
Selling, general and administrative expenses	25.0	26.2	27.4	33.1
Research and development expenses	12.4	10.1	12.7	12.6
Amortization of intangible assets	1.0	2.3	0.9	2.8
Operating income (loss)	(13.2)	1.7	(5.6)	(9.6)
Interest income	0.1	0.7	0.2	1.3
Interest expense		(0.2)		(0.3)
Income (loss) before income taxes (credits)	(13.1)	2.2	(5.4)	(8.6)
Provision for income taxes (credits)	(4.6)	0.6	(1.8)	(3.0)
Net income (loss)	(8.5)%	1.6%	(3.6)%	(5.6)%

Three Months Ended August 31, 2002 Compared to Three Months Ended August 31, 2001

Net Sales. Our net sales were \$13.6 million for the three months ended August 31, 2002, with \$10.5 million attributable to Troy Systems and \$3.1 million attributable to Troy Wireless. Net sales in the three months ended August 31, 2002 decreased by \$25,000 from \$13.7 million in the three months ended August 31, 2001. This decrease in net sales represents a \$470,000 increase in sales of our laser printers, proprietary imaging supplies, services, and electronic payment solutions, and a decrease of

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\$495,000 in sales of our connectivity products. Net sales were not significantly affected by price changes.

Cost of Goods Sold. Cost of goods sold increased by \$2.0 million or 25.6% to \$10.2 million in the three months ended August 31, 2002 from \$8.2 million in the three months ended August 31, 2001. This increase primarily was due to an increase in the reserve for excess and obsolete inventory of Troy Systems of \$703,000, and severance costs of \$169,000. Cost of goods sold as a percentage of net sales increased to 75.0% in the three months ended August 31, 2002 from 59.7% in the three months ended August 31, 2001, primarily due to the increase in the inventory reserve and severance costs described above.

Gross Profit. Gross profit decreased by \$2.1 million to \$3.4 million in the three months ended August 31, 2002 from \$5.5 million in the three months ended August 31, 2001. Gross profit as a percentage of net sales decreased to 25.2% in the three months ended August 31, 2002 from 40.3% in the three months ended August 31, 2001. The decrease in gross profit was primarily due to the inventory reserve increases and severance payments discussed above.

Selling, General and Administrative Expenses. Selling, general and administrative expenses decreased by \$169,000 or 4.7% to \$3.4 million in the three months ended August 31, 2002 from \$3.6 million in the three months ended August 31, 2001. This decrease primarily was due to a \$60,000 reduction in the allowance for doubtful accounts related to improved collections, and \$177,000 in foreign currency gains, partially offset by \$237,000 of severance expense and other expenses. Selling, general and administrative expenses as a percentage of net sales decreased to 25.0% in the three months ended August 31, 2002 from 26.2% in the three months ended August 31, 2001.

Research and Development Expenses. Research and development expenses increased by \$317,000 or 23.0% to \$1.7 million in the three months ended August 31, 2002 from \$1.4 million in the three months ended August 31, 2001, primarily due to increased spending for electronic payment software. The total research and development expenses for the third quarter of fiscal 2002 included \$1.3 million for Troy Systems and \$415,000 for Troy Wireless. There were no software development costs capitalized in the three months ended August 31, 2002 and \$551,000 were capitalized in the three months ended August 31, 2001. Research and development expenses as a percentage of net sales was 12.4% in the three months ended August 31, 2002 and 10.1% in the three months ended August 31, 2001.

Amortization of Intangible Assets. Amortization of intangible assets decreased by \$190,000 or 59.4% to \$130,000 in the three months ended August 31, 2002 from \$320,000 in the three months ended August 31, 2001. This decrease was the result of the write-down of impaired long-lived assets at the end of fiscal year 2001.

Operating Income (Loss). Operating income (loss) decreased by \$2.0 million to a loss of \$(1.8) million in the three months ended August 31, 2002 from income of \$230,000 in the three months ended August 31, 2001. The operating loss as a percentage of net sales was (13.2)% in the three months ended August 31, 2002 compared to income of 1.7% in the three months ended August 31, 2001.

Interest Income. Interest income decreased by \$85,000 to \$17,000 in the three months ended August 31, 2002 from \$102,000 in the three months ended August 31, 2001. This decrease is the result of reductions in our investment in available-for-sale securities due to working capital requirements and lower rates of interest on invested securities.

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Interest Expense. Interest expense decreased by \$25,000 to \$3,000 in the three months ended August 31, 2002 from \$28,000 in the three months ended August 31, 2001. This decrease was due to reductions in the balance due on notes payable.

Income Taxes. Income taxes decreased to a \$627,000 tax benefit in the three months ended August 31, 2002 from an \$84,000 tax expense in the three months ended August 31, 2001. This decrease is a result of decreased income before income taxes. Income tax expense (benefit) as a percentage of pretax income (loss) was (35.0)% in the three months ended August 31, 2002 compared to 27.6% in the three months ended August 31, 2001.

Nine Months Ended August 31, 2002 Compared to Nine Months Ended August 31, 2001

Net Sales. Our net sales were \$41.2 million for the nine months ended August 31, 2002, with \$32.1 million attributable to Troy Systems and \$9.3 million attributable to Troy Wireless. Net sales in the nine months ended August 31, 2002 increased by \$6.5 million, or 18.6%, from \$34.8 million in the nine months ended August 31, 2001. This increase in net sales represents a \$4.3 million increase in sales of our laser printers, proprietary imaging supplies, services, and electronic payment solutions, and an increase of \$2.1 million in sales of our wireless and connectivity products, primarily due to the acquisition of certain assets of Extended Systems, Inc. on May 31, 2001. Net sales were not significantly affected by price changes.

Cost of Goods Sold. Cost of goods sold increased by \$5.4 million or 25.5% to \$26.7 million in the nine months ended August 31, 2002 from \$21.2 million in the nine months ended August 31, 2001. This increase was primarily due to increased net sales, inventory reserve increases of \$703,000 and severance costs of \$169,000. Cost of goods sold as a percentage of net sales increased to 64.6% in the nine months ended August 31, 2002 from 61.1% in the nine months ended August 31, 2001, primarily due to the increase in the inventory reserve and severance costs described above.

Gross Profit. Gross profit increased by \$1.0 million to \$14.6 million in the nine months ended August 31, 2002 from \$13.5 million in the nine months ended August 31, 2001. Gross profit as a percentage of net sales decreased to 35.4% in the nine months ended August 31, 2002 from 38.9% in the nine months ended August 31, 2001.

Selling, General and Administrative Expenses. Selling, general and administrative expenses decreased by \$251,000 or 2.2% to \$11.3 million in the nine months ended August 31, 2002 from \$11.5 million in the nine months ended August 31, 2001. This decrease was primarily due to a \$285,000 reduction in the allowance for doubtful accounts related to improved collections, and \$177,000 in foreign currency gains, partially offset by \$472,000 of severance expense. Selling, general and administrative expenses as a percentage of net sales decreased to 27.4% in the nine months ended August 31, 2002 from 33.1% in the nine months ended August 31, 2001.

Research and Development Expenses. Research and development expenses increased by \$821,000, or 18.7% to \$5.2 million in the nine months ended August 31, 2002 from \$4.4 million in the nine months ended August 31, 2001. Of this increase, approximately \$641,000 was due to development expenses for our electronic payment solutions and \$180,000 was due to development for our wireless products. The total research and development expenses for 2002 included \$3.5 million for Troy Systems and \$1.7 million for Troy Wireless. There were no software development costs capitalized in the nine months ended August 31, 2002 and \$814,000 were capitalized in the nine months ended August 31, 2001. Research and development expenses as a percentage of net sales were 12.7% in the nine months ended August 31, 2002 and 12.6% in the nine months ended August 31, 2001.

Amortization of Intangible Assets. Amortization of intangible assets decreased by \$570,000 or 59.4% to \$390,000 in the nine months ended August 31, 2002 from \$960,000 in the nine months ended August 31, 2001. This decrease was the result of the write-down of impaired long-lived assets at the end of fiscal year 2001.

Operating Income (Loss). The operating loss decreased by \$1.1 million to \$(2.3) million in the nine months ended August 31, 2002 from a loss of \$(3.4) million in the nine months ended August 31, 2001. Operating loss as a percentage of net sales was (5.6)% in the nine months ended August 31, 2002 compared to (9.6)% in the nine months ended August 31, 2001.

Interest Income. Interest income decreased by \$372,000 to \$96,000 in the nine months ended August 31, 2002 from \$468,000 in the nine months ended August 31, 2001. This decrease is the result of reductions in our investment in available-for-sale securities due to our stock repurchase program, working capital requirements and lower rates of interest on invested securities.

Interest Expense. Interest expense decreased by \$59,000 to \$33,000 in the nine months ended August 31, 2002 from \$92,000 in the nine months ended August 31, 2001. This decrease was due to reductions in the balance due on notes payable.

Income Taxes. Income taxes decreased to a \$786,000 tax benefit in the nine months ended August 31, 2002 from a \$1.0 million tax benefit in the nine months ended August 31, 2001. This decrease is a result of a reduced loss before income taxes. Income tax expense (benefit) as a percentage of pretax income (loss) was (35.0)% in the nine months ended August 31, 2002 compared to (34.6)% in the nine months ended August 31, 2001.

Liquidity and Capital Resources

Cash flows provided by operating activities were \$908,000 in the nine months ended August 31, 2002 compared to \$760,000 provided by operating activities in the nine months ended August 31, 2001. This increase was due primarily to a decrease in inventories and accounts receivable, and a net loss of \$(1.5) million in 2002 compared to a net loss of \$(1.9) million in 2001. The accounts receivable decrease resulted primarily from collections.

Cash flows provided by investing activities were \$3.3 million in the nine months ended August 31, 2002 compared to \$1.9 million in the nine months ended August 31, 2001. Included in cash flows provided by investing activities in the nine months ended August 31, 2002 was \$3.9 million in net maturities of available-for-sale securities. In connection with split-dollar life insurance arrangements with our major stockholder, we previously had committed to funding the premium on three life insurance policies for the foreseeable future. Annual premiums on these policies are approximately \$586,000 per year for the next five years.

Cash flows provided by financing activities were \$18,000 in the nine months ended August 31, 2002 compared to cash flows used in financing activities of \$810,000 in the nine months ended August 31, 2001. Included in cash flows provided by financing activities in the nine months ended August 31, 2001 was \$918,000 used for the purchase of treasury stock.

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We have a \$5,000,000 line-of-credit agreement with a bank. As of August 31, 2002, there were no borrowings outstanding against the line of credit. Borrowings under the line of credit bear interest at the lesser of the bank's reference rate (4.75% at August 31, 2002) less 0.25% or the bank's LIBOR rate (1.82% at August 31, 2002) plus 2% and are limited to 80% of eligible accounts receivable and 50% of

16 eligible inventories if total liabilities to tangible effective net worth is greater than two to one. In connection with the line-of-credit agreement, we have a \$650,000 standby letter-of-credit sublimit agreement of which approximately \$80,000 was outstanding at August 31, 2002. This line of credit is secured by substantially all of our assets. Our borrowing arrangement requires us to comply with certain financial covenants, and at August 31, 2002 we were in compliance with those covenants. As of August 31, 2002, we had approximately \$4,920,000 in availability under the line of credit. The line-of-credit borrowings are due on demand. The agreement may be terminated by either party.

We believe that existing cash balances, cash generated by operating activities, and funds available under our credit facility will be sufficient to finance our operating activities for at least the next 12 months. To the extent that the funds generated from these sources are insufficient to finance our operating activities, we would need to raise additional funds through public or private financing. We cannot assure you that additional financing will be available on terms favorable to us, or at all.

In March 2001, Troy established a stock repurchase program under which Troy's common stock, with an aggregate market value up to \$4.0 million, may be acquired in the open market. As of August 31, 2002, Troy has purchased approximately 320,565 shares of common stock in the open market, at an average price of \$3.67 per share, under the stock repurchase program. Approximately \$2.8 million remains available for future common stock repurchases.

Contractual Obligations and Commercial Commitments

We have the following contractual obligations and commercial commitments.

	Total		Less than 1 year*		1-3 years		4-5 years		After 5 years	
Notes Payable	\$	211,000	\$	18,000	\$	193,000				
Related party operating lease		1,505,000		67,000		809,000	\$	539,000	\$	90,000
Other operating leases		765,000		134,000		631,000				
Split dollar life insurance policy		**		**		**		**		**
Total	\$	2,481,000	\$	219,000	\$	1,633,000	\$	539,000	\$	90,000

*The annual commitments reflected in the table above are based on our November 30 year-end.

**We previously had committed to making payments on the split dollar life insurance policy based on continued employment. As of November 30, 2001 and August 31, 2002, we had advanced \$1,666,000 and \$2,123,000, respectively, to stockholders in connection with the purchase of split dollar life insurance policies. The company and the stockholders have executed a split-dollar agreement for the amount of the advance. The advance is due on demand, however we do not anticipate demanding payment in the next 12 months and accordingly we have classified this amount as long-term. The Sarbanes-Oxley Act of 2002 prohibits extensions of credit in the form of a personal loan to certain company insiders after July 29, 2002. As a result, since July 29, 2002 the Company has not funded the annual premium payments on these policies. If the SEC issues new regulations or other guidance that causes us to reevaluate our position, we may demand payment on the note and terminate the company's participation in these arrangements.

Critical Accounting Policies

Use of estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

The Company's operations are affected by numerous factors including market acceptance, changes in technologies and new laws and government regulations and policies. The Company cannot predict what impact, if any, the occurrence of these or other events might have on our operations. Significant estimates and assumptions made by management are used for, but not limited to, the allowance for doubtful accounts, the reserve for slow moving or obsolete inventories and the carrying value of long-lived and intangible assets.

Inventories

Inventories are valued at the lower of cost or market on a first-in, first-out basis. We use a standard cost system for purposes of determining cost. The standards are adjusted periodically to ensure they approximate actual costs. We write down the carrying value of our inventory to market value for estimated obsolete or excess inventory based upon assumptions about future demand and market conditions. We compare current inventory levels on a product basis to our current sales forecasts in order to assess our inventory balance. Our sales forecasts are based on economic conditions and trends (both current and projected), anticipated customer demand, expected future products and other assumptions. If actual market conditions are less favorable than those projected by management, additional write-downs may be required.

Evaluation of long-lived and intangible assets

The Company periodically reviews the value of its long-lived and intangible assets to determine if impairment has occurred by comparing the carrying value of the long-lived assets with the lowest level of identifiable future net undiscounted cash flows expected to result from the use of the assets, including cash flows from disposition. The Company recorded an impairment loss on certain long-lived assets during fiscal year 2001 based on an evaluation of projected operating income, cash flows and business prospects. In addition, management determined other long-lived assets were not impaired. In making these determinations, the assumptions used by management about future cash flows are critical. If these expected cash flows are not realized, future additional impairment losses may be recorded.

Revenue recognition

We recognize revenue from the sale of our equipment and supplies to end users, distributors, original equipment manufacturers (OEM) and resellers when the product is shipped and the title is transferred to the buyer, net of an allowance for estimated returns, as long as no

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significant post-delivery obligations exist and collection of the resulting receivable is probable. Revenue from equipment maintenance contracts is recorded as deferred income when billed and is recognized straight-line over the term of the contract. We accrue for warranty expense at the time revenue is recognized and maintain a warranty accrual for estimated future warranty obligations based upon the relationship between historical and anticipated warranty costs and sales volumes. To the extent we experience increased warranty claim activity or increased costs associated with servicing those claims, our warranty accrual will increase resulting in decreased gross profit.

We recognize revenue from software arrangements in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition as amended by SOP 98-9, Modification of SOP 97-2 with Respect to Certain Transactions. Revenue is recognized when persuasive evidence of an arrangement exists and delivery has occurred, provided the fee is fixed or determinable, collectibility is probable and the arrangement does not require significant customization or modification of the software. For arrangements where the software requires significant customization or modification, the Company recognizes revenue for the software license and consulting services portion of the arrangement upon customer acceptance. Maintenance revenue is recognized ratably over the term of the maintenance contract, typically 12 months.

Revenue from software license agreements with OEMs whereby the Company provides ongoing support over the term of the contract is recognized based on the greater of royalties earned or straight line over the term of the contract.

Allowance for doubtful accounts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. The amount of the reserve is based on historical experience and our analysis of the accounts receivable outstanding. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required which would result in an additional expense in the period such determination was made.

Income taxes

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Stock-based compensation

The Company accounts for stock-based employee compensation under the requirements of Accounting Principles Board (APB) Opinion No. 25, which does not require compensation to be recorded if the consideration to be received is at least equal to fair value of the shares to be received at the measurement date. Nonemployee stock-based transactions are accounted for under the requirements of Statement No. 123, *Accounting for Stock-Based Compensation*, which requires compensation to be recorded based on the fair value of the securities issued or the services received, whichever is more reliably measurable.

Recently Issued Accounting Standards

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In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141 (SFAS No. 141), *Business Combinations*, and Statement of Financial Accounting Standards No. 142 (SFAS No. 142), *Goodwill and Other Intangible Assets*. SFAS No. 141 addresses financial accounting and reporting for business combinations and is effective for all business combinations after June 30, 2001. SFAS No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets and is effective for fiscal years beginning after December

15, 2001. We will adopt SFAS No. 142 as of the beginning of fiscal year 2003. We are in the process of determining the expected impact on earnings and existing goodwill and other intangibles upon adoption, which will include the elimination of goodwill amortization and may include additional impairment. As of August 31, 2002, unamortized goodwill totaled \$253,000.

The FASB recently issued SFAS No. 143, *Accounting for Asset Retirement Obligations*, addressing financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 requires an enterprise to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of a tangible long-lived asset. SFAS No. 143 also requires the enterprise to record the contra to the initial obligation as an increase to the carrying amount of the related long-lived asset and to depreciate that cost over the remaining useful life of the asset. The liability is changed at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the initial fair value measurement. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. We are currently examining the impact of this pronouncement on the results of our operations and financial position.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which supersedes previous guidance on financial accounting and reporting for the impairment or disposal of long-lived assets and for segments of a business to be disposed of. Adoption of SFAS 144 is required no later than the beginning of fiscal 2003. Management does not expect the adoption of SFAS 144 to have a significant impact on our financial position or results of operations. However, further impairment reviews may result in charges against earnings to write down the value of long-lived assets.

On April 30, 2002, the FASB issued SFAS No. 145, *Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. This statement updates, clarifies and simplifies existing accounting pronouncements. Statement 145 rescinds Statement 4, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. As a result, the criteria in Opinion 30 will now be used to classify those gains and losses. Statement 64 amended Statement 4, and is no longer necessary because Statement 4 has been rescinded. Statement 44 was issued to establish accounting requirements for the effects of transition to the provisions of the Motor Carrier Act of 1980. Because the transition has been completed, Statement 44 is no longer necessary. Statement 145 amends Statement 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. This amendment is consistent with the FASB's goal of requiring similar accounting treatment for transactions that have similar economic effects. We will adopt Statement 145 in fiscal 2003. Statement 145 is not expected to have a material impact on our results of operations or financial position.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss to future earnings, to fair values or to future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument may change as a result of changes in interest rates, exchange rates, commodity prices, equity prices and other market changes. Market risk is attributed to all market sensitive financial instruments, including long-term debt.

We do not utilize derivative financial instruments. Accordingly, our exposure to market risk is through our investments in available-for-sale securities and our bank debt which bears interest at variable rates. Available-for-sale securities consist of corporate debt and marketable equity securities. These securities generally have contractual maturity dates of up to one year. At August 31, 2002, market values approximated carrying values. Due to the short-term maturities of these securities, management believes that there is no significant market risk. At August 31, 2002, we had approximately \$6.8 million in cash, cash equivalents and investments in available-for-sale securities, and, accordingly, a sustained decrease in the rate of interest earned of 1% would cause a decrease in the amount of interest earned of \$68,000. The bank debt is a revolving line of credit. All borrowings bear interest based upon the reference rate per annum as announced by the bank (4.75% at August 31, 2002) less 0.25%. At August 31, 2002, there were no amounts outstanding under the line of credit agreement and, accordingly, a sustained increase in the reference rate of 1% would not cause our annual interest expense to change.

ITEM 4. CONTROLS AND PROCEDURES

Within the 90 days prior to the date of this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rules 13a-14 and 13a-15 under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective.

On October 15, 2002, we issued a press release announcing that the filing of our Form 10-Q for the fiscal quarter ended August 31, 2002 would be delayed. We had conducted physical inventory counts and discovered certain inventory shortfalls and other adjustments. We delayed the filing of our Form 10-Q for the fiscal quarter ended August 31, 2002 in order to give us sufficient time to review the causes of such inventory adjustments and to determine if any of the financial statements for prior periods would need to be restated. We also reviewed our inventory accounting controls and determined that there were certain material weaknesses. As a result, we have taken a number of corrective measures to address these weaknesses. Our Irvine and Boise facilities have now been closed and consolidated into our Wheeling facility, where the employees have more experience in using our materials management system. In addition, we have implemented additional training procedures to ensure that this continues to be the case, have hired personnel with more experience in managing the accounting function in a manufacturing environment, and currently expect to install a new ERP system by the end of fiscal year 2003. The Company also intends to conduct quarterly physical inventory counts until it is satisfied that its systems are operating properly. There were no other significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of our evaluation.

PART II: OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

Not applicable.

ITEM 2 - CHANGES IN SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 3 - DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

Not applicable.

ITEM 5 - OTHER INFORMATION

None.

ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits.

Exhibit Number	Description
99.1	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.2	Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

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On June 4, 2002, we filed a Current Report on Form 8-K dated May 28, 2002 under Item 4 regarding the decision by our Board of Directors to dismiss McGladrey & Pullen LLP as our independent public accountants.

On July 9, 2002, we filed a Current Report on Form 8-K dated July 5, 2002 under Item 4 regarding the decision by our Board of Directors to appoint KPMG LLP as the our independent public accountants.

SIGNATURES

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

TROY GROUP, INC.

March 17, 2003

/s/ Patrick J. Dirk

Patrick J. Dirk

Chairman, President and Chief Executive Officer

/s/James W. Klingler

James W. Klingler

Vice President-Finance, Treasurer and Chief Financial Officer

CERTIFICATIONS

I, Patrick J. Dirk, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Troy Group, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report; and

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

March 17, 2003

/s/ Patrick J. Dirk

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Patrick J. Dirk
President and Chief Executive Officer

CERTIFICATIONS

I, James W. Klingler certify that:

1. I have reviewed this quarterly report on Form 10-Q of Troy Group, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report; and

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

March 17, 2003

/s/James W. Klingler
James W. Klingler
Vice President-Finance, Treasurer and Chief Financial Officer

The written statements required pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, accompanied the filing of this report by correspondence to the Securities and Exchange Commission.