

TROY GROUP INC
Form 10-Q
October 10, 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, 2003.

**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)

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

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Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes
 No

As of September 30, 2003, 10,653,605 shares of the Registrant's Common Stock were outstanding. The aggregate market value of the Registrant's outstanding common stock as of that date (based upon the last sale price of a share of common stock on that date reported by the Nasdaq National Market), excluding outstanding shares beneficially owned by directors and executive officers, was \$11,291,952.

TROY GROUP, INC.

**Quarterly Report on Form 10-Q for the
Quarterly Period Ended August 31, 2003**

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PART I: FINANCIAL INFORMATION

ITEM 1 FINANCIAL STATEMENTS

TROY GROUP, INC.
CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

| | August 31, 2003 (Unaudited) | November 30, 2002 |
|--|-----------------------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 8,894 | \$ 6,615 |
| Investment in available-for-sale securities | | 497 |
| Accounts receivable, less allowance for doubtful accounts of \$640 and \$884 | 7,781 | 9,227 |
| Income tax refund receivable | | 1,076 |
| Inventories | 5,331 | 5,540 |
| Prepaid expenses and other | 724 | 440 |
| Deferred tax assets | 3,715 | 3,715 |
| Total current assets | 26,445 | 27,110 |
| Equipment and leasehold improvements, net | 2,228 | 2,039 |
| Other assets, including notes receivable from stockholders \$2,071 and \$2,123 | 4,130 | 4,390 |
| Total assets | \$ 32,803 | \$ 33,539 |
| Liabilities and Stockholders Equity | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ 76 | \$ 73 |
| Accounts payable | 2,296 | 4,138 |
| Accrued expenses | 2,894 | 2,218 |
| Deferred revenue | 1,124 | 1,364 |
| Total current liabilities | 6,390 | 7,793 |
| Long-term debt, net of current portion | 64 | 120 |
| 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 10,974,170 shares in 2003, and 10,969,657 shares in 2002 | 110 | 110 |
| Additional paid-in capital | 21,122 | 21,113 |
| Retained earnings, including accumulated other comprehensive income of \$134 and none | 6,292 | 5,578 |
| | 27,524 | 26,801 |

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| | | | |
|--|--|-----------|-----------|
| Less cost of treasury stock | 320,565 common shares in 2003 and 2002 | 1,175 | 1,175 |
| Total stockholders' equity | | 26,349 | 25,626 |
| Total liabilities and stockholders' equity | | \$ 32,803 | \$ 33,539 |

See Notes to Consolidated Financial Statements.

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

| | Three Months Ended August 31, | | Nine Months Ended August 31, | |
|---|--------------------------------------|-------------|-------------------------------------|-------------|
| | 2003 | 2002 | 2003 | 2002 |
| Net sales | \$ 14,671 | \$ 13,649 | \$ 42,474 | \$ 41,245 |
| Cost of goods sold | 9,636 | 10,314 | 26,267 | 26,958 |
| Gross profit | 5,035 | 3,335 | 16,207 | 14,287 |
| Operating expenses: | | | | |
| Selling, general and administrative | 3,590 | 3,415 | 11,302 | 11,282 |
| Research and development | 1,265 | 1,696 | 3,957 | 5,221 |
| Amortization of intangible assets | 11 | 30 | 33 | 90 |
| Operating income (loss) | 169 | (1,806) | 915 | (2,306) |
| Interest income | 13 | 17 | 39 | 96 |
| Interest expense | (1) | (3) | (9) | (33) |
| Income (loss) before income taxes | 181 | (1,792) | 945 | (2,243) |
| Provision for income taxes (credits) | 74 | (627) | 366 | (786) |
| Net income (loss) | \$ 107 | \$ (1,165) | \$ 579 | \$ (1,457) |
| Net income (loss) per share: | | | | |
| Basic | \$.01 | \$ (.11) | \$.05 | \$ (.14) |
| Diluted | \$.01 | \$ (.11) | \$.05 | \$ (.14) |
| Shares used in per share computations: | | | | |
| Basic | 10,653 | 10,649 | 10,651 | 10,646 |
| Diluted | 10,653 | 10,649 | 10,651 | 10,646 |

See Notes to Consolidated Financial Statements.

TROY GROUP, INC.

CONSOLIDATED STATEMENTS
OF CASH FLOWS

(Unaudited)

(in thousands)

| | Nine Months Ended August 31, | |
|--|------------------------------|------------|
| | 2003 | 2002 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 579 | \$ (1,457) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 889 | 980 |
| Provision for (recovery of) doubtful accounts | 130 | (212) |
| Loss on disposal of furniture | 99 | |
| Accrued interest on available for sale securities | | (85) |
| Changes in working capital components: (Increase) decrease in: | | |
| Accounts receivable | 1,316 | 2,526 |
| Income tax refund receivable | 1,076 | (314) |
| Inventories | 209 | 2,116 |
| Prepaid expenses and other | (284) | (449) |
| Increase (decrease) in: | | |
| Accounts payable | (1,842) | (1,927) |
| Accrued expenses | 784 | (103) |
| Deferred revenue | (240) | (167) |
| Net cash provided by operating activities | 2,716 | 908 |
| Cash flows from investing activities: | | |
| Purchase of equipment and leasehold improvements | (936) | (302) |
| Purchase of available-for-sale securities | | (1,449) |
| Maturities of available-for-sale securities | 497 | 5,393 |
| Increase in other assets, net | 46 | (319) |
| Net cash provided by (used in) investing activities | (393) | 3,323 |
| Cash flows from financing activities: | | |
| Payments on notes payable | (53) | (52) |
| Proceeds from issuance of common stock | 9 | 149 |
| Purchase of treasury stock | | (79) |
| Net cash provided by (used in) financing activities | (44) | 18 |
| Net increase in cash and cash equivalents | 2,279 | 4,249 |
| Cash and cash equivalents, beginning of period | 6,615 | 1,210 |
| Cash and cash equivalents, end of period | \$ 8,894 | \$ 5,459 |

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, 2003 are not necessarily indicative of the results that may be expected for the year ending November 30, 2003. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for its fiscal year ended November 30, 2002 (File No. 000-24413).

Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, prescribes accounting and reporting standards for all stock-based compensation plans, including employee stock option plans. As allowed by SFAS No. 123, the Company has elected to continue to account for its employee stock-based compensation plan using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations, which does not require compensation to be recorded if the consideration to be received is at least equal to the fair value of the common stock to be received at the measurement date. Under the requirements of SFAS No. 123, non-employee stock-based transactions require compensation to be recorded based on the fair value of the securities issued or the services received, whichever is more reliably measurable.

The following table illustrates the effect on net income (loss) and net income (loss) per share had compensation costs for the stock-based compensation plan been determined based on grant date fair values of awards under the provisions of SFAS No. 123, for the three-month and nine-month periods ended August 31 (unaudited; in thousands, except per share data):

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| | Three months ended August 31, (amounts in thousands, except per share data) | | Nine months ended August 31, (amounts in thousands, except per share data) | |
|--|---|------------|--|------------|
| | 2003 | 2002 | 2003 | 2002 |
| Net income (loss) applicable to common stockholders | | | | |
| As reported | \$ 107 | \$ (1,165) | \$ 579 | \$ (1,457) |
| Less total stock-based employee compensation expense determined under fair value-based method for all awards, net of related tax effects | | | | |
| Proforma | \$ 8 | \$ (1,343) | \$ 278 | \$ (2,066) |
| Net income (loss) per share applicable to common stockholders, basic and diluted | | | | |
| As reported | \$.01 | \$ (.11) | \$.05 | \$ (.14) |
| Proforma | \$ | \$ (.13) | \$.03 | \$ (.19) |

Certain reclassifications have been made to the income statement with no effect on net income or stockholders equity.

Note 2. Inventories

In the third quarter of fiscal 2003, the Company adjusted the inventory reserve for the wireless and connectivity products from a projected one-year usage to a projected six-month usage to more closely match the risk from changes in the technology of the product components. As a result, the inventory reserve was increased by \$381,000, and net income was reduced by \$229,000.

Inventories consisted of the following as of August 31, 2003 and November 30, 2002 (amounts in thousands):

| | August 31, 2003 unaudited | | November 30, 2002 | |
|--|------------------------------|----------|-------------------|----------|
| Raw materials | \$ 5,038 | \$ 5,038 | \$ 5,136 | \$ 5,136 |
| Work-in-process | 687 | 687 | 205 | 205 |
| Finished goods | 2,902 | 2,902 | 4,112 | 4,112 |
| Reserve for slow moving and obsolete inventories | (3,296) | (3,296) | (3,913) | (3,913) |
| Total | \$ 5,331 | \$ 5,331 | \$ 5,540 | \$ 5,540 |

Note 3. Goodwill and Intangible Assets

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The Company adopted SFAS No. 142 effective December 1, 2002 and performed the initial transitional impairment test as of that date. The provisions of SFAS No. 142 require that the Company allocate its goodwill to its various reporting units, determine the carrying value of those businesses, and estimate the fair value of the reporting units so that a two-step goodwill impairment test can be performed. The Company's reporting units are consistent with its operating segments, which are the same as the reportable segments, identified in Note 6. In the first step of the goodwill impairment test, the fair value of each reporting unit is compared to its carrying value. If the fair value exceeds the carrying value, goodwill is not impaired and no further testing is performed. If the carrying value exceeds the fair value,

then the second step must be performed, and the implied fair value of the reporting unit's goodwill must be determined and compared to the carrying value of the goodwill for the reporting unit. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then an impairment loss equal to the difference is recorded.

The fair value of the Company's reporting units was determined using the income approach under which the fair value of a reporting unit is calculated based on the present value of estimated future cash flows. Based on the results of its transitional impairment test, the Company has determined that no impairment of goodwill existed as of December 1, 2002. However, future goodwill impairment tests could result in a charge to earnings. The Company will continue to evaluate goodwill on an annual basis as of the beginning of the fourth quarter, and whenever events and changes in circumstances indicate that there may be a potential impairment.

The Company's intangible assets subject to amortization at August 31, 2003 and November 30, 2002 are composed of (amounts in thousands):

| | Weighted Average Remaining Life | Gross | August 31, 2003 unaudited Accumulated Amortization | Net | Gross | November 30, 2002 Accumulated Amortization | Net |
|--|---------------------------------------|--------|---|--------|--------|--|--------|
| Customer Lists | 2 years | \$ 25 | \$ (19) | \$ 6 | \$ 25 | \$ (16) | \$ 9 |
| Core Technology | 6 years | 392 | (162) | 230 | 392 | (132) | 260 |
| Total amortizable intangible assets | | \$ 417 | \$ (181) | \$ 236 | \$ 417 | \$ (148) | \$ 269 |

Amortization expense related to intangible assets was \$11,000 and \$30,000 for the three-month periods and \$33,000 and \$90,000 for the nine-month periods ended August 31, 2003 and 2002, respectively.

Estimated future amortization expense related to purchased intangible assets at August 31, 2003 is as follows:

| Fiscal year: | (In thousands) |
|---------------------------|----------------|
| 2003 (Remaining 3 months) | \$ 11 |
| 2004 | 44 |
| 2005 | 42 |
| 2006 | 40 |
| 2007 | 40 |
| Thereafter | 59 |
| Total | \$ 236 |

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On December 1, 2002 the Company completed the allocation of goodwill (including amounts previously classified as assembled workforce) to its reportable segments as part of its transitional impairment test. Goodwill allocated to the Company's reportable segments as of November 30, 2002 and changes in the carrying amount of goodwill for the nine-month period ended August 31, 2003 are as follows (amounts in thousands):

| | Wireless & Connectivity | Security Printing Solutions | Total |
|---|----------------------------|--------------------------------|--------|
| Balance at November 30, 2002 | \$ | \$ 235 | \$ 235 |
| Goodwill adjustment for previously classified assembled workforce | | 46 | 46 |
| Balance at August 31, 2003 | \$ | \$ 281 | \$ 281 |

If the provisions of SFAS No. 142 had been in effect for all periods presented, the Company's net income (loss) and net income (loss) per share would have been as follows for the three- and nine-month periods ended August 31, 2003 and 2002:

| | Three months ended August 31, (amounts in thousands, except per share data) | | Nine months ended August 31, (amounts in thousands, except per share data) | |
|--|---|------------|--|------------|
| | 2003 | 2002 | 2003 | 2002 |
| Net income (loss): | | | | |
| As reported | \$ 107 | \$ (1,165) | \$ 579 | \$ (1,457) |
| Add back amortization of goodwill, net of taxes | | 13 | | 34 |
| Net income (loss), as adjusted | \$ 107 | \$ (1,152) | \$ 579 | \$ (1,423) |
| Net income (loss) per share, basic and diluted | | | | |
| As reported | \$.01 | \$ (.11) | \$.05 | \$ (.14) |
| Add back amortization of goodwill, net of taxes | | | | |
| Net income (loss) per share, basic and diluted, net of taxes | \$.01 | \$ (.11) | \$.05 | \$ (.14) |

Note 4. Stock Option and Stock Warrant Plans

During the nine months ended August 31, 2003, the Company did not grant any options to employees. The following is a summary of total outstanding options and stock warrants at August 31, 2003:

| Range of Exercise Prices | Options and Warrants Outstanding | | | Options and Warrants Exercisable | |
|--------------------------|----------------------------------|---------------------------------|---|----------------------------------|---------------------------------|
| | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Life | Number of Shares | Weighted-Average Exercise Price |
| \$2.85 - 4.51 | 662,666 | \$ 3.93 | 6.8 years | 359,456 | \$ 3.78 |
| 6.31 - 8.75 | 486,000 | 7.31 | 5.8 years | 394,821 | 7.30 |
| 13.16 - 14.25 | 15,000 | 13.52 | 6.3 years | 4,999 | 13.52 |
| | 1,163,666 | | | 759,276 | |

At August 31, 2003, there were 1,688,000 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 loss per share:

| | Three months ended August 31, (amounts in thousands, except per share data) | | Nine months ended August 31, (amounts in thousands, except per share data) | |
|--|---|------------|--|------------|
| | 2003 | 2002 | 2003 | 2002 |
| <u>Numerator for basic and diluted net income (loss) per share:</u> | | | | |
| Net income (loss) | \$ 107 | \$ (1,165) | \$ 579 | \$ (1,457) |
| Denominator for basic net income (loss) per share weighted-average shares outstanding | 10,653 | 10,649 | 10,651 | 10,646 |
| Effect of employee stock options and warrants Denominator for diluted net income (loss) per share | 10,653 | 10,649 | 10,651 | 10,646 |
| <u>Net income (loss) per share:</u> | | | | |
| Basic | \$.01 | \$ (.11) | \$.05 | \$ (.14) |
| Diluted | \$.01 | \$ (.11) | \$.05 | \$ (.14) |

Note 6. Segment Information

The following tables summarize net sales and net income (loss) by the Company's operating segments, Security Printing Solutions and Wireless and Connectivity, and unallocated corporate for the three and nine months ended August 31, 2003 and 2002:

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| | Three months ended August 31, (amounts in thousands) | | Nine months ended August 31, (amounts in thousands) | |
|-----------------------------|---|------------|--|------------|
| | 2003 | 2002 | 2003 | 2002 |
| Net sales: | | | | |
| Security Printing Solutions | \$ 10,819 | \$ 10,547 | \$ 31,257 | \$ 32,134 |
| Wireless and Connectivity | 3,852 | 3,157 | 11,217 | 9,314 |
| Less intersegment revenue | | (55) | | (203) |
| | \$ 14,671 | \$ 13,649 | \$ 42,474 | \$ 41,245 |
| Net income (loss): | | | | |
| Security Printing Solutions | \$ 1,292 | \$ 379 | \$ 4,028 | \$ 2,914 |
| Wireless and Connectivity | (460) | (813) | (157) | (2,068) |
| Unallocated Corporate | (725) | (731) | (3,292) | (2,303) |
| | \$ 107 | \$ (1,165) | \$ 579 | \$ (1,457) |

Certain reclassifications have been made to the August 31, 2002 segment information to conform to the August 31, 2003 presentation (amounts in thousands).

| | August 31, 2003 | November 30, 2002 |
|-----------------------------|-----------------|-------------------|
| Segment Assets: | | |
| Security Printing Solutions | \$ 11,072 | \$ 11,637 |
| Wireless and Connectivity | 10,875 | 10,339 |
| Unallocated Corporate | 17,524 | 24,478 |
| | \$ 39,471 | \$ 46,454 |

The following schedule is presented to reconcile August 31, 2003 and November 30, 2002 segment assets to the amounts reported in the Company's consolidated financial statements (amounts in thousands).

| | August 31, 2003 | November 30, 2002 |
|-------------------------------------|-----------------|-------------------|
| Total assets of reportable segments | \$ 39,471 | \$ 46,454 |
| Intersegment receivables | (6,434) | (12,681) |
| Investment in subsidiaries | (234) | (234) |
| Consolidated assets | \$ 32,803 | \$ 33,539 |

Note 7. Cash Flow Information

Supplemental disclosure of cash flow information

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| | Nine months ended | |
|----------------------------------|------------------------|-----------------|
| | (amounts in thousands) | |
| | August 31, 2003 | August 31, 2002 |
| Cash paid during the period for: | | |
| Interest | \$ 8 | \$ 46 |
| Income taxes | \$ 513 | \$ 13 |

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 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 current 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 the expected decline in 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; 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 in our annual report on Form 10-K 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.

Recent Developments

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On September 18, 2003, TROY Group, Inc. (TROY) announced that its stockholders had voted against approval of the merger agreement between TROY and Dirk Inc., a company controlled by Patrick J. Dirk, the founder of TROY, and his family members, pursuant to which Mr. Dirk and his family members would have acquired the outstanding shares of TROY common stock that they do not already own at a price of \$2.76 per share in cash.

Although Mr. Dirk and his family members had sufficient share ownership to approve the merger agreement under applicable law, the merger agreement was also conditioned on the affirmative vote of the holders of a majority of the shares cast either for or against the merger agreement, excluding the shares held by Mr. Dirk and his family members and the officers and directors of TROY. At a special meeting of stockholders held on September 18, 2003, these unaffiliated stockholders voted against approval of the merger agreement. Following this special meeting of stockholders, the Board of Directors of TROY terminated the merger agreement and dissolved the Special Committee.

Background

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TROY Group, Inc. is a worldwide provider of enterprise output solutions, which include products and services for enterprises or businesses, that are used in producing an output in a process. 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 print servers and 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 the two primary business segments: Security Printing Solutions (previously TROY Systems) and Wireless and Connectivity Solutions (previously TROY Wireless).

Security Printing Solutions 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 funds 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. Chase Manhattan, Citigroup, Del Monte Foods, Deutsche Bank, Federal Express, The Federal Reserve, Fidelity Investments, GMAC Commercial, Heinz USA, Hewlett Packard, IBM, Maersk Line Ltd., Marsh USA, Monsanto, NCR Corporation, Progressive Insurance, Safeway Stores, Unisys, VISA USA, and Xerox are among the TROY customers that purchased payment products during the last 12 months.

Wireless and Connectivity Solutions 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 include several devices which exchange information via *Bluetooth* and 802.11b short-range radio connections. Brother Industries, Ltd., Seiko Epson Corporation and DaimlerChrysler AG are among the Wireless and Connectivity Solutions 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 network of distributors and value-added resellers and a direct sales force. More than 5,000 customers have purchased our products and services during the last 12 months.

In the first nine months of fiscal 2003, there were no customers who accounted for 10% of the Company's net sales.

Results of Operations

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 August 31, | | Nine Months Ended August 31, | |
|--|-------------------------------|--------|------------------------------|--------|
| | 2003 | 2002 | 2003 | 2002 |
| Net sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of goods sold | 65.7 | 75.6 | 61.8 | 65.4 |
| Gross profit | 34.3 | 24.4 | 38.2 | 34.6 |
| Selling, general and administrative expenses | 24.5 | 25.0 | 26.7 | 27.3 |
| Research and development expenses | 8.6 | 12.4 | 9.3 | 12.7 |
| Amortization of intangible assets | 0.1 | 0.2 | 0.1 | 0.2 |
| Operating income (loss) | 1.1 | (13.2) | 2.1 | (5.6) |
| Interest income | 0.1 | 0.1 | 0.1 | 0.2 |
| Interest expense | | | | |
| Income (loss) before income taxes | 1.2 | (13.1) | 2.2 | (5.4) |
| Provision for income taxes (credits) | 0.5 | (4.6) | 0.9 | (1.8) |
| Net income (loss) | 0.7% | (8.5)% | 1.3% | (3.6)% |

Three Months Ended August 31, 2003 Compared to Three Months Ended August 31, 2002

Net Sales. Our net sales were \$14.7 million for the three months ended August 31, 2003, with \$10.8 million attributable to Security Printing Solutions and \$3.9 million attributable to Wireless and Connectivity Solutions. Net sales in the three months ended August 31, 2003 increased by \$1.0 million, or 7.5%, from \$13.7 million in the three months ended August 31, 2002. The increase in sales was primarily due to a \$0.7 million increase in sales of both wired and wireless and connectivity products and a \$0.3 million increase in revenue from our StarACH software. Although sales of our wired connectivity products increased in the third quarter of fiscal 2003, we anticipate that sales of wired connectivity products, which constitute a significant portion of our overall sales of Wireless and Connectivity Solutions, will decline as these products are at or approaching end of life. Net sales were not significantly affected by price changes.

Cost of Goods Sold. Cost of goods sold decreased by \$0.7 million, or 6.6%, to \$9.6 million in the three months ended August 31, 2003 from \$10.3 million in the three months ended August 31, 2002, primarily due to cost reductions from the consolidation of manufacturing facilities. Inventory adjustments of \$0.7 million and severance costs of \$0.2 million in 2002 were offset by a \$0.9 million increase in the inventory reserve in 2003. Cost of goods sold as a percentage of net sales decreased to 65.7% in the three months ended August 31, 2003 from 75.6% in the three months ended August 31, 2002. Cost of goods sold as a percent of sales will fluctuate based on shifts in the mix of products sold.

Gross Profit. Gross profit increased by \$1.7 million to \$5.0 million in the three months ended August 31, 2003 from \$3.3 million in the three months ended August 31, 2002, primarily due to increased sales of wired and wireless connectivity products (\$0.3 million), increased software revenue (\$0.2 million), and cost reductions from the consolidation of manufacturing facilities. Gross profit as a percentage of net sales increased to 34.3% in the three months ended August 31, 2003 from 24.4% in the three months ended August 31, 2002.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased by \$0.2 million, or 5.1%, to \$3.6 million in the three months ended August 31, 2003 from \$3.4 million in the three months ended August 31, 2002. General and administrative expenses in the third quarter of fiscal 2003 included \$0.5 million in professional fees related to the proposed merger described above under Recent Developments, which were offset by cost savings from reductions in staff. Selling, general and administrative expenses as a percentage of net sales decreased to 24.5% in the three months ended August 31, 2003 from 25.0% in the three months ended August 31, 2002.

Research and Development Expenses. Research and development expenses decreased by \$0.4 million, or 25.4%, to \$1.3 million in the three months ended August 31, 2003 from \$1.7 million in the three months ended August 31, 2002, primarily due to reduced spending for Security Printing Solutions products. The total research and development expenses for the third quarter of fiscal 2003 included \$0.8 million for Security Printing Solutions and \$0.5 million for Wireless and Connectivity Solutions. Research and development expenses as a percentage of net sales was 8.6% in the three months ended August 31, 2003 compared to 12.4% in the three months ended August 31, 2002. We expect research and development activities to focus primarily on our security printing solutions products and to a lesser extent on enhancements to our wireless networking products. However, we have the ability to redirect our research and development activities as needed based on our product strategies and market opportunities. We forecast and budget research and development expenses by segment, but not by project. The anticipated timing for the commercialization of any of our development efforts is not currently known.

Amortization of Intangible Assets. Amortization of intangible assets decreased by \$19,000 to \$11,000 in the three months ended August 31, 2003 from \$30,000 in the three months ended August 31, 2002. This decrease resulted from no amortization of goodwill in fiscal 2003 compared to amortization of \$19,000 in fiscal 2002.

Operating Income (Loss). Operating income increased by \$2.0 million to income of \$0.2 million in the three months ended August 31, 2003 from a loss of \$1.8 million in the three months ended August 31, 2002. The operating income as a percentage of net sales was 1.1% in the three months ended August 31, 2003 compared to loss of (13.2)% in the three months ended August 31, 2002.

Interest Income. Interest income decreased by \$4,000 to \$13,000 in the three months ended August 31, 2003 from \$17,000 in the three months ended August 31, 2002. This decrease was 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.

Interest Expense. Interest expense decreased by \$2,000 to \$1,000 in the three months ended August 31, 2003 from \$3,000 in the three months ended August 31, 2002.

Income Taxes. Income taxes increased to a \$74,000 tax expense in the three months ended August 31, 2003 from a \$627,000 tax credit in the three months ended August 31, 2002. This increase is a result of increased income before income taxes. Income tax expense (credit) as a percentage of pretax income (loss) was 40.9% in the three months ended August 31, 2003 compared to (35.0)% in the three months ended August 31, 2002.

Nine Months Ended August 31, 2003 Compared to Nine Months Ended August 31, 2002

Net Sales. Our net sales were \$42.5 million for the nine months ended August 31, 2003, with \$31.3 million attributable to Security Printing Solutions and \$11.2 million attributable to Wireless and Connectivity Solutions. Net sales in the nine months ended August 31, 2003 increased by \$1.2 million, or 3.0%, from \$41.2 million in the nine months ended August 31, 2002, primarily due to increased sales of our wired connectivity products, partially offset by decreased sales of Security Printing Solutions products. The decline in Security Printing Solutions sales was primarily due to a \$0.7 million reduction in sales to a major distributor that declared Chapter 11 bankruptcy in May 2003. Although sales of our wired connectivity products increased in the first nine months of fiscal 2003, we anticipate that sales of wired connectivity products, which constitute a significant portion of our overall sales of Wireless and Connectivity Solutions, will decline as these products are at or approaching end of life. Net sales were not significantly affected by price changes.

Cost of Goods Sold. Cost of goods sold decreased by \$0.7 million, or 2.6%, to \$26.3 million in the nine months ended August 31, 2003 from \$27.0 million in the nine months ended August 31, 2002, primarily due to inventory adjustments of \$1.2 million and severance costs of \$0.2 million in 2002, which were partially offset by a \$1.0 million increase in the inventory reserve in 2003, and cost reductions from the consolidation of manufacturing facilities. Cost of goods sold as a percentage of net sales decreased to 61.8% in the nine months ended August 31, 2003 from 65.4% in the nine months ended August 31, 2002.

Gross Profit. Gross profit increased by \$1.9 million to \$16.2 million in the nine months ended August 31, 2003 from \$14.3 million in the nine months ended August 31, 2002, primarily due to increased sales of wired connectivity products (\$0.6 million), the inventory adjustments described above, and cost reductions from the consolidation of manufacturing facilities. Gross profit as a percentage of net sales increased to 38.2% in the nine months ended August 31, 2003 from 34.6% in the nine months ended August 31, 2002.

Selling, General and Administrative Expenses. Selling, general and administrative expenses were \$11.3 million in the nine months ended August 31, 2003 and 2002. General and administrative expenses in the first nine months of fiscal 2003 included \$1.5 million in professional fees related to the proposed merger described above under Recent Developments, which were offset by cost savings from reductions in staff. Selling, general and administrative expenses as a percentage of net sales decreased to 26.7% in the nine months ended August 31, 2003 from 27.3% in the nine months ended August 31, 2002.

Research and Development Expenses. Research and development expenses decreased by \$1.3 million, or 24.2%, to \$3.9 million in the nine months ended August 31, 2003 from \$5.2 million in the nine months ended August 31, 2002, due to reduced spending in both Wireless and Connectivity and Security Printing Solutions. The total research and development expenses for the first nine months of fiscal 2003 included \$2.5 million for Security Printing Solutions and \$1.4 million for Wireless and Connectivity Solutions. Research and development expenses as a percentage of net sales was 9.3% in the nine months ended August 31, 2003 and 12.7% in the nine months ended August 31, 2002. We expect research and development activities to focus primarily on our security printing solutions products and to a lesser extent on enhancements to our wireless networking products. However, we have the ability to redirect our research and development activities as needed based on our product strategies and market opportunities. We forecast and budget research and development expenses by segment, but not by project. The anticipated timing for the commercialization of any of our development efforts is not currently known.

Amortization of Intangible Assets. Amortization of intangible assets decreased by \$57,000 to \$33,000 in the nine months ended August 31, 2003 from \$90,000 in the nine months ended August 31, 2002. This decrease resulted from no amortization of goodwill in fiscal 2003 compared to amortization of \$57,000 in fiscal 2002.

Operating Income (Loss). Operating income (loss) increased by \$3.2 million to income of \$0.9 million in the nine months ended August 31, 2003 from a loss of \$2.3 million in the nine months ended August 31, 2002. The operating income as a percentage of net sales was 2.2% in the nine months ended August 31, 2003 compared to loss of (5.6)% in the nine months ended August 31, 2002.

Interest Income. Interest income decreased by \$57,000 to \$39,000 in the nine months ended August 31, 2003 from \$96,000 in the nine months ended August 31, 2002. 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.

Interest Expense. Interest expense decreased by \$24,000 to \$9,000 in the nine months ended August 31, 2003 from \$33,000 in the nine months ended August 31, 2002. This decrease was due to reductions in the balance due on notes payable.

Income Taxes. Income taxes increased to a \$0.4 million tax expense in the nine months ended August 31, 2003 from a \$0.8 million tax credit in the nine months ended August 31, 2002. This increase is a result of increased income before income taxes. Income tax expense (credit) as a percentage of pretax income (loss) was 38.7% in the nine months ended August 31, 2003 compared to (35.0)% in the nine months ended August 31, 2002.

Liquidity and Capital Resources

Cash flows provided by operating activities were \$2.7 million in the nine months ended August 31, 2003 compared to \$0.9 million in the nine months ended August 31, 2002. This increase in cash flows provided was primarily due to increased net income, a refund of income taxes, and improved collections of accounts receivable.

Cash flows used in investing activities were \$0.4 million in the nine months ended August 31, 2003 compared to cash flows provided by investing activities of \$3.3 million in the nine months ended August 31, 2002. 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.

Cash flows used in financing activities were \$44,000 in the nine months ended August 31, 2003 compared to cash flows provided by financing activities of \$18,000 in the nine months ended August 31, 2002, due to reduced proceeds from issuance of common stock.

We have a \$5.0 million line-of-credit agreement with Comerica Bank. As of August 31, 2003, 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 (4.00% at August 31, 2003) less 0.25%

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or the bank's LIBOR rate (1.12 % at August 31, 2003) plus 2% and are limited to 80% of eligible accounts receivable and 50% of eligible inventories if total liabilities to tangible effective net worth is greater than two to one. No formula is required if total liabilities to tangible effective net worth is less than two to one. In connection with the line-of-credit agreement, we have a \$650,000 standby letter-of-credit sub-limit, of

which approximately \$80,000 was outstanding at August 31, 2003. This line of credit is secured by substantially all of our assets. Our borrowing arrangement requires us to comply with certain financial covenants. As of August 31, 2003, we had approximately \$4.9 million 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, which will include expenditures of approximately \$1.9 million for toner compounding equipment, and approximately \$400,000 for a new ERP system. 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, if required, 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, 2003, Troy had purchased approximately 320,565 shares of common stock in the open market under this stock repurchase program, at an average price of \$3.67 per share. Approximately \$2.8 million remains available for future common stock repurchases.

Critical Accounting Policies and Estimates

We reaffirm the critical accounting policies and our use of estimates as reported in our Annual Report on Form 10-K for our fiscal year ended November 30, 2002.

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 foreign currency transactions and through our bank debt which bears interest at variable rates. We do not hedge our exposure to foreign currency fluctuations. Rather, we monitor our foreign currency exposure on a monthly basis. Principal foreign currencies are the Euro and the Canadian Dollar. The bank debt is a revolving line of credit. Borrowings under the line of credit bear interest at the lesser of the bank's reference rate (4.00 % at August 31, 2003) less 0.25% or the bank's LIBOR rate (1.12 % at August 31, 2003) plus 2% and are limited to 80% of eligible accounts receivable and 50% of eligible inventories if total liabilities to tangible effective net worth is greater than two to one. At August 31, 2003, 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

(a) **Evaluation of disclosure controls and procedures.** We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that, subject to the limitations noted above, our disclosure controls and procedures were effective to ensure that material information relating to TROY is made known to them by others, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

(b) **Changes in internal controls.** There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with the evaluation described in Item 4(a) above that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II: OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

On November 21, 2002, Tom Lloyd filed an action in the Superior Court of the State of California in and for Orange County against TROY and its directors, alleging that the defendants breached their fiduciary duties by attempting to provide the Dirk family with preferential treatment in connection with their efforts to complete a sale of TROY (the Lloyd Action). The complaint in the Lloyd Action sought to enjoin an acquisition of TROY by the Dirk family, as well as attorneys' fees. On June 25, 2003, TROY announced that it had reached an agreement in principle to settle the Lloyd Action, subject to court approval and other conditions, including consummation of the proposed merger agreement between TROY and Dirk, Inc., a company controlled by Patrick J. Dirk and his family members. On September 18, 2003, TROY announced that its stockholders had voted against approval of the merger agreement between TROY and Dirk Inc. As a result, defendants have asked plaintiff to dismiss the action as moot. Plaintiff has not responded to this request. Discovery has commenced in this action, but no trial date has been set.

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

A Special Meeting of Stockholders was held on September 18, 2003, to consider and vote upon a proposal to approve an Agreement and Plan of Merger pursuant to which Dirk, Inc., a newly formed Delaware corporation controlled by Patrick Dirk, the founder of TROY, and his family members, would be merged with and into TROY. The Merger was subject to:

- (1) approval by the holders of a majority of the outstanding shares of TROY's common stock, and
- (2) approval by the holders of a majority of the shares of TROY's common stock cast either for or against the Agreement and Plan of Merger (excluding shares beneficially owned by Dirk, Inc., the Dirk family members and any officers or directors of Dirk, Inc. or TROY).

The voting results were as follows:

| | For | Against | Abstain |
|---|-----------|-----------|---------|
| (1) Approval by holders of a majority of the outstanding shares | 7,761,962 | 1,488,727 | 23,425 |
| (2) Approval by holders of a majority of the shares cast either for or against, excluding shares beneficially owned by Dirk, Inc., the Dirk family members and any officers or directors of Dirk, Inc. or TROY. | 702,112 | 1,438,727 | N/A |

ITEM 5 - OTHER INFORMATION

None.

ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits.

| Exhibit Number | Description |
|----------------|---|
| 31.1 | Rule 13a-14(a) Certification of Chief Executive Officer. |
| 31.2 | Rule 13a-14(a) Certification of Chief Financial Officer. |
| 32.1 | Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

(b) Reports on Form 8-K

On July 14, 2003, the Company filed a Current Report on Form 8-K dated July 11, 2003 under Item 9. regarding a press release announcing its financial results for the second quarter and six months ended May 31, 2003.

On September 19, 2003, the Company filed a Current Report on Form 8-K dated September 18, 2003 under Item 5. regarding a press release announcing that its stockholders had voted against approval of the merger agreement between the Company and Dirk

Inc., a company controlled by Patrick J. Dirk, the founder of the Company, and his family members, pursuant to which Mr. Dirk and his family members would have acquired the outstanding shares of the Company common stock that they do not already own at a price of \$2.76 per share in cash.

SIGNATURES

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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.

October 10, 2003

/S/ Patrick J. Dirk
Patrick J. Dirk
Chairman, President and Chief Executive Officer

October 10, 2003

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