TROY GROUP INC
Form 10-Q
July 15, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 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 May 31, 2004.
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: 000-24413

TROY GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**33-0807798**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2331 South Pullman Street **Santa Ana, California**	**92705**
(Address of principal executive offices)	(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 o No ý

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 o No ý

As of June 30, 2004, 10,642,677 shares of the Registrant s Common Stock were outstanding.

TROY GROUP, INC.

Quarterly Report on Form 10-Q for the

Quarterly Period Ended May 31, 2004

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PART I: FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

TROY GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	May 31, 2004 (Unaudited)	November 30, 2003 (a)
Assets		
Current assets:		
Cash and cash equivalents	$ 2,571	$ 1,727
Investment in available-for-sale securities	8,000	8,000
Accounts receivable, less allowance for doubtful accounts $626 in 2004; $393 in 2003	8,665	8,419
Inventories, net	5,221	4,891
Prepaid expenses and other	1,333	1,414
Deferred tax assets	2,789	2,789
Total current assets	28,579	27,240
Equipment and leasehold improvements, net	3,183	3,213
Goodwill	281	281
Receivable from stockholders	1,903	1,903
Deferred tax assets	1,240	1,330
Other assets	614	993
Total assets	$ 35,800	$ 34,960
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 3,412	$ 2,172
Accrued expenses	3,560	4,322
Deferred revenue	1,840	1,807
Total current liabilities	8,812	8,301
Commitments and contingencies		
Stockholders equity:		
Preferred stock, no par value authorized 5,000,000 shares, issued none		
Common stock, par value $.01 per share authorized 50,000,000 shares, issued 10,642,677 shares in 2004; 10,974,170 shares in 2003	107	110
Additional paid-in capital	19,921	21,122

Accumulated other comprehensive income		10		33
Retained earnings		6,958		6,598
		26,996		27,863
Less cost of treasury stock, 2,800 shares in 2004; 331,493 shares in 2003		(8)		(1,204)
Total stockholders equity		26,988		26,659
Total liabilities and stockholders equity	$	35,800	$	34,960

(a) Derived from the audited consolidated financial statements for the year ended November 30, 2003

See Notes to Condensed Interim Consolidated Financial Statements.

TROY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS
OF OPERATIONS

(Unaudited)

(in thousands, except per share amounts)

	Three Months Ended May 31,		Six Months Ended May 31,	
	2004	2003	2004	2003
Net sales	$ 14,422	$ 13,395	$ 28,039	$ 27,803
Cost of goods sold	8,756	8,193	17,029	16,631
Gross profit	5,666	5,202	11,010	11,172
Operating expenses:				
Selling, general and administrative	4,500	3,683	8,090	7,712
Research and development	1,099	1,230	2,336	2,692
Amortization of intangible assets	24	11	51	22
Operating income	43	278	533	746
Interest income	23	23	53	26
Interest expense		(6)		(8)
Income before income taxes	66	295	586	764
Provision for income taxes	26	105	226	292
Net income	$ 40	$ 190	$ 360	$ 472
Net income per share:	$	$ .02	$ .03	$ .04
Basic	$	$ .02	$ .03	$ .04
Diluted				
Shares used in per share computations:				
Basic	10,640	10,651	10,641	10,650
Diluted	10,640	10,651	10,644	10,650

See Notes to Condensed Interim Consolidated Financial Statements.

TROY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands)

	Six Months Ended May 31,	
	2004	**2003**
Cash flows from operating activities:		
Net income	$ 360	$ 472
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	528	591
Impairment of long-lived assets	284	
Provision for doubtful accounts	233	200
Changes in working capital components:		
(Increase) decrease in:		
Accounts receivable	(480)	759
Income tax refund receivable		49
Inventories	(330)	(1,135)
Prepaid expenses and other	81	151
Deferred taxes	90	
Increase (decrease) in:		
Accounts payable	1,240	(1,563)
Accrued expenses	(761)	643
Deferred revenue	33	(119)
Net cash provided by operating activities	1,278	48
Cash flows from investing activities:		
Purchase of equipment and leasehold improvements	(373)	(621)
Maturities of available-for-sale securities		497
Increase in other assets, net	(30)	(39)
Net cash used in investing activities	(403)	(163)
Cash flows from financing activities:		
Payments on notes payable		(35)
Proceeds from issuance of common stock		9
Purchase of treasury stock	(8)	
Net cash used in financing activities	(8)	(26)
Effect of foreign currency translation	(23)	
Net increase (decrease) in cash and cash equivalents	844	(141)

Cash and cash equivalents, beginning of period		1,727		6,615
Cash and cash equivalents, end of period	$	2,571	$	6,474

See Notes to Condensed Interim Consolidated Financial Statements.

TROY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(Unaudited)

(in thousands except share amounts)

	Common Stock		Additional	Accumulated Other		Treasury Stock		Total	
	Number of Shares	Amount	Paid-in Capital	Comprehensive Income	Retained Earnings	Number of Shares	Amount	Stockholders Equity	Comprehensive Income (Loss)
Balance, November 30, 2003	10,974,170	$ 110	$ 21,122	$ 33	$ 6,598	331,493	$ (1,204)	$ 26,659	$
Retirement of treasury stock	(331,493)	(3)	(1,201)			(331,493)	1,204		
Purchase of common stock for the treasury						2,800	(8)	(8)	
Foreign currency translation adjustment, net of tax				(23)				(23)	(23)
Net income					360			360	360
Balance, May 31, 2004	10,642,677	$ 107	$ 19,921	$ 10	$ 6,958	2,800	$ (8)	$ 26,988	$ 337

See Notes to Condensed Interim Consolidated Financial Statements

TROY GROUP, INC.

NOTES TO CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1. Basis of Presentation

The accompanying unaudited consolidated financial statements of TROY Group, Inc. (the Company) 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 six months ended May 31, 2004 are not necessarily indicative of the results that may be expected for the year ending November 30, 2004. 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, 2003.

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 and net income per share had compensation costs for the stock-based compensation plan been determined based on the fair values of awards on the grant date under the provisions of SFAS No. 123, for the three-month and six-month periods ended May 31, 2004 and 2003 (amounts in thousands, except per share data):

	Three months ended May 31,		Six months ended May 31,	
	2004	**2003**	**2004**	**2003**
Net income (loss) applicable to common stockholders:				
As reported	$ 40	$ 190	$ 360	$ 472
Less total stock-based employee compensation expense determined under fair value-based method for all awards, net of related tax effects	(163)	(100)	(333)	(202)
Proforma	$ (123)	$ 90	$ 27	$ 270
Net income per share applicable to common stockholders, basic and diluted:				
As reported	$	$ .02	$ .03	$ .04

Proforma	$ (.01)	$ .01	$	$ .03

There were no stock option grants in the quarter ended May 31, 2004.

Recent Accounting Pronouncements

In May 2003 FASB issued Statement of Financial Accounting Standards (SFAS) No. 150, *Accounting for Certain Financial*

Instruments with Characteristics of both Liabilities and Equity, which requires that certain financial instruments previously presented as equity or temporary equity be presented as liabilities. Such instruments include mandatory redeemable preferred and common stock, and certain options and warrants. SFAS No.150 is effective for financial instruments issued, entered into or modified after May 31, 2003 and is generally effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No.150 is not expected to have a material effect on the Company s financial position or results of its operations.

In 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51*, as revised. Prior to FIN 46, a company generally included another entity in the company s financial statements only if it controlled the entity through ownership of the majority voting interests. 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 other parties. We have adopted FIN 46 effective with the quarter ending May 31, 2004, and we have determined that we do not have any variable interest entities that are required to be consolidated in our financial statements.

Note 2. Inventories

Inventories consisted of the following as of May 31, 2004 and November 30, 2003 (amounts in thousands):

	May 31, 2004 (unaudited)	November 30, 2003
Raw materials	$ 3,052	$ 4,671
Work-in-process	438	401
Finished goods	4,070	2,264
Reserve for slow moving and obsolete inventories	(2,339)	(2,445)
Total	$ 5,221	$ 4,891

Note 3. Other Assets

Other assets consisted of the following at May 31, 2004 and November 30, 2003 (amounts in thousands):

	May 31, 2004 (unaudited)	November 30, 2003
Customer list, net of accumulated amortization 2004 $22 and 2003 $20	$ 3	$ 5
Core technology, net of accumulated amortization 2004 $272 and 2003 $236	120	156
		13

Purchased software, net of accumulated amortization 2004 $133 and 2003 $120				
Software development costs, net of accumulated amortization 2004 $718 and 2003 $359				359
Cash surrender value of officers life insurance		491		460
	$	614	$	993

Note 4. Goodwill and Intangible Assets

The Company adopted SFAS No. 142 *Goodwill and Other Intangible Assets* 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 represent components of its operating segments, which are the same as the reportable segments, identified in Note 11. 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.

For the year ended November 30, 2003, no impairment loss was recognized. 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 fiscal quarter, and whenever events and changes in circumstances indicate that there may be a potential impairment.

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, 2003 and May 31, 2004 are as follows (amounts in thousands):

	Wireless & Connectivity	Secure Payment Systems	Total
Balance at November 30, 2003	$	$ 281	$ 281
Balance at May 31, 2004 (unaudited)	$	$ 281	$ 281

The Company s intangible assets subject to amortization at May 31, 2004 and November 30, 2003 are composed of (amounts in thousands):

	May 31, 2004 (unaudited)			November 30, 2003		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Customer Lists	$ 25	$ (22)	$ 3	$ 25	$ (20)	$ 5
Core Technology	392	(272)	120	392	(236)	156
Purchased Software	133	(133)		133	(120)	13
Total amortizable intangible assets	$ 550	$ (427)	$ 123	$ 550	$ (376)	$ 174

For long-lived assets, other than goodwill, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires the evaluation for impairment whenever events or changes in circumstances have indicated that an asset may not be recoverable. Long-lived assets evaluated for impairment are grouped with other assets to the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. If the sum of the projected undiscounted cash flows (excluding interest charges) is less than the carrying value of the assets, the assets will be written down to the estimated fair value, and the loss recognized in income from continuing operations in the period in which the determination is made.

In the second quarter of fiscal 2004, management evaluated the long-lived intangible assets for impairment using the methodology described above and determined that the asset representing the capitalized software development costs for ACH software was impaired. As a result, the unamortized amount of $284,000 at April 30, 2004 was written off in the second quarter.

Amortization expense related to intangible assets was approximately $24,000 and $11,000 for each of the three-month periods and $51,000 and $22,000 for each of the six-month periods ended May 31, 2004 and 2003, respectively.

Estimated future amortization expense related to purchased intangible assets at May 31, 2004 is as follows:

Fiscal year:		**(In thousands)**
2004	$	37
2005		75
2006		11
Total	$	123

Note 5. Notes Payable

The Company has a $5.0 million line-of-credit agreement with Comerica Bank. As of May 31, 2004, 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 May 31, 2004) less 0.25% or the bank s LIBOR rate (1.11 % at May 31, 2004) 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, the Company has a $650,000 standby letter-of-credit sub-limit, of which approximately $80,000 was outstanding at May 31, 2004. This line of credit is secured by substantially all of the Company s assets. The borrowing arrangement requires the Company to comply with certain financial covenants and other restrictions, including its ability to pay dividends, and as of May 31, 2004 the Company was in compliance with those covenants. As of May 31, 2004, the Company 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 at any time.

Note 6. Stock Option and Stock Warrant Plans

During the six months ended May 31, 2004, the Company granted 40,000 stock options to employees and a director. The following is a summary of total outstanding options and stock warrants at May 31, 2004:

	Options and Warrants Outstanding				**Options and Warrants Exercisable**		
Range of Exercise Prices	**Number of Shares**		**Weighted - Average Exercise Price**	**Weighted - Average Remaining Contractual Life**	**Number of Shares**		**Weighted - Average Exercise Price**
$2.85 - $4.51	702,666	$	3.87	6.2 years	469,332	$	3.81
6.63 - 8.75	461,000		7.32	5.6 years	385,569		7.35
13.16 - 14.25	15,000		13.52	5.8 years	9,998		13.52
$2.85 - $14.25	1,178,666	$	5.34	6.0 years	864,899	$	5.50

At May 31, 2004, there were 1,618,000 shares remaining available for grant under the Company s stock option plan.

Note 7. Net Income Per Share

The following table sets forth the computation of basic and diluted net income per share (amounts in thousands, except per share data):

	Three months ended May 31,		Six months ended May 31,	
	2004	2003	2004	2003
Numerator for basic and diluted net income per share:				
Net income	$ 40	$ 190	$ 360	$ 472
Denominator for basic net income per share				
Weighted-average shares outstanding	10,640	10,651	10,641	10,650
Effect of employee stock options and warrants			3	
Denominator for diluted net income per share	10,640	10,651	10,644	10,650
Net income per share:				
Basic	$	$ .02	$ .03	$ .04
Diluted	$	$ .02	$ .03	$ .04

Note 8. Contractual Obligations and Commercial Commitments

We have the following minimum non-cancelable contractual obligations and commercial commitments (amounts in thousands):

	Total	Fiscal 2004	Fiscal 2005-07	Fiscal 2008
Related party operating lease	$ 1,096	$ 143	$ 858	$ 95
Other operating leases	380	182	198	
Split dollar life insurance policy	**	**	**	**
Total	$ 1,476	$ 325	$ 1,056	$ 95

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

The Company leases its operating facilities under non-cancelable operating lease agreements, including certain operating facilities from a company related through common ownership, which expire through 2008. The related-party lease requires monthly payments of approximately $23,800.

As of May 31, 2004 and November 30, 2003, we had a balance of advanced payments of $1,903,000 to affiliated stockholders in connection with the purchase of split dollar life insurance policies. The Company and the stockholders have executed split-dollar agreements governing the unsecured non-interest bearing advances. The advances are due upon the death, termination or retirement of the Company s Chairman, Chief Executive Officer and majority stockholder. We previously had committed to making payments on the split dollar life insurance policies based on continued employment; however, the Sarbanes-Oxley Act of 2002 prohibits extensions of credit in the form of a personal loan to certain company insiders after July 29, 2002. As a result, since July 29, 2002 we have not funded the annual premium payments on these policies. If the SEC issues new regulations or other guidance that causes us to reevaluate our position, we may demand payment on the advance and terminate our participation in these arrangements.

Note 9. Major Vendors

The Company purchases key components from a vendor and also sells products to this same vendor. Purchases from this vendor for the six months ended May 31, 2004 and 2003 were (in thousands): $6,238, and $4,677, respectively. Net payable balances to this vendor as of May 31, 2004 and November 30, 2003 were (in thousands): $780 and $149, respectively.

Note 10. Major Customers

There were no customers that accounted for 10% or more of net sales in the first six months of fiscal 2004, or fiscal 2003.

Note 11. Segment Information and Geographical Information

Segment Information

The following tables summarize net sales and net income by the Company s operating segments, Secure Payment Systems and Wireless and Connectivity Solutions, for the three months and six months ended May 31, 2004 and 2003 (amounts in thousands):

	Three months ended May 31, (unaudited)		Six months ended May 31, (unaudited)	
	2004	2003	2004	2003
Net Sales:				
Secure Payment Systems	$ 9,887	$ 10,099	$ 19,394	$ 20,438
Wireless and Connectivity Solutions	4,535	3,296	8,645	7,365
	$ 14,422	$ 13,395	$ 28,039	$ 27,803
Net Income:				
Secure Payment Systems	$ 257	343	261	607
Wireless and Connectivity Solutions	$ (217)	(153)	99	(135)
	$ 40	$ 190	$ 360	$ 472

	May 31, 2004 (unaudited)	November 30, 2003
Segment Assets:		
Secure Payment Systems	$ 30,748	$ 29,083
Wireless and Connectivity Solutions	10,923	11,281
	$ 41,671	$ 40,364

The following schedule is presented to reconcile May 31, 2004 and November 30, 2003 segment assets to the amounts reported in the Company s consolidated financial statements (amounts in thousands).

	May 31, 2004 (unaudited)	November 30, 2003
Total assets of reportable segments	$ 41,671	$ 40,364
Inter-segment receivables	(5,637)	(5,170)
Investment in subsidiaries	(234)	(234)
Consolidated assets	$ 35,800	$ 34,960

Geographical Information

	Three months ended May 31, (unaudited)		Six months ended May 31, (unaudited)	
	2004	2003	2004	2003
Net Sales:				
United States	$ 11,004	$ 9,911	$ 21,772	$ 21,462
All Other Countries	3,418	3,484	6,267	6,341
	$ 14,422	$ 13,395	$ 28,039	$ 27,803

Note 12. Cash Flow Information

Supplemental disclosure of cash flow information; (amounts in thousands):

	Six months ended May 31, (unaudited)			
	2004		2003	
Cash paid during the period for:				
Interest	$		$	8
Income taxes	$	192	$	271
Supplemental disclosure of non-cash activities:				
Retirement of treasury stock	$	1,204	$	

Note 13. Income Taxes

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carry forwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when it is determined to be more likely than not that some portion or all of the deferred tax assets will not be realized. In evaluating the need for a valuation allowance, the Company considers future taxable income and prudent and feasible tax planning strategies. The Company has placed substantial reliance on its current projections of future taxable income. The Company re-assesses its projections of taxable income on a quarterly basis. If it is determined that the Company would not be able to realize all or part of its deferred tax assets in the future, which would include the Company s failure to materially meet its projections of taxable income, an adjustment to the carrying value of the deferred tax assets would be charged to income in the period in which such determination was made and may affect our annual effective income tax rate.

Management currently believes the deferred tax assets are more likely than not to be realized based on current expectations of future earnings and available tax planning strategies. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

The net deferred tax assets have been classified on the accompanying consolidated balance sheets as follows (in thousands):

	May 31, 2004		November 30, 2003	
Current assets	$	2,789	$	2,789
Long-term assets		1,240		1,330
	$	4,029	$	4,119

Note 14. Proposed Merger

On May 26, 2004, we announced that TROY had entered into a merger agreement (the Merger) with Dirk, Inc., a company controlled by Patrick Dirk, the founder of TROY, and his family members, pursuant to which Mr. Dirk and his family will acquire the outstanding shares of TROY common stock that they do not already own. TROY expects the Merger to close in August 2004. The Merger is subject to approval by TROY stockholders as required under applicable state law, to completion of financing arrangements necessary to accomplish the Merger, and to certain other closing conditions. On June 17, 2004, we filed a Preliminary Proxy Statement on Schedule 14A and a Schedule 13E-3 in connection with the proposed Merger.

Note 15. Litigation

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 defendants breached their fiduciary duties in connection with the previous merger by attempting to provide the Dirk family with preferential treatment in connection with their efforts to complete a sale of TROY. The complaint

sought to enjoin an acquisition of TROY by the Dirk family, as well as attorneys fees. Following termination of the previous merger Agreement, the plaintiff filed a motion for dismissal of the action and award of attorney s fees and expenses of $387,250. TROY filed a motion in support of the plaintiffs motion for dismissal of the action and in opposition to plaintiffs motion for fees. On March 4, 2004 the court issued a ruling granting the motion for dismissal with prejudice, and granting the motion for attorneys fees of $175,000. On April 30, 2004, TROY filed a notice of appeal. TROY has accrued an estimate of expenses to be incurred in connection with this litigation in fiscal 2003 in excess of the deductible amount, which was recorded as an expense in fiscal 2002.

Following the announcement of the proposed Merger, Osmium Partners LLC, Ralph Hamer, Roy Liedtke, and Tilson Growth Fund, LP, respectively, filed purported class action complaints in the California Superior Court for Orange County against TROY and our directors. The Liedtke complaint also names Dirk, Inc. In all four actions, plaintiffs allege that defendants breached their fiduciary duties in connection with the Merger by attempting to provide the Dirk family with preferential treatment in connection with their efforts to complete a sale of TROY. Plaintiffs in all four actions seek declaratory relief, an order enjoining the acquisition, and attorneys fees. The Liedtke complaint also seeks damages. TROY and our directors have not yet been served with the Liedtke and Tilson Growth Fund complaints. Osmium Partners LLC has served discovery requests, but discovery has not commenced in the other actions. No trial date has been set in any of these actions. If these actions are successful in enjoining the transaction, or the Liedtke action is successful in obtaining damages, it could have a material adverse effect on our business, financial position, or results of operation. Currently, the amount of such an adverse effect cannot be estimated.

Note 16. Guarantees

Indemnifications

In the ordinary course of business, TROY enters into contractual arrangements under which TROY may agree to indemnify the third party in the arrangement from any losses incurred relating to services performed on behalf of TROY or for losses arising from certain events as defined within the particular contract, which may include litigation or claims relating to past performance. These arrangements include, but are not limited to, TROY s indemnification of its officers and directors to the maximum extent under the laws of the state of Delaware, the indemnification of its lessors for certain claims arising from the use of the facilities, and the indemnification of its bank for certain claims arising from the bank's grants of credit to TROY. Such indemnification obligations may not be subject to maximum loss clauses. Historically, payments, if any, or if made or required related to these indemnifications have been immaterial.

Warranty

TROY accrues for warranty expense at the time revenue is recognized and maintains a warranty accrual for estimated future warranty obligations based upon the relationship between historical and anticipated warranty costs and sales volumes. To the extent TROY experiences increased warranty claim activity or increased costs associated with servicing those claims, our warranty accrual will increase resulting in decreased gross profit. The standard warranty period for TROY s products ranges from one month to five years.

Deferred Revenue

TROY offers fixed-price support or maintenance contracts, including extended warranties, to its customers. Revenue from equipment maintenance contracts on check printing equipment and software is recorded as deferred income when billed and is recognized straight-line over the term of the contract.

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. *Such forward looking statements include, but are not limited to, statements regarding the proposed merger with Dirk, Inc., our ability to finance our operating activities, our critical accounting policies and recent accounting pronouncements, international sales, compliance with laws and regulations, benefits of our ERP system, our current litigation and our efforts to defend such litigation.*

Various risks and uncertainties could cause actual results to differ materially from those expressed in forward-looking statements. These risks and uncertainties include, but are not limited to, completion of the proposed merger, the continued demand for printed financial documents; the useful life of our products, the market acceptance of products incorporating wireless printing technologies; the impact of competition from existing and new technologies and companies; the impact of litigation regarding the proposed merger; and the other factors set forth below under the heading Certain Important Factors and in our other periodic reports and other documents that we file from time to time with the Securities and Exchange Commission. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

We own or have rights to trademarks that we use in connection with the sale of our products. TROY®, *e*Check 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.

All references to TROY, we, us or our means TROY Group, Inc. and its subsidiaries, except where it is made clear that the term means only the parent company.

Recent Developments

On May 26, 2004, we announced that TROY had entered into a merger agreement (the Merger) with Dirk, Inc., a company controlled by Patrick Dirk, the founder of TROY, and his family members, pursuant to which Mr. Dirk and his family will acquire the outstanding shares of TROY common stock that they do not already own. TROY expects the Merger to close in August 2004. The Merger is subject to approval by TROY stockholders as required under applicable state law, to completion of financing arrangements necessary to accomplish the Merger, and to certain other closing conditions. On June 17, 2004, we filed a Preliminary Proxy Statement on Schedule 14A and a Schedule 13E-3 in connection with the proposed Merger.

Background

TROY offers a full range of products to its customers in two primary product lines: Secure Payment Systems and Wireless and Connectivity Solutions. Secure Payment Systems include Security Printing Solutions, which enable the secure printing and management of checks, and Financial Service Solutions, which enable secure electronic payments. Wireless and Connectivity Solutions includes hardware and software solutions that enable enterprises to share intelligent devices, such as printers, either wirelessly or using traditional networks.

Our products have been adopted by a wide variety of industries including electronic bill payment utilities, retail and brokerage firms, telecommunications, financial services, insurance, computer hardware, automotive, personnel and others. We market our products in 55 countries and had more than 7,000 active customers in the past year. In the first six months of fiscal 2004, there were no customers who accounted for 10% or more of our 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 May 31,		Six Months Ended May 31,	
	2004	2003	2004	2003
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	60.7	61.2	60.7	59.8
Gross profit	39.3	38.8	39.3	40.2
Selling, general and administrative expenses	31.2	27.5	28.9	27.7
Research and development expenses	7.6	9.2	8.3	9.7
Amortization of intangible assets	0.2		0.2	0.1
Operating income	0.3	2.1	1.9	2.7
Interest income	0.2	0.1	0.2	0.1
Interest expense				
Income before income taxes	0.5	2.2	2.1	2.8
Provision for income taxes	0.2	0.8	0.8	1.1
Net income	0.3%	1.4%	1.3%	1.7%

Three Months Ended May 31, 2004 Compared to Three Months Ended May 31, 2003

Net Sales

Net sales by product segment and related percent changes are as follows:

	Three months ended May 31, (amounts in millions)		
	2004	2003	Percent Change
Net sales:			
Secure Payment Systems	$ 9.9	$ 10.1	(2.1)%
Wireless and Connectivity Solutions	4.5	3.3	37.6%
	$ 14.4	$ 13.4	7.7%

Net sales in the three months ended May 31, 2004 increased by $1.0 million, or 7.7%, to $14.4 million from $13.4 million in the three months ended May 31, 2003. The increase in sales was primarily due to a $1.2 million increase in revenue from our Wireless and Connectivity print

server sales and royalties, partially offset by a $0.2 million decline in sales of MICR printers and supplies and StarACH software, both in our Secure Payment Systems segment. Net sales were not significantly affected by price changes.

Gross Profit

Gross profit, related percent changes and percent of total sales are as follows:

	Three months ended May 31, (amounts in millions)			Percent of Total Sales May 31,	
	2004	**2003**	**Percent Change**	**2004**	**2003**
Gross profit	$ 5.7	$ 5.2	8.9%	39.3%	38.8%

Gross profit increased in the three months ended May 31, 2004 from the three months ended May 31, 2003, primarily due to increased sales of Wireless and Connectivity products, partially offset by decreased sales of Secure Payment Systems products and the impairment charge of $284,000, related to ACH software (see Note 4). Gross profit as a percent of sales will fluctuate based on shifts in the mix of products sold. Gross profit was not significantly affected by price changes.

Selling, General and Administrative Expenses.

Selling, general and administrative expenses, related percent changes and percent of total sales are as follows:

	Three months ended May 31, (amounts in millions)			Percent of Total Sales May 31,	
	2004	**2003**	**Percent Change**	**2004**	**2003**
Selling, general and administrative expenses	$ 4.5	$ 3.7	22.2%	31.2%	27.5%

The increase in selling, general and administrative expenses was primarily due to increases in costs associated with implementation of the new ERP system and professional fees, partially offset by cost savings from reductions in staff and foreign currency translation gains. General and administrative expenses in the second quarter of fiscal 2004 included $0.5 million in professional fees related to audit fees, the currently proposed Merger to take TROY private and the deductible portion of TROY s directors and officer s insurance policy related to the recent litigation regarding the proposed Merger described under Legal Proceedings, and $0.2 million for the implementation of the new ERP system. General and administrative expenses in the second quarter of fiscal 2003 included $0.4 million in professional fees related to the year-end audit and the previously proposed merger to take TROY private.

Research and Development Expenses.

Research and development expenses, related percent changes and percent of total sales are as follows:

	Three months ended May 31, (amounts in millions)			Percent of Total Sales May 31,	
	2004	**2003**	**Percent Change**	**2004**	**2003**
Research and development expenses	$ 1.1	$ 1.2	(10.7)%	7.6%	9.2%

Research and development expenses decreased in the three months ended May 31, 2004 compared to the three months ended May 31, 2003, primarily due to reduced spending for Secure Payment Systems products. The total research and development expenses for the second quarter of fiscal 2004 included $0.6 million for Secure Payment Systems and $0.5 million for Wireless and Connectivity Solutions. 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 increased by $13,000 to $24,000 in the three months ended May 31, 2004 from $11,000 in the three months ended May 31, 2004.

Operating Income. As a result of the above factors, operating income decreased by $235,000 to $43,000 in the three months ended May 31, 2004 from $278,000 in the three months ended May 31, 2003. The operating income as a percentage of net sales was 0.3% in

the three months ended May 31, 2004 compared to 2.1% in the three months ended May 31, 2003.

Interest Income. Interest income was $23,000 in each of the three months ended May 31, 2004 and 2003.

Interest Expense. There was no interest expense in the three months ended May 31, 2004 compared to $6,000 in the three months ended May 31, 2003, due to the payment of the note payable in fiscal 2003.

Income Taxes. Income tax expense was $26,000 in the three months ended May 31, 2004 compared to $105,000 in the three months ended May 31, 2003. Income tax expense as a percentage of pretax income was 39.4% in the three months ended May 31, 2004 compared to 35.6% in the three months ended May 31, 2003. The increase in the effective tax rate in fiscal 2004 compared to fiscal 2003 was primarily due to a higher proportion in fiscal 2004 of foreign source income which has a higher effective tax rate.

Six Months Ended May 31, 2004 Compared to Six Months Ended May 31, 2003

Net Sales

Net Sales by product segment and related percent changes are as follows:

	Six months ended May 31, (amounts in millions)		
	2004	**2003**	**Percent Change**
Net sales:			
Secure Payment Systems	$ 19.4	$ 20.4	(5.1)%
Wireless and Connectivity Solutions	8.6	7.4	17.4%
	$ 28.0	$ 27.8	0.8%

Net sales in the six months ended May 31, 2004 increased by $0.2 million, or 0.8% to $28.0 million from $27.8 million in the six months ended May 31, 2003. The increase in sales was primarily due to a $1.2 million increase in revenue from our Wireless and Connectivity print server sales and royalties, partially offset by a $0.5 million reduced demand for MICR printers and supplies, and a $0.5 million decline in revenue of StarACH software, both in our Secure Payment Systems segment. Net sales were not significantly affected by price changes.

Gross Profit

Gross profit, related percent changes and percent of total sales are as follows:

	Six months ended May 31, (amounts in millions)			Percent of Total Sales May 31,	
	2004	2003	Percent Change	2004	2003
Gross profit	$ 11.0	$ 11.2	(1.5)%	39.3%	40.2%

Gross profit decreased in the six months ended May 31, 2004 from the six months ended May 31, 2003, primarily due to decreased sales of Secure Payment Systems products described above and the impairment charge of $284,000 related to ACH software (see Note 4), partially offset by increased sales of Wireless and Connectivity products. Gross profit as a percent of sales will fluctuate based on shifts in the mix of products sold. Gross profit was not significantly affected by price changes.

Selling, General and Administrative Expenses.

Selling, general and administrative expenses, related percent changes and percent of total sales are as follows:

	Six months ended May 31, (amounts in millions)		Percent Change	Percent of Total Sales May 31,	
	2004	**2003**		**2004**	**2003**
Selling, general and administrative expenses	$ 8.1	$ 7.7	4.9%	28.9%	27.7%

The increase in selling, general and administrative expenses was primarily due to increases in costs associated with the implementation of the new ERP system, partially offset by cost savings from reductions in staff, professional fees and foreign currency translation gains. General and administrative expenses in the six months of fiscal 2004 included $0.8 million in professional fees related to the year-end audit, the currently proposed Merger to take TROY private and the deductible portion of our director and officers insurance policy related to the recent litigation regarding the currently proposed Merger described under Legal Proceedings, and $0.5 million for the implementation of the new ERP system. General and administrative expenses in the six months of fiscal 2003 included $1.1 million in professional fees related to the year-end audit and the previously proposed merger to take TROY private.

Research and Development Expenses.

Research and development expenses, related percent changes and percent of total sales are as follows:

	Six months ended May 31, (amounts in millions)		Percent Change	Percent of Total Sales May 31,	
	2004	**2003**		**2004**	**2003**
Research and development expenses	$ 2.3	$ 2.7	(13.2.)%	8.3%	9.7%

Research and development expenses decreased in the six months ended May 31, 2004 compared to the six months ended May 31, 2003, primarily due to reduced spending for Secure Payment Systems products. The total research and development expenses for the six months of fiscal 2004 included $1.4 million for Secure Payment Systems and $0.9 million for Wireless and Connectivity Solutions. 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 increased by $29,000 to $51,000 in the six months ended May 31, 2004 from $22,000 in the six months ended May 31, 2004.

Operating Income. As a result of the above factors, operating income decreased by $213,000 to $533,000 in the six months ended May 31, 2004 from $746,000 in the six months ended May 31, 2003. The operating income as a percentage of net sales was 1.9% in the six months ended May 31, 2004 compared to 2.7% in the six months ended May 31, 2003.

Interest Income. Interest income increased by $27,000 to $53,000 in the six months ended May 31, 2004 from $26,000 in the six months ended May 31, 2003. This increase was the result of increases in our investment in available-for-sale securities.

Interest Expense. There was no interest expense in the six months ended May 31, 2004 compared to $8,000 in the six months ended May 31, 2003, due to the payment of the note payable in fiscal 2003.

Income Taxes. Income tax expense was $226,000 in the six months ended May 31, 2004 compared to $292,000 in the six months ended May 31, 2003. Income tax expense as a percentage of pretax income was 38.6% in the six months ended May 31, 2004 compared to 38.2% in the six months ended May 31, 2003. The increase in the effective tax rate in fiscal 2004 compared to fiscal

2003 was primarily due to a higher proportion in fiscal 2004 of foreign source income which has a higher effective tax rate.

Liquidity and Capital Resources

Cash flows provided by operating activities were $1.3 million in the six months ended May 31, 2004 compared to $48,000 provided by operating activities in the six months ended May 31, 2003. This increase in cash flows provided was primarily due to delayed payments to vendors in fiscal 2004 partially offset by increased accounts receivable and accrued expenses. The cash provided in fiscal 2003 was primarily due to collections of accounts receivable offset by increases in inventories.

Cash flows used in investing activities were $0.4 million in the six months ended May 31, 2004 compared to $0.2 million in the six months ended May 31, 2003. Cash flows used included capital expenditures of $0.4 million in fiscal 2004 and $0.6 million in fiscal 2003, partially offset by $0.5 million in maturities of available-for-sale securities.

Cash flows used in financing activities were $8,000 in the six months ended May 31, 2004 compared to cash flows used in financing activities of $26,000 in the six months ended May 31, 2003. The decrease in cash used in financing activities primarily resulted from the payment of the note payable in fiscal 2003, partially offset by the purchase of treasury stock in fiscal 2004.

We have a $5.0 million line-of-credit agreement with Comerica Bank. As of May 31, 2004, 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 May 31, 2004) less 0.25% or the bank s LIBOR rate (1.11% at May 31, 2004) 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 May 31, 2004. This line of credit is secured by substantially all of our assets. Our borrowing arrangement requires us to comply with certain financial covenants and other restrictions, including our ability to pay dividends and as of May 31, 2004 we were in compliance with those covenants. As of May 31, 2004, 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 have completed a commitment letter with Comerica Bank in connection with the proposed Merger described above under Recent Developments. This commitment will increase our current line of credit from $5.0 million to $7.0 million and is subject to customary conditions, including the negotiation, execution and delivery of definitive documentation. As of May 31, 2004 we have not executed definitive documents. Execution of the loan documents is anticipated at or around the effective time of the proposed Merger.

We believe that existing cash balances of $2.6 million, our investments of $8.0 million, 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 capital expenditures of approximately $0.5 million. 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 May 31, 2004, TROY had purchased approximately 334,293 shares of common stock in the open market under this stock repurchase program, at an average price of $3.63 per share. In February 2004, TROY retired 331,493 shares purchased under the program. Approximately $2.8 million remains available for future common stock repurchases.

Critical Accounting Policies and Estimates

Application of Critical Accounting Policies

Critical accounting policies are defined as those that are the most important to the accurate portrayal of our financial condition and results of operations. Critical accounting policies require management s subjective judgment and may produce materially different results under different assumptions and conditions. Our operations are affected by numerous factors including continued demand for printed documents, development and market acceptance of wireless products, changes in technologies and new laws and government regulations and policies. We cannot predict what impact, if any, the occurrence of these or other events might have on our operations.

Significant estimates and assumptions made by management are used for, but not limited to, the allowance for doubtful accounts, the reserve for slow moving or obsolete inventories, the carrying value and fair value of long-lived and intangible assets and the realizability of deferred tax assets. The following are our critical accounting policies:

Inventories

We value inventories at the lower of cost or market on a first-in, first-out basis. We use a standard cost system for purposes of determining cost. The standards are adjusted periodically to ensure they approximate actual costs. We include materials, labor and manufacturing overhead in the cost of inventories. We write down the carrying value of our inventory to market value based upon assumptions about future demand and market conditions. We compare current inventory levels on a product basis to our current sales forecasts in order to assess our inventory balance. Our sales forecasts are based on economic conditions and trends (both current and projected), anticipated customer demand, expected future products and other assumptions. Our estimates may differ from actual results due to the quality, quantity and mix of products in inventory, customer preferences and economic conditions and as a result, additional write-downs may be required.

Capitalization of software development costs

Costs incurred in the research, design and development of software for sale to others as a separate product or embedded in a product and sold as part of the product as a whole are charged to expense until technological feasibility is established. Thereafter, software development costs are capitalized until the products are offered for sale, and amortized to product cost of sales on a straight-line basis over the lesser of five years or the estimated economic lives of the respective products, beginning when the products are offered for sale. At each balance sheet date, we compare the unamortized capitalized costs to the net realizable value of that product. The net realizable value is the estimated future gross revenues from that product reduced by the estimated future costs of completing and disposing of that product, including the costs of performing maintenance and customer support required to satisfy our responsibility set forth at the time of sale. For developed software components of a product or process marketed as an integral part of that product or process and not sold separately, we evaluate net realizable value of that component with the total system. We determine net realizable value considering many of the same factors we use in establishing reserves for estimated obsolete or excess inventory.

Long-lived and intangible assets

Depreciation and amortization of our long-lived assets is provided using the straight-line method over their estimated useful lives. Changes in circumstances such as the passage of new laws or changes in regulations, technological advances, changes to our business model or changes in the capital strategy could result in the actual useful lives differing from initial estimates. In those cases where we determine that the useful life of a long-lived asset should be revised, we will depreciate the net book value in excess of the estimated residual value over its revised remaining useful life. Factors such as changes in the planned use of equipment, customer attrition, contractual amendments or mandated regulatory requirements could result in shortened useful lives.

We periodically review the value of our long-lived tangible and our amortizing intangible assets to determine if impairment has occurred by comparing the carrying value of the long-lived assets with the lowest level of identifiable future net undiscounted cash flows expected to result from the use of the assets, including cash flows from disposition. As discussed in Note 14 to the consolidated financial statements in our annual report on Form 10-K for the fiscal year ended November 30, 2003, we recorded an impairment loss on certain long-lived assets during fiscal

year 2001 based on an evaluation of projected operating income, cash flows and business prospects. In addition, we determined other long-lived assets were not impaired. In making these determinations, the assumptions used by management about future cash flows are critical. If these expected cash flows are not realized, future additional impairment losses may be recorded.

Goodwill and Other Intangible Assets

We adopted Statement of Financial Accounting Standards (SFAS) No. 142 *Goodwill and Other Intangible Assets* effective December 1, 2002 and performed our initial transitional impairment test as of that date. The provisions of SFAS No. 142 require that we allocate our goodwill to our 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. Our reporting units represent components of our

operating segments, which are the same as the reportable segments, identified in Note 11. 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. For the year ended November 30, 2003, no impairment loss was recognized. Our annual impairment testing date is the beginning of the fiscal fourth quarter, which is September 1.

Evaluation of long-lived and intangible assets

For long-lived assets, other than goodwill, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires the evaluation for impairment whenever events or changes in circumstances have indicated that an asset may not be recoverable. Long-lived assets evaluated for impairment are grouped with other assets to the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. If the sum of the projected undiscounted cash flows (excluding interest charges) is less than the carrying value of the assets, the assets will be written down to the estimated fair value, and the loss recognized in income from continuing operations in the period in which the determination is made. Management has determined that no impairment of long-lived assets existed at November 30, 2003. In the second quarter of fiscal 2004, management evaluated the long-lived intangible assets for impairment using the methodology described in SFAS No. 144, and determined that the asset representing the capitalized software development costs for ACH software was impaired. As a result, the unamortized amount of $284,000 at April 30, 2004 was written off in the second quarter.

Revenue recognition

We recognize revenue from the sale of our check printing equipment and supplies and print servers to end users, distributors, original equipment manufacturers (OEM) and resellers when the price is fixed and determinable, the product is shipped and the title is transferred to the buyer, with economic substance, net of an allowance for estimated returns, as long as no significant post-delivery obligations exist and collection of the resulting receivable is probable and not contingent on resale of the product. Revenue from equipment maintenance contracts on check printing equipment is recorded as deferred income when billed and is recognized straight-line over the term of the contract. We provide for estimated reserves based upon our historical rates of returns and allowances. Actual returns in any future period are inherently uncertain and thus may differ from our estimates. We accrue for warranty expense at the time revenue is recognized and maintain a warranty accrual for estimated future warranty obligations based upon the relationship between historical and anticipated warranty costs and sales volumes. To the extent we experience increased warranty claim activity or increased costs associated with servicing those claims, our warranty accrual will increase resulting in decreased gross profit.

We recognize revenue from software arrangements of our StarACH software in accordance with Statement of Position (SOP) 97-2, *Software Revenue Recognition* as amended by SOP 98-9, *Modification of SOP 97-2 with Respect to Certain Transactions*. Revenue is recognized when persuasive evidence of an arrangement exists and delivery has occurred, provided the fee is fixed or determinable, collectibility is probable and the arrangement does not require significant customization or modification of the software. For arrangements where the software requires significant customization or modification, we recognize revenue for the software license and consulting services portion of the arrangement using the completed contract method of accounting under SOP 81-1. Contracts are considered complete upon customer acceptance. Maintenance revenue for the StarACH software is recognized ratably over the term of the maintenance contract, typically 12 months.

Revenue from software license agreements with OEMs for print servers whereby we provide ongoing support over the term of the contract is recognized when the licensed software is incorporated into the OEMs products.

Allowance for doubtful accounts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. The amount of the reserve is based on historical experience and our analysis of the accounts receivable outstanding. If the

financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required which would result in an additional expense in the period such determination was made.

Off-balance sheet financings and liabilities

Other than lease commitments and legal contingencies incurred in the normal course of business, we do not have any off-balance sheet financing arrangements or liabilities. We do not have any majority-owned subsidiaries or any interests in, or relationships with, any material special-purpose entities that are not included in the consolidated financial statements, except for a related party lease arrangement.

Comprehensive Income

Management has determined that the functional currency of its foreign subsidiary located in Canada is the local currency, while the functional currency of its foreign subsidiary located in Germany is the U.S. dollar. Assets and liabilities of our foreign subsidiary whose local currency is the functional currency are translated into U.S. dollars at the period-end exchange rates. Income and expenses are translated at the average exchange rate for the period and the resulting translation adjustments are accumulated as a separate component of stockholders equity, which totaled $10,000 and $33,000 at May 31, 2004 and November 30, 2003, respectively. The German subsidiary s financial statements are remeasured at month-end exchange rates for monetary assets and liabilities, and historical exchange rates for non-monetary assets and liabilities and equity. Income and expenses are translated at the average exchange rate for the period, and translation adjustments are included in income for foreign entities whose functional currency is the U.S. dollar. Foreign currency gains and losses from transactions denominated in other than respective local currencies are included in income.

Income taxes

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carry forwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when it is determined to be more likely than not that some portion or all of the deferred tax assets will not be realized. In evaluating the need for a valuation allowance, we consider future taxable income and prudent and feasible tax planning strategies. We have placed substantial reliance on our current projections of future taxable income. We re-assess our projections of taxable income on a quarterly basis. If it is determined that we would not be able to realize all or part of our deferred tax assets in the future, which would include our failure to materially meet our projections of taxable income, an adjustment to the carrying value of the deferred tax assets would be charged to income in the period in which such determination was made and may affect our annual effective income tax rate.

We currently believe the deferred tax assets are more likely than not to be realized based on current expectations of future earnings and available tax planning strategies. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Stock-based compensation

As allowed by Statement of Financial Accounting Standards (SFAS) No. 123, we have elected to continue to account for our 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. Non-employee stock-based transactions are accounted for under the requirements of SFAS No. 123, *Accounting for Stock-Based Compensation*, which requires compensation to be recorded based on the fair value of the securities issued or the services received, whichever is more reliably measurable.

Recent Accounting Pronouncements

In May 2003 FASB issued Statement of Financial Accounting Standards (SFAS) No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, which requires that certain financial instruments previously presented

as equity or temporary equity be presented as liabilities. Such instruments include mandatory redeemable preferred and common stock, and certain options and warrants. SFAS No.150 is effective for financial instruments issued, entered into or modified after May 31, 2003 and is generally effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No.150 is not expected to have a material effect on the Company s financial position or results of its operations.

In 2003, the Financial Accounting Standards Board issued FASB Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51*, as revised. Prior to FIN 46, a company generally included another entity in the company s financial statements only if it controlled the entity through ownership of the majority voting interests. 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 other parties. We have adopted FIN 46 effective with the quarter ending May 31, 2004, and we have determined that we do not have any variable interest entities that are required to be consolidated in our financial statements.

CERTAIN IMPORTANT FACTORS

There are several important factors that could cause our actual results to differ materially from those we anticipate or those reflected in any of our forward-looking statements. These factors, and their impact on the success of our operations and our ability to achieve our goals, include, but are not limited to, those set forth below.

Our business depends on the continued demand for printed documents, including financial documents.

Because we provide solutions that allow enterprises to distribute and print information, our business depends in large part on the continued demand for printed documents. Demand for these solutions could decline if businesses and organizations move toward paperless environments and reduce their dependence on printed documents. Demand for printed financial documents may be reduced as a result of competition from alternate financial document delivery or payment methods, such as electronic banking, electronic commerce, on-line services and other electronic media. We cannot assure you that changes in the business environment or competition from alternate financial document delivery or payment methods will not significantly erode the demand for our products and cause our business to suffer.

Although we have re-engineered certain of our wired connectivity products in a manner that we believe will extend their useful life, there can be no assurance that this will be the case.

Although we have re-engineered certain of our wired connectivity products in a manner that we believe will extend their useful lives, there can be no assurance that this will be the case. Should these changes not extend the useful life of these products, we anticipate that sales of these products will begin to decline, in which case it would be necessary for us to offset this potential decline through increased sales of other products. There is no assurance that we will be successful in achieving increased sales in other products.

The success of our wireless solutions depends on our ability to develop and introduce on a timely basis new products for existing and emerging wireless communications markets and the ability of these products to gain market acceptance.

The development of new wireless networking products is highly complex, and we may experience delays in developing and introducing new products on a timely basis. Due to the intensely competitive nature of the wireless market, any delay in the

commercial availability of new products could materially and adversely affect our business. In addition, if we are unable to develop or obtain access to emerging wireless networking technologies as they become available, or are unable to design, develop and introduce on a timely basis products based on these emerging technologies, our future operating results would be materially and adversely affected. To date, our wireless solutions have not gained market acceptance or had any meaningful commercial impact, and there can be no assurance that our wireless solutions will ever gain market acceptance or have a commercial impact. In addition, there can be no assurance that our wireless products will be based on the wireless standards that are ultimately adopted by the marketplace.

Technology in our industry evolves rapidly, and we must continue to enhance existing products and develop new products or our business will suffer.

Rapid technological advances, obsolescence and large fluctuations in demand and changing industry standards characterize the markets for our current products. Our existing and development-stage products may easily become obsolete if our competitors introduce newer or better technologies or if industry standards change. To be successful, we must continually enhance our existing products and develop and introduce other secure payment system products and wireless and connectivity products. If we fail to adequately anticipate or respond to changing technological developments and standards or customer requirements, or if we are significantly delayed in developing and introducing products, our business will suffer. In addition, our success in this rapidly changing environment depends on our ability to appropriately refocus our management attention and other resources on the emerging technologies and standards that will ultimately gain market acceptance.

We face significant competition that may negatively impact our revenues, gross margins and market share.

We face increased competition in developing and selling secure payment systems as well as our wireless and connectivity solutions. Many of our competitors in this market have substantially greater financial, development, marketing and personnel resources than we have. We cannot assure you that we will be able to compete successfully against our current or future competitors. Increased competition may result in price reductions, lower gross margins and loss of market share.

We maintain strategic supply, OEM and marketing arrangements, and termination of these relationships could adversely affect our revenues and earnings.

We maintain and depend on strategic relationships with a number of companies, including Certegy, HP, IBM, Novell, and Standard Register. These relationships include supply, OEM, marketing and service arrangements which are important to our business. Certain of these relationships are not covered by written agreements and could be terminated at any time. If our relationship with any of these companies were to end, our revenues and earnings could fall. We cannot assure you that we will be able to maintain our strategic relationships with these companies.

We sell a significant portion of our products internationally, which exposes us to currency fluctuations and other risks.

We sell a significant amount of our products to customers outside the United States. International sales accounted for 22.4% of our net sales in the six months ended May 31, 2004 and represented 22.8% of our net sales in the six months ended May 31, 2003. We expect that shipments to international customers will continue to account for a material portion of our net sales. Sales outside the United States involve the following risks, among others:

- foreign governments may impose tariffs, quotas and taxes;

political and economic instability may reduce demand for our products;

restrictions on the export or import of technology may reduce or eliminate our ability to sell in certain markets; and

potentially limited intellectual property protection may cause us to refrain from selling in certain markets.

Because we denominate some of our international sales in U.S. dollars, currency fluctuations could also cause our products to become less affordable or less price-competitive than those of foreign manufacturers. We cannot assure you that these factors will not have a material adverse effect on our international sales. Any adverse impact on our international sales would affect our results of operations and would cause our business to suffer. In addition, currency fluctuations could result in transaction or translation gains or losses which could have an effect on our net sales and profits.

Our quarterly operating results fluctuate as a result of many factors.

Our quarterly operating results fluctuate due to various factors. Some of the factors that influence our quarterly operating results include:

- the mix of products and services sold in the quarter;
- life-cycle stages of the products sold in the quarter;
- the availability and cost of components and materials;
- costs and benefits of new product and service introductions; and
- customer order and shipment timing.

Because of these factors, our quarterly operating results are difficult to predict and are likely to vary in the future. If our revenues or earnings are below expectations in any quarter, our stock price is likely to drop.

Patrick J. Dirk and his family members beneficially own approximately 67% of our common stock and this concentration of ownership allows them to control all matters requiring stockholder approval, could delay or prevent a change in control of TROY and limits the trading volume for our shares.

Patrick J. Dirk and his family members beneficially own approximately 67% of our outstanding common stock. As a result, Mr. Dirk and his family members are able to control all matters requiring stockholder approval, including election of directors, and could delay or prevent a change in control of TROY. In addition, because of the significant percentage of outstanding shares beneficially owned by Mr. Dirk and his family members and the fact that they have not historically traded their shares to any significant extent, the trading volume for shares of our common stock has been, and continues to be, limited. As a result, many stockholders may not be able to sell their shares without a significant impact on the market price of our common stock.

We may not be able to adequately protect or enforce our intellectual property rights or to protect ourselves against infringement claims of others.

We cannot be certain that the steps we have taken to protect our intellectual property rights will be adequate or that third parties will not infringe or misappropriate our proprietary rights. Any such infringement or misappropriation could have a material adverse effect on our future financial results. We also cannot be certain that we have not infringed the proprietary rights of others. Any such infringement could cause third parties to bring claims against us, resulting in significant costs, possible damages and substantial uncertainty.

We depend on our executive officers for our success.

We are significantly dependent upon Patrick J. Dirk, our Chairman and Chief Executive Officer, and our other executive officers. There could be a material adverse effect on our business if we lose the services of Mr. Dirk or any other executive officer.

The impact of the litigation associated with the Merger and the costs associated with the proposed Merger could have a negative financial impact on TROY.

As described under Legal Proceedings, following the announcement of the proposed Merger, several parties filed purported class action complaints in the California Superior Court for Orange County. If these actions are successful in enjoining the Merger, or the Liedtke action is successful in obtaining damages, it could have a material adverse effect on our business, financial position, or results of operation. In addition, the costs associated with defending these actions and completing the Merger could have a negative financial impact on TROY.

Compliance with government regulations may cause us to incur unforeseen expenses.

Our MICR printer and imaging supplies manufacturing operations are subject to a number of federal, state and local laws and regulations. These regulations include laws and regulations promulgated by the Environmental Protection Agency and similar state agencies regarding storing, shipping, disposing, discharging and manufacturing hazardous materials and hazardous and non-hazardous waste. Although we believe that our operations materially comply with all current laws and regulations, we cannot assure you that these regulations will not change. We also cannot assure you that unforeseen environmental incidents will not occur, or that past contamination or non-compliance with environmental laws will not be discovered on our current or former properties. Any of these events could result in significant expense or require changes in our operations, which could materially and adversely affect our business.

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 May 31, 2004) less 0.25% or the bank s LIBOR rate (1.11 % at May 31, 2004) plus 2% and are limited to 80% of eligible accounts receivable and 50% of May 31, 2004, 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. In the first quarter of fiscal 2004, we began the implementation of a new ERP system. Although this new ERP system has not yet been fully implemented, we expect that, once fully implemented, it will improve our overall disclosure controls and procedures.

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. In the first fiscal quarter of 2004, we began the implementation of a new ERP system. Although this new ERP system has not yet been fully implemented, we expect that, once fully implemented, it will improve our internal controls 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 defendants breached their fiduciary duties in connection with the previous merger by attempting to provide the Dirk family with preferential treatment in connection with their efforts to complete a sale of TROY. The complaint sought to enjoin an acquisition of TROY by the Dirk family, as well as attorneys fees. Following termination of the previous merger Agreement, the plaintiff filed a motion for dismissal of the action and award of attorney s fees and expenses of $387,250. TROY filed a motion in support of the plaintiff s motion for dismissal of the action and in opposition to plaintiff s motion for fees. On March 4, 2004 the court issued a ruling granting the motion for dismissal with prejudice, and granting the motion for attorney s fees of $175,000. On April 30, 2004, TROY filed a notice of appeal. TROY has accrued an estimate of expenses to be incurred in connection with this litigation in fiscal 2003 in excess of the deductible amount, which was recorded as an expense in fiscal 2002.

Following the announcement of the proposed Merger, Osmium Partners LLC, Ralph Hamer, Roy Liedtke, and Tilson Growth Fund, LP, respectively, filed purported class action complaints in the California Superior Court for Orange County against TROY and our directors. The Liedtke complaint also names Dirk, Inc. In all four actions, plaintiffs allege that defendants breached their fiduciary duties in connection with the Merger by attempting to provide the Dirk family with preferential treatment in connection with their efforts to complete a sale of TROY. Plaintiffs in all four actions seek declaratory relief, an order enjoining the acquisition, and attorneys fees. The Liedtke complaint also seeks damages. TROY and our directors have not yet been served with the Liedtke and Tilson Growth Fund complaints. Osmium Partners LLC has served discovery requests, but discovery has not commenced in the other actions. No trial date has been set in any of these actions. Management believes that the complaints are without merit, and intends to defend them vigorously. If these actions are successful in enjoining the transaction, or the Liedtke action is successful in obtaining damages, it could have a material adverse effect on our business, financial position, or results of operation. Currently, the amount of such an adverse effect cannot be estimated.

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

Our Annual Meeting of Stockholders was held on March 29, 2004. The following individuals were elected at the Annual Meeting as Directors of TROY to serve until the next annual meeting or until their respective successors are elected and qualified. Shares voted in favor of these Directors and shares withheld were as follows:

Director	Shares For	Shares Withheld
Patrick J. Dirk	9,766,409	479,146
Brian P. Dirk	9,766,409	479,146
Gene A. Bier	10,078,481	166,874
Stephen G. Holmes	10,078,481	166,874
Lambert Gerhart	10,078,481	166,874

ITEM 5 - OTHER INFORMATION

As disclosed on our report on Form 8-K filed March 26, 2004, as amended on Form 8 K/A filed April 7, 2004, on March 22, 2004, the Audit Committee of our Board of Directors approved a change in our independent accountants for the fiscal year ending November 30, 2004. The Board of Directors ratified the Audit Committee s dismissal of McGladrey & Pullen, LLP and the selection of BDO Seidman, LLP as our independent accounts.

As disclosed in our Form 8-K filed June 18, 2004, on June 16, 2004, the Audit Committee of our Board of Directors approved a change in our independent accountants. The Committee selected Corbin & Company LLP to replace BDO Seidman LLP, who resigned effective June 15, 2004.

ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits.

Exhibit Number	Description
2.1	Agreement and Plan of Merger, dated May 26,2004, by and between TROY Group, Inc. and Dirk, Inc. (incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K filed on May 27, 2004).
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 March 3, 2004 we filed a Current Report on Form 8-K dated February 23, 2004 under Item 12, furnishing the transcript of our conference call held on February 23, 2004.

We filed a Current Report on Form 8-K on March 26, 2004, as amended on Form 8-K/A filed on April 7, 2004, under Item 4, regarding the Audit Committee of our Board of Directors approval of a change in our independent accountants for the fiscal year ending November 30, 2004 from McGladrey & Pullen, LLP to BDO Seidman, LLP.

On April 20, 2004 we filed a Current Report on Form 8-K dated April 19, 2004 furnishing under Item 12, our press release announcing our preliminary financial results for the first quarter ended February 29, 2004.

On May 17, 2004 we filed a Current Report on Form 8-K dated May 13, 2004 furnishing under Item 12, our press release announcing our final financial results and the filing of our Form 10-Q for the first quarter ended February 29, 2004.

On May 27, 2004 we filed a Current Report on Form 8-K dated May 26, 2004 under Item 5, regarding a press release announcing that we had entered into an Agreement and Plan of Merger, dated as of May 26, 2004 with Dirk, Inc., a company controlled by Patrick Dirk, the founder of TROY, and his family members.

SIGNATURES

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

TROY GROUP, INC.

July 15, 2004	/s/ Patrick J. Dirk Patrick J. Dirk Chairman, President and Chief Executive Officer
July 15, 2004	/s/ James W. Klingler James W. Klingler Vice President-Finance, Treasurer and Chief Financial Officer

EXHIBIT INDEX

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