MEDIA ARTS GROUP INC
Form 10-Q
August 07, 2003

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2003

OR

o 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: 0-24294

Media Arts Group, Inc.
(Exact name of registrant as specified in its charter)

Delaware	**77-0354419**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

900 Lightpost Way, Morgan Hill, CA 95037
(Address of principal executive offices and zip code)

Registrant s telephone number: **(408) 201-5000**

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 ý No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes o No ý

The number of shares outstanding of the Registrant s Common Stock, $0.01 par value, was 13,226,498 at August 7, 2003.

Media Arts Group, Inc.

FORM 10-Q

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MEDIA ARTS GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	June 30, 2003 (unaudited)	December 31, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$ 20,439	$ 24,538
Accounts receivable, net of allowance for doubtful accounts, adjustments and sales returns of $5,190 and $5,010	6,615	12,868
Inventories	13,183	12,563
Prepaid expenses and other current assets	4,561	6,473
Deferred income taxes	6,899	3,334
Income taxes receivable	2,671	1,585
Total current assets	54,368	61,361
Property and equipment, net	16,515	17,992
Notes receivable	609	613
Notes receivable from related parties		96
Long-term deferred income taxes	2,228	2,174
Other assets	71	72
Total assets	$ 73,791	$ 82,308
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 4,750	$ 6,850
Commissions payable	655	1,145
Accrued royalties	154	496
Accrued compensation costs	937	3,114
Accrued expenses	6,818	3,920
Capital lease obligation, current	272	281
Total current liabilities	13,586	15,806
Reserve for leases	2,347	2,268
Capital lease obligation long-term	96	303
Total liabilities	16,029	18,377
Commitments and contingencies (Notes 8, 9, 10, 11 and 12)		
Stockholders equity:		
Preferred Stock, $0.01 par value; 1,000,000 shares authorized; none issued or outstanding		
Common Stock, $0.01 par value; 80,000,000 shares authorized; 13,540,675 shares issued and 13,224,603 shares outstanding at June 30, 2003 and December 31, 2002	90	90
Additional paid-in capital	38,862	38,862

Retained earnings		22,482		28,651
Treasury Stock, 316,072 shares at cost at June 30, 2003 and December 31, 2002		(3,672)		(3,672)
Total stockholders equity		57,762		63,931
Total liabilities and stockholders equity	$	73,791	$	82,308

See accompanying notes to condensed consolidated financial statements.

MEDIA ARTS GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts, unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenues:				
Net product and other revenues	$ 8,643	$ 18,336	$ 22,319	$ 49,041
Licensing revenues	2,152	2,698	4,708	4,389
Net revenues	10,795	21,034	27,027	53,430
Cost of revenues:				
Cost of revenues product and other	7,240	11,195	15,814	28,914
Cost of licensing revenues	108	89	235	251
Total cost of revenues	7,348	11,284	16,049	29,165
Gross margin	3,447	9,750	10,978	24,265
Operating expenses:				
Selling and marketing	5,652	5,058	12,082	13,081
General and administrative	3,952	6,117	10,033	16,324
Total operating expenses	9,604	11,175	22,115	29,405
Operating loss	(6,157)	(1,425)	(11,137)	(5,140)
Interest income (expense)	98	22	205	(53)
Gain on disposal of fixed assets			14	
Gain on sales of company-owned stores	26	29	45	94
Loss before income taxes	(6,033)	(1,374)	(10,873)	(5,099)
Benefit from income taxes	2,419	741	4,362	2,110
Loss from continuing operations	(3,614)	(633)	(6,511)	(2,989)
Discontinued operations tax benefit from closure of subsidiary			342	
Net loss	$ (3,614)	$ (633)	$ (6,169)	$ (2,989)
Net loss per share from continuing operations:				
Basic and diluted	$ (0.27)	$ (0.05)	$ (0.49)	$ (0.23)
Income per share from discontinued operations:				
Basic and diluted			0.03	
Net loss per share:				
Basic and diluted	$ (0.27)	$ (0.05)	$ (0.46)	$ (0.23)
Shares used in net loss per share computation:				
Basic and diluted	13,224	13,219	13,224	13,219

See accompanying notes to condensed consolidated financial statements.

MEDIA ARTS GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands, unaudited)

	Six Months Ended June 30,	
	2003	**2002**
Cash flows from operating activities:		
Net loss	$ (6,169)	$ (2,989)
Adjustments to reconcile net loss to net cash from operating activities:		
Depreciation and amortization	1,873	5,571
Gain on sales of company-owned stores	(45)	(94)
Loss on disposal of fixed assets		766
Amortization of stock based compensation		6
Deferred income taxes	(3,619)	(1,121)
Changes in assets and liabilities:		
Accounts receivable	6,253	7,740
Notes receivables from related parties	96	50
Inventories	(620)	4,581
Prepaid expenses and other assets	1,826	(236)
Other assets	1	46
Accounts payable	(2,100)	(1,703)
Commissions payable	(490)	(451)
Accrued compensation costs	(2,177)	1,879
Income taxes receivable	(1,086)	
Accrued expenses	2,898	387
Accrued royalties	(342)	(1,234)
Reserve for leases	79	
Net cash provided by (used in) operating activities	(3,622)	13,198
Cash flows from investing activities:		
Acquisitions of property and equipment	(396)	(789)
Restricted cash		(2,000)
Purchased notes receivable		(446)
Proceeds from the disposals of galleries	111	139
Proceeds from payments of notes receivable	24	120
Increase in cash surrender value of life insurance		8
Net cash used in investing activities	(261)	(2,968)
Cash flows from financing activities:		
Payments on line-of-credit		(1,500)
Repayment of capital lease obligation	(216)	(121)

Proceeds from issuance of common stock				19
Net cash used in financing activities		(216)		(1,602)
Net increase (decrease) in cash and cash equivalents		(4,099)		8,628
Cash and cash equivalents at beginning of period		24,538		2,148
Cash and cash equivalents at end of period	$	20,439	$	10,776

See accompanying notes to condensed consolidated financial statements.

MEDIA ARTS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

The condensed interim consolidated financial statements of Media Arts Group, Inc. (the Company or Media Arts) include the accounts of its wholly owned subsidiary, Thomas Kinkade Stores, Inc. The Company is a designer, manufacturer, marketer, branded retailer, and licensor of: fine-art reproductions, art-based home accessories and collectibles and gift products based upon the lifestyle brand and artwork by Thomas Kinkade and operates in one segment. The Company s primary products are canvas and paper lithographs as well as other forms of fine-art reproductions. The Company distributes products through a variety of distribution channels - primarily independently owned branded retail stores, independent dealers and strategic partners.

The condensed interim consolidated financial statements as of June 30, 2003 and the three months and six months ended June 30, 2003 and 2002 have been prepared by the Company without audit. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles of the United States of America have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission. The information included in this report should be read in conjunction with the Company s audited consolidated financial statements and notes thereto included in the Company s annual report on Form 10-K.

In the opinion of management, the accompanying unaudited interim condensed consolidated financial statements reflect all material adjustments (consisting solely of normal recurring adjustments) necessary for a fair presentation of the financial position, operating results and cash flows for the periods presented. The results of the interim period ended June 30, 2003 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2003.

Note 2 Recent Accounting Pronouncements

In April 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145 eliminates SFAS No. 4, Reporting Gains and Losses from Extinguishment of Debt, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item. Under SFAS No. 145, such gains and losses should be classified as extraordinary only if they meet the criteria of Accounting Principles Board (APB) Opinion No. 30. In addition, SFAS No. 145 amends SFAS No. 13, Accounting for Leases, to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. Media Arts adopted SFAS No. 145, on January 1, 2003. The adoption of this statement did not have a material effect on its consolidated financial condition, results of operations or cash flows.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue

No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). This Statement requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. SFAS No. 146 will be applied to exit or disposal activities that are initiated after December 31, 2002.

In November 2002, the FASB issued Financial Interpretation No. (FIN) 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 requires that a liability be recorded in the guarantor s balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosures about the guarantees that an entity has issued, including a roll forward of the entity s product warranty liabilities. We have applied the recognition provisions of FIN 45 to guarantees issued or modified after January 1, 2003. The adoption of this standard did not have a material impact on the Company s consolidated financial condition, results of operations or cash flows.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of

accounting for stock-based employee compensation. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The Company adopted the disclosure requirements in these interim financial statements.

In January 2003, the FASB issued FIN 46, Consolidation of Variable Interest Entities, and an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from the other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. The adoption of FIN 46 did not have a material effect on the Company s financial condition, results of operations or cash flows.

Note 3 Net loss per share

Net loss per share is computed by dividing the net income (loss) for the period by the weighted average number of common shares outstanding during the period. Due to the net losses incurred during the three month and six month periods ended June 30, 2003 and 2002, no adjustment is made for the assumed exercise of stock options, as the effect would be antidilutive. Therefore, common equivalent shares of 1,190,000 and 1,205,000 as of June 30, 2003 and 2002, respectively, have been excluded from the shares used to calculate diluted net loss per common share.

Note 4 Stock-based compensation

As permitted by SFAS No. 123, Accounting for Stock-Based Compensation, the Company accounts for employee stock-based compensation in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees , and FASB Interpretation No. 44 (FIN 44), Accounting for Certain Transactions Involving Stock-Based Compensation, an interpretation of APB Opinion No. 25 and related interpretations in accounting for its stock-based compensation plans. Stock-based compensation expense related to non-employees is measured based on the fair value of the related stock or options in accordance with SFAS No. 123 and its interpretations. Expense associated with stock-based compensation is amortized over the vesting period of each individual award.

The Company applies the provisions of APB No. 25 and related interpretations in accounting for compensation expense under the Company s option plans. Had compensation expense under these plans been determined pursuant to SFAS No. 123, the Company s net loss and net loss per share would have been as follows (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net loss				
As reported	$ (3,614)	$ (633)	$ (6,169)	$ (2,989)
Less stock based compensation expense determined under fair value based method, net of tax effects	(63)	(46)	(101)	(116)
Net loss Pro forma	(3,677)	(679)	(6,270)	(3,105)

Net loss per share:				
Basic and diluted:				
As reported	(0.27)	(0.05)	(0.46)	(0.23)
Pro forma	(0.27)	(0.05)	(0.47)	(0.23)
Shares used in net loss per share computation:				
Basic and diluted	13,224	13,219	13,224	13,219

Note 5 - Inventories

Inventories consisted of (in thousands):

	June 30, 2003	December 31, 2002
Raw materials	$ 8,296	$ 7,852
Work-in-process	1,404	2,472
Finished goods	3,483	2,239
	$ 13,183	$ 12,563

Note 6 Comprehensive Income (Loss)

To date, the Company has not had any transactions that are required to be reported in comprehensive income (loss) as compared to its reported net income (loss).

Note 7 Guarantees and Indemnifications

As is customary in the art publishing and licensing industry, standard contracts may provide for indemnification of defense costs, settlement costs and liabilities resulting from intellectual property claims related to the use of Company products. From time to time, customers and licensees are indemnified against combinations of loss, expense, or liability arising from various trigger events related to the sale and the use of our products and services. In addition, from time to time the Company also provides protection to customers and licensees against claims related to undiscovered liabilities, additional product liability or the Company s business activities. Based upon the Company s experience, claims made under such indemnifications are rare.

The Company s by-laws provide that the Company is required to indemnify any officer or director that is party to any civil, criminal, administrative or investigative action, suit or proceeding, by reason of the fact that such person was serving as a director or officer of the Company, against all expenses (including attorney fees), judgments fines and settlement amounts; provided the director or officer acted in good faith in a manner he or she reasonably believed to be in the best interests of the Company. The Company is not required to indemnify an officer or director if the claim, action or suit is brought by the Company and such officer or director is adjudged to be liable to the Company (unless a proper court determines that such officer or director is entitled to indemnity).

Note 8 - Litigation

From time to time, the Company is involved in various legal proceedings arising from the normal course of its business activities. Included among these various legal proceedings are lawsuits, claims and other proceedings against the Company and its affiliates by dealers and gallery

owners. These dealer and gallery owner matters generally arise out of contractual, dealer and other relationships with the Company, and involve or may involve compensatory, punitive, antitrust or other damage claims or demands for restitution, rescission, damages or equitable relief. Generally, the Company also has claims against these dealers or gallery owners, primarily for non-payment of trade accounts payable to the Company incurred by the dealer or gallery owner from the purchase of reproductions and other products. The Company regularly evaluates the expected outcome of these litigation matters. Any adverse outcome from these matters is currently not expected to have a material adverse impact on the results of operations, cash flows or financial position of the Company, either individually or in the aggregate. However, the Company s evaluation of the likely impact of these pending disputes could change in the future. In addition, although the Company does not currently expect any adverse outcomes in these litigation matters to have a material adverse impact, due to the inherently uncertain nature of litigation, the Company may be unable to successfully defend itself in these litigation matters, and its results of operations, cash flows or financial position could be materially adversely affected as a result.

Note 9 Related Party Transactions

Certain original artworks used for reproductions by the Company have been supplied by Thomas Kinkade, a founder, director and significant stockholder of the Company, and remain his property. The Company incurred royalties to Mr. Kinkade under a licensing agreement in the amounts of $784,000 and $1,153,000 for the three months ended June 30, 2003 and 2002, respectively, and $1,790,000 and $3,281,000 for the six months ended June 30, 2003 and 2002, respectively. The Company paid Mr. Kinkade a salary in the amount of $43,075 and $86,150 for both the three months and six months ended June 30, 2003 and 2002, respectively.

The Company and Creative Brands Group, Inc. (CBG) are parties to a contract dated July 17, 2001, as amended as of August 1, 2002, pursuant to which CBG manages and develops licensing arrangements with certain of the Company s business partners. The contract also provides that CBG was to manage the key account relationship with QVC and Avon until December 31, 2002. The contract expires July 31, 2006. Under the contract CBG is entitled to receive 24% of licensing revenues received by the Company from the business partners that CBG manages on behalf of the Company. CBG is primarily owned by Kenneth E. Raasch, a significant shareholder, co-founder, former Chief Executive Officer and former member of the Board of Directors of the Company. The Company incurred commissions to CBG of $444,000 and $341,000 for the three months ended June 30, 2003 and 2002, respectively, and $1,138,000 and $726,000 for the six months ended June 30, 2003 and 2002, respectively.

On May 1, 2002, the Company and Richard Barnett, a former company executive, entered into an agreement (the May Agreement) pursuant to which the Employment Agreement, dated as of March 31, 1996, between the Company and Mr. Barnett, was terminated, and Mr. Barnett s employment with the Company ended. Pursuant to the May Agreement, the Company agreed to pay Mr. Barnett a cash severance payment of $1,000,000 payable in four equal quarterly payments starting July 1, 2002, which has been fully paid and either issue to him common stock of the Company or provide him with an inventory credit of $750,000 if he were to own and operate a Signature Dealer gallery. In addition, the Company and Mr. Barnett entered into a one-year consulting agreement commencing as of April 1, 2002. Upon expiration of that agreement, the Company and Mr. Barnett entered into a new one year consulting agreement effective April 1, 2003 for $125,000 of inventory credit at the Company s wholesale price. The Company incurred consulting fees to Rick Barnett of $0 and $262,000 for the three months ended June 30, 2003 and 2002, respectively, and $62,500 and $262,000 for the six months ended June 30, 2003 and 2002, respectively. The Company also transferred inventory at the Company s wholesale price to Rick Barnett of $0 and $163,000 for the three months ended June 30, 2003 and 2002, respectively, and $6,723 and $163,000 for the six months ended June 30, 2003 and 2002, respectively. As of June 30, 2003, the Company has transferred to Mr. Barnett inventory at the Company s wholesale price of $592,000 with a remaining balance of $283,000.

During the three months and six months ended June 30, 2003, the Company paid severance payments to a terminated executive in the amount of $0 and $550,000, respectively.

From time to time, the Company makes donations to, contributes product to, or otherwise assists, certain charities (Charitable Contributions). From time to time, the Company has made Charitable Contributions to World Vision U.S. The Charitable Contributions to World Vision U.S. are not material to the Company s financial results. Richard Stearns, a member of the Company s Board of Directors, is President of World Vision U.S.

From time to time, the Company has sold products to the Thomas Kinkade Foundation, at the Company s cost. The Thomas Kinkade Foundation is an organization established by Thomas Kinkade and Nanette Kinkade. Mr. Kinkade is a co-founder of the Company and a member of the Board of Directors of the Company and the Chairman of the Board of the Thomas Kinkade Foundation. The sales to the Thomas Kinkade Foundation are not material to the Company s financial results.

Effective September 30, 2001, the Company converted $1,600,000 of trade accounts receivable, due from an entity in which a relative of Thomas Kinkade is an investor, into a full recourse three year promissory note. The balance is repayable in equal installments during the three-year period and bears interest of 12% per annum. The terms of this note are consistent with those of other notes the Company has received from non-related parties in the sale of company-owned Thomas Kinkade stores. In addition, the related party is indebted to the Company for the sale of the company-owned Thomas Kinkade stores in Monterey and Carmel, California as discussed below. The note is in default and the Company has commenced legal proceedings to recover the full amount of the note.

Effective September 15, 1999, the Company sold the company-owned Thomas Kinkade Stores located in Monterey and Carmel, California to an entity in which a relative of Thomas Kinkade is an investor. Consideration for this sale consisted of cash of $75,000 and an 8.5% promissory note in the amount of $1,100,000 due in August 2006 with semi-annual principal and interest payments. The inventory in the stores at the time of the transfer was sold under a separate transaction at normal wholesale prices with extended payment terms. The terms of this company-owned store sale are consistent with the terms for the sales of other company-owned stores to non-related parties. The Company commissioned an independent valuation of the company-owned stores in Monterey and Carmel, California and the terms of the sale were based upon the independent valuation. At December 31, 2001, the Company determined that the notes described above were impaired and accordingly wrote them down to estimated realizable value. The note is in default and the Company has commenced legal proceedings to recover the full amount of the note.

Note 10 Contingent Rent Liability

The Company established a contingent rent liability for leases in which it is either a guarantor or assignor on facility leases for previously company-owned stores sold to third parties. If the purchaser defaults on the facility lease, the lessor has the right to seek remedy from the Company. The Company increased this liability reserve by approximately $0 and $164,000 through the three months and six months ended June 30, 2003, respectively, and increased the balance $400,000 and $400,000 during the three months and six months ended June 30, 2002, respectively, for leases where there was known evidence of default or strong evidence that a default was probable. The Company paid approximately $42,000 and $245,000, subject to this liability, during the three months and six months ended June 30, 2003, and $12,000, subject to this liability, during the three months and six months ended June 30, 2002. The balance of the reserve at June 30, 2003 and December 31, 2002 was $673,000 and $638,000, respectively. The total third party rental payments due under guaranteed or assigned leases are approximately $4.7 million with such leases expiring at various times through February 2009.

Note 11 Bank Line-of-Credit

In June 2003, the Company renewed its bank line-of-credit facility with Comerica Bank-California, which provides for borrowings up to $15 million under a secured revolving line-of-credit. This facility, which has a term of 360 days, contains financial and other covenants including the requirement that the Company maintains 40% of all of the Company s deposits and investment account balances with the bank. The amount available to be borrowed is $10 million prior to the time the Company satisfies certain financial covenants, then $15 million thereafter. Borrowings under the facility bear interest at the bank s prime rate plus 0.25%. There is a 0.25% non-usage fee on un-borrowed amounts under the facility, which fee is reduced to 0.125% if the Company satisfies certain financial covenants. The facility is secured by substantially all of the Company s assets. At June 30, 2003, there were no borrowings under this line-of -credit and the Company had approximately $11.0 million on deposit with Comerica Bank California and the remaining balance invested in cash and cash equivalents with other financial institutions. At June 30, 2003, up to $10 million was available under the line-of -credit.

Note 12 Warehouse and Building Leases

In July 2002, the Company, pursuant to its plan established in the March 2002 interim period, vacated its warehouse facility located in Morgan Hill, California and consolidated its manufacturing, warehousing and administration into two existing leased buildings. At March 31, 2002 the Company established a reserve of approximately $1.3 million to cover the costs of abandonment and revised its amortization period for leasehold improvements and other related assets to record such assets at their estimated salvage value. This resulted in depreciation and amortization charge of approximately $2.4 million in the quarter ended March 31, 2002.

The Company determined in the quarter ended September 30, 2002 that it desired to sublease the building for a portion of the remaining lease term, and has placed the property on the rental market. As a result of this change in strategy, in the quarter ended September 30, 2002, the Company reversed the remaining amount of the abandonment accrual of $1.0 million and reversed $2.1 million of the charge discussed above for amortization and depreciation, as the property is no longer deemed to be abandoned. Also in the quarter ended September 30, 2002, the Company established a reserve of approximately $3.5 million for the estimated loss on the sublease term of 39 months. The amount accrued also includes an assumption of the period of time to sublease of six months. The Company has also assumed that, if necessary, to sublease beyond the initial term, sublease rentals will equal rent expense. During the three months ended March 31, 2003, the Company recorded an additional liability of approximately $1.7 million, representing an increase in the time before sublease with a corresponding increase in the rental costs to be borne by the Company prior to subleasing the subject property. The annual rent expense on this building is approximately $1.5 million per year. As of June 30, 2003 the subject building has not been subleased. Continuing volatility in the market and the current economic conditions may cause the Company to revise its strategy for its leased buildings. The Company plans to reassess this liability quarterly and

adjust as necessary based on changes in the timing and amounts of expected sublease rental income. In the event the Company is unable to achieve expected levels of sublease rental income, the Company will need to revise its estimate of the liability, which could materially impact the Company s financial position, liquidity, cash flows and results of operations.

The Company has long-term leases for its corporate and manufacturing facilities in Morgan Hill, California above current market rates, some of which are vacated or partially occupied; this could have a material impact on the Company's future consolidated financial condition, results of operations or cash flows.

Item 2: Management s Discussion and Analysis of Financial Condition and Results of Operations

The information set forth below should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto included in Part I - Item 1 of this Quarterly Report and the Company s Form 10-K for the period ended December 31, 2002, which contains the audited consolidated financial statements and notes thereto for the year ended December 31, 2002, the nine-month period ended December 31, 2001 and the fiscal year ended March 31, 2001 and the

Management s Discussion and Analysis of Financial Condition and Results of Operations for those respective periods.

This Quarterly Report on Form 10-Q and the documents incorporated herein by reference contain forward-looking statements that have been made pursuant to the provisions of the Private Securities Litigation Reform Act of 1995. In some cases, forward-looking statements can be identified by the use of such words as anticipates, expects, intends, plans, believes, seeks, estimates, variations of such words and similar expressions, particularly statements referencing our annual and quarterly revenue expectations for fiscal 2003. Such forward-looking statements are based on current expectations, estimates and projections about the Company s industry, management beliefs and certain assumptions made by Media Arts Group, Inc. management. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict; therefore, actual results may differ materially from those expressed or forecasted in any such forward-looking statements. Such risks and uncertainties include those set forth herein under Risk Factors beginning on page 15. Unless required by law, we undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. However, readers should carefully review the risk factors set forth in other reports and documents that we file from time to time with the Securities and Exchange Commission, particularly the Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.

RESULTS OF OPERATIONS

Net Revenues

Net revenues for the three and six-month periods ended June 30, 2003 were $10.8 million and $27 million, respectively. This represents a 48.7% and 49.4% decrease from $21 million and $53.4 million of net revenues for the same three and six month periods in the prior year.

Net product and other revenues for the three and six-month periods ended June 30, 2003 were $8.6 million and $22.3 million, respectively. This represents a 52.9% and 54.5% decrease from $18.3 million and $49 million of net product and other revenues for the same three and six month periods in the prior year. The decrease in net product and other revenues for the three and six-month periods ended June 30, 2003 primarily is due to the continuing softness in consumer purchasing attitudes of discretionary spending reflective of the current economic uncertainties. Net product and other revenues for the six-month period ended June 30, 2003 further decreased relative to the same period in the prior year due to the high demand for Thomas Kinkade s Lombard Street release that was very popular and had significant sales in the first quarter of 2002.

Licensing revenues for the three and six-month periods ended June 30, 2003 were $2.2 million and $4.7 million, respectively. This represents a 20.2% decrease and a 7.3% increase from $2.7 million and $4.4 million of licensing revenues for the same three and six month periods in the prior year. The decrease in licensing revenues for the three-month period ended June 30, 2003 is due to the continuing softness in demand reflective of the current economic uncertainties. The increase in licensing revenues for the six month period ended June 30, 2003 is due to the increase in the number of licensing agreements from the prior year.

Gross Margin

Gross margin of $3.4 million and $11 million for the three and six-month periods ended June 30, 2003, respectively, decreased by $6.3 million, or 64.6%, and $13.3 million, or 54.8%, as compared with the same three and six-month periods of last year. Gross margin was 31.9% and 40.6% of net revenue for the three and six-month periods ended June 30, 2003, respectively, as compared to 46.4% and 45.4% of net revenue for the same periods in the prior year. The decline in gross margin and gross margin percentage for the three and six-month period ended June 30, 2003 was due primarily to lower absorption of fixed manufacturing expenses related to the decline in revenues due to the current economic slowdown. Cost of product and other revenues represent manufacturing costs including payroll, benefits and other expenses, royalties and distribution costs. Cost of revenue for licensing represents royalties accrued on license revenues recorded during the period.

Selling and Marketing Expenses

Selling and marketing expenses were $5.7 million and $12.1 million for the three and six-month periods ended June 30, 2003, respectively, as compared to $5.1 million and $13.1 million for the same periods in the prior year. As a percentage of net revenue, selling and marketing expenses were 52.4% and 44.7% for the three and six-month periods ended June 30, 2003, respectively, as compared to 24% and 24.5% for the same periods in the prior year. The increase in sales and marketing expense for the three-month period was primarily due to costs relating to two separate conferences held in the second quarter

of 2003. The decrease in sales and marketing expenses for the six-month period was due to the Company s cost reduction programs.

General and Administrative Expenses

General and administrative expenses were $4 million and $10 million for the three and six-month periods ended June 30, 2003, respectively, as compared to $6.1 million and $16.3 million for the same periods in the prior year. As a percentage of net revenue, general and administrative expenses for the three and six-month periods ended June 30, 2003 were 36.6% and 37.1%, respectively, as compared to 29.1% and 30.6%, respectively, for the same periods in the prior year. The decline in general and administrative expenses for both the three and six-month period was due to reduced costs realized from the Company s cost reduction programs. In addition, the decrease in general and administrative expenses for the six-month period ended June 30, 2003 as compared with the same time period in the prior year was also due to the significant charges that occurred in the first quarter of 2002 that included a $3.2 million charge representing rental liabilities and increased amortization expense for the vacating of the Company s warehouse facility in Morgan Hill, California, and for the six-month period ended June 30, 2003 a $1.7 million charge for an increase in the estimated time to sublease the Company s vacated warehouse facility in Morgan Hill, California.

Interest Income (Expense)

Net interest income was $98,000 and $205,000 for the three and six-month period ended June 30, 2003, respectively, as compared to net interest income of $22,000 and expense of $53,000, respectively, for the same periods in the prior year. The increase in net interest income for the three and six-month periods was due to the higher cash balances available for investment, the absence of convertible notes payable to related parties and reduced debt.

Sale of Company-Owned Stores

During the fiscal year ended March 31, 2001, the Company sold 30 of its company-owned stores to Signature Gallery owners. No stores were sold during the six-months ended June 30, 2003. During the three and six-month periods ended June 30, 2003, the Company recognized $26,000 and $45,000 of gain on the sales of company-owned stores, respectively, as compared with $29,000 and $94,000 in gain for the same time periods of last year. The gain recognition was based on the cost recovery method. As of June 30, 2003, the remaining deferred gains totaled $598,000. The Company has reported the net of the notes receivable and deferred gains as other assets at June 30, 2003.

Benefit from Income Tax

The benefit from income taxes was $2.4 million and $4.4 million for the three and six-month periods ended June 30, 2003, as compared to $741,000 and $2.1 million for the same time periods in the prior year. The Company s effective income tax rate for the three and six-month periods ended June 30, 2003 was 40.1% and 40.6%, respectively, compared to 53.9% and 41.4% for the same time periods in the prior year. The effective tax rates of 53.9% for the three months ended June 30, 2002 includes the effect of the increase in the annual effective tax rate for fiscal 2002 from 36.8% to 41%.

The Company recorded a benefit from income taxes of $2.4 million and $4.4 million for the three and six-month periods ended June 30, 2003, increasing the related cumulative net deferred tax asset of $9.1 million as of June 30, 2003, reflecting net operating loss and credit carry forwards and deductible temporary differences. Although realization is not assured, the Company has concluded that it is more likely than not that the net deferred tax assets will be realized based on the deferred tax liabilities and projected taxable income in 2003 and beyond. The amount of the net deferred tax assets actually realized, however, could vary if there are differences in the timing or amount of future reversals of existing deferred tax liabilities or changes in the actual or projected amounts of future taxable income.

Discontinued Operations

In the year ended March 31, 1997, the Company discontinued a business segment and provided a tax reserve related to the losses incurred by the segment. In the quarter ended March 31, 2003, this reserve was released and recorded in a manner similar to the source of the loss in the year ended March 31, 1997. Accordingly, the Company recorded a tax benefit of $0 and $342,000 in the three and six-month periods ended June 2003, representing the tax benefit from the closure of a subsidiary in September 1996.

LIQUIDITY AND CAPITAL RESOURCES

The Company s primary source of funds during the three and six-months ended June 30, 2003 has been from operations. The Company closed the quarter ended June 30, 2003 with cash and cash equivalents of $20.4 million and working capital of $40.8 million, as compared to cash and cash equivalents of $24.5 million and working capital of $45.6 million as of December 31, 2002.

Net cash used in operations during the six months ended June 30, 2003 was $3.6 million consisting primarily of changes in assets and liabilities including a decrease in accounts receivable of $6.3 million, prepaid expenses and other assets of $1.8 million, accounts payable of $2.1 million and accrued compensation cost of $2.2 million, offset by an increase in accrued expenses of $2.9 million and income tax receivable of $1.1 million. Operating cash was also provided by non-cash items including depreciation and amortization of $1.9 million, offset by current and deferred income taxes of $3.6 million adjusted against the net loss of $6.2 million. Net cash provided by operations during the six months ended June 30, 2002 was $13.2 million consisting primarily of changes in assets and liabilities including a decrease in accounts receivable of $7.7 million and in inventories of $4.6 million and an increase in accrued compensation costs and accrued expenses of $2.3 million, offset by a decrease in accounts payable, accrued commissions and accrued royalties of $3.4 million and an increase in prepaid expenses and other assets of $236,000. Operating cash was also provided by non-cash items including depreciation and amortization of $5.6 million and the loss on disposal of fixed assets of $766,000 offset by current and deferred income taxes of $1.1 million adjusted against the net loss of $3.0 million. Inventories decreased primarily as a result of the establishment of additional reserves for paper inventory in the first quarter.

Net cash used in investing activities was $261,000 during the six months ended June 30, 2003 and primarily related to $396,000 of cash used in the acquisition of property and equipment offset by proceeds from notes receivable of $111,000. Net cash used in investing activities was $3.0 million during the six months ended June 30, 2002 and primarily related to the increase in restricted cash of $2.0 million, the purchase of a note receivable of $446,000 and $789,000 of cash used in the acquisition of property and equipment offset by proceeds from notes receivable and the disposal of galleries of $259,000.

The Company anticipates that total capital expenditures for the balance of 2003 will be approximately $500,000 and will primarily relate to information system upgrades and manufacturing equipment.

Cash used in financing activities was $216,000 during the six months ended June 30, 2003 and was related to the repayment of a capital lease obligation of $216,000. Cash used in financing activities was $1.6 million during the six months ended June 30, 2002 and primarily was related to payments on its line-of-credit of $1.5 million and the repayment of a capital lease obligation of $121,000 and proceeds from the issuance of common stock through the Company s Employee Stock Purchase Plan and the exercise of options for its common stock of $19,000.

In June 2003, the Company renewed its bank line-of-credit facility with Comerica Bank-California, which provides for borrowings up to $15 million under a secured revolving line-of-credit. This facility, which has a term of 360 days, contains financial and other covenants including the requirement that the Company maintains 40% of all of the Companies deposits and investment account balances with the bank. The amount available to be borrowed is $10 million prior to the time the Company satisfies certain financial covenants, then $15 million thereafter. Borrowings under the facility bear interest at the bank s prime rate plus 0.25%. There is a 0.25% non-usage fee on un-borrowed amounts under the facility, which fee is reduced to 0.125% if the Company satisfies certain financial covenants. The facility is secured by substantially all of the Company s assets. At June 30, 2003, there were no borrowings under this line-of -credit and the Company had approximately $11 million on deposit with Comerica Bank California and the remaining balance invested in cash and cash equivalents with other financial institutions. At June 30, 2003, up to $10 million was available under the line-of -credit.

The Company has long-term leases for its corporate and manufacturing facilities in Morgan Hill, California above current market rates, some of which are vacated or partially occupied; this could have a material impact on the Company s future consolidated financial condition, results of operations or cash flows.

Throughout the economic slowdown that has been acutely impacting the Company, the Company has experienced a deterioration of the quality of its accounts receivable. The Company has been monitoring each of its dealer accounts closely and believes that it has adequate reserves, but additional reserves may be required in the future depending on the Company s ability to collect outstanding accounts receivable.

The Company s working capital requirements in the foreseeable future will change depending on operating results, the rate of expansion, changes in the economy or any other changes to its operating plan needed to respond to competition, acquisition

opportunities or unexpected events. The Company and its management believe that its current cash and cash equivalent balance together with future projected net income from operations and existing borrowing capacity under its line-of-credit will be sufficient to meet its working capital requirements for at least the next twelve months. The Company may consider alternative financing, such as issuance of additional equity or convertible debt securities or obtaining further credit facilities, if market conditions make such alternatives financially attractive.

Seasonality and Fluctuations in Operating Results

The Company s business has experienced, and is expected to continue to experience, seasonal fluctuations in net revenue and income. Its net revenue historically has been highest in the December quarter and lower in the March, June and September quarters. The Company believes that the seasonal effect is due to customer buying patterns, particularly with respect to holiday purchases, and is typical of the home decorative accessories, collectibles and gift product industries. The Company expects these seasonal trends to continue in the foreseeable future.

The Company s quarterly operating results have fluctuated significantly in the past and may continue to fluctuate as a result of numerous factors, including:

Change in demand for the art of Thomas Kinkade and the Company s (and its licensees) Thomas Kinkade products (including new product categories and series);

The Company s ability to achieve its expansion plans;

The timing, mix and number of new product releases;

The continued success of the Signature Gallery program;

The Company s successful entrance into new, and expansion of existing, distribution channels, both foreign and domestic, and new retail concepts;

The Company s ability to implement strategic business alliances, including attracting and retaining licensees;

Continued implementation of manufacturing efficiencies;

Timing of product deliveries;

The ability to absorb other operating costs; and

Conflict among distribution channels.

In addition, since a significant portion of the Company s net revenue is generated from orders received in the quarter, revenue in any quarter is substantially dependent on orders booked in that quarter. Results of operations may also fluctuate based on extraordinary events. Accordingly, the results of operations in any quarter will not necessarily be indicative of the results that may be achieved for a full fiscal year or any other quarter. Fluctuations in operating results may also result in volatility in the price of the Company s Common Stock.

RECENT ACCOUNTING PRONOUNCEMENTS

In April 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145 eliminates SFAS No. 4, Reporting Gains and Losses from Extinguishment of Debt, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item. Under SFAS No. 145, such gains and losses should be classified as extraordinary only if they meet the criteria of Accounting Principles Board (APB) Opinion No. 30. In addition, SFAS No. 145 amends SFAS No. 13, Accounting for Leases, to eliminate an inconsistency between the required accounting for sale-leaseback transactions and

the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. Media Arts adopted SFAS No. 145, on January 1, 2003. The adoption of this statement did not have a material effect on its consolidated financial condition, results of operations or cash flows.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). This Statement requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. SFAS No. 146 will be applied to exit or disposal activities that are initiated after December 31, 2002.

In November 2002, the FASB issued Financial Interpretation No. (FIN) 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 requires that a liability be recorded in the guarantor s balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosures about the guarantees that an entity has issued, including a roll forward of the entity s product warranty liabilities. We have applied the recognition provisions of FIN 45 to guarantees issued or modified after January 1, 2003. The adoption of this standard did not have a material impact on the Company s consolidated financial condition, results of operations or cash flows.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The Company adopted the disclosure requirements in these interim financial statements.

In January 2003, the FASB issued FI N 46, Consolidation of Variable Interest Entities, and an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from the other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. The adoption of FIN 46 did not have a material effect on the Company s financial condition, results of operations or cash flows.

RISK FACTORS

Investing in the Company s Common Stock involves a high degree of risk. Any of the following risks, or additional risks not presently known to the Company that the Company deems immaterial, could materially adversely affect the Company s business, operating results and financial condition and could result in a complete loss of your investment.

The Company Faces Risks Related to Its Dependence on One Artist. If the license agreement with Thomas Kinkade were terminated or if he were unable or unwilling to produce new artwork for any reason, the loss of Mr. Kinkade s services would have a material adverse effect on the Company s business, operating results, financial position and cash flow.

Life and disability insurance covering Thomas Kinkade in the amount of approximately $60 million and $30 million, respectively, is currently maintained by the Company. The available remedies in the event of a breach of the license agreement by Mr. Kinkade are limited to monetary damages because the license is a personal service contract. In limited circumstances, Mr. Kinkade has the right to terminate the Company s rights to certain images. Upon any loss of Mr. Kinkade s services, the Company may seek to expand the number of products based upon Mr. Kinkade s then existing images, to the extent Mr. Kinkade has not terminated the Company s rights thereto, and/or develop relationships with other artists and offer products based upon their work. In addition, the Company is highly dependent upon continued consumer satisfaction with Thomas Kinkade and the brand, and consumer demand for products based upon the artwork of Thomas Kinkade. Consumer dissatisfaction with Thomas Kinkade or the brand could result in a decline in sales of Thomas Kinkade products or a failure of such products to gain consumer acceptance in new market channels, which could have a material adverse effect on the Company s business, financial position, operating results and cash flow.

The Company Faces Risks Associated with Expansion of Existing Dealer Network Distribution Channels. The Company s strategy includes expansion of its dealer network and distribution channels. The Company s ability to increase revenues will depend, in part, upon the effectiveness of this strategy and the market s continued acceptance of Thomas

Kinkade art and products related to the brand. As in the past, the Company continues to direct capital and personnel resources toward enhancing retail support services to licensed gallery owners and licensees, improving manufacturing systems and streamlining systems and procedures.

The expansion of exclusive Thomas Kinkade Signature Galleries and Showcase Galleries is dependent upon a number of factors, including the Company s ability to locate suitable sites, identify appropriate dealer/owners and integrate them into the independent dealer network, as well as the ability of such owners to effectively promote and sell products. The Company may authorize galleries in certain geographic markets that may present competitive challenges that have not been experienced to date. In addition, new stores may open in the proximity of existing galleries and dealers, which may reduce revenue to existing locations. Furthermore, the laws of certain states may limit the Company s