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STEPHAN CO
Form 10-Q
November 22, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

For the Quarterly Period Ended: September 30, 2004

Commission File No. 1-4436

THE STEPHAN CO.
(Exact Name of Registrant as Specified in its Charter)

Florida
(State or Other Jurisdiction of
Incorporation or Organization)

59-0676812
(I.R.S. Employer
Identification No.)

1850 West McNab Road, Fort Lauderdale, Florida
(Address of principal executive offices)

33309
(Zip Code)

Registrant's Telephone Number, including Area Code: (954) 971-0600

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 X NO

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

YES NO X

Approximate number of shares of Common Stock outstanding
as of November 8, 2004:

4,389,805

THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13

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OF THE SECURITIES EXCHANGE ACT OF 1934
SEPTEMBER 30, 2004

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THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934
SEPTEMBER 30, 2004

CAUTIONARY STATEMENT FOR PURPOSES OF THE SAFE HARBOR
PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

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This quarterly report contains certain "forward-looking" statements. The Stephan Co. ("Stephan" or the "Company") desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 and is including this statement for the express purpose of availing itself of the protections of such safe harbor with respect to all such forward-looking statements. Such forward-looking statements involve risks, uncertainties and other factors which may cause the actual results, condition (financial or otherwise), performance, trends or achievements of the Company and its subsidiaries to be materially different from any results, condition, performance, trends or achievements projected, anticipated or implied by such forward-looking statements.

Such factors include, but are not limited to, the following: general economic and business conditions; competition; relative success of operating initiatives; development and operating costs; advertising and promotional efforts; brand awareness; the existence or absence of adverse publicity; acceptance of any new product offerings; changing trends in customer tastes; the success of multi-branding; changes in business strategy or development plans; quality of management; costs and expenses incurred by the Company in pursuing strategic alternatives; availability, terms and deployment of capital; Stephan's ability to come into compliance with AMEX's continued listing requirements; regulatory approvals of the pending preliminary proxy filings in connection with the going-private transaction discussed in this report; business abilities and judgment of personnel; availability of qualified personnel; labor and employee benefit costs; availability and cost of raw materials and supplies; changes in or newly-adopted accounting principles; changes in, or failure to comply with, law; changes in product mix and associated gross profit margins; and other factors or events referenced in this Form 10-Q.

The Company does not undertake, subject to applicable law, any obligation to publicly release the results of any revisions which may be made to any forward-looking statements to reflect events or circumstances occurring after the date of such statements or to reflect the occurrence of anticipated or unanticipated events. Therefore, the Company cautions each reader of this report to carefully consider the specific factors and qualifications discussed herein with respect to such forward-looking statements, as such factors and qualifications could affect the ability of the Company to achieve its objectives and may cause actual results to differ materially from those projected, anticipated or implied herein.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

THE STEPHAN CO. AND SUBSIDIARIES UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

September 30, December 31,

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| | | |
|---|---------------|---------------|
| TOTAL CURRENT LIABILITIES | 3,507,167 | 5,085,274 |
| DEFERRED INCOME TAXES, net | 1,402,238 | 1,133,051 |
| LONG-TERM DEBT | 3,515,000 | 4,347,500 |
| | <hr/> | <hr/> |
| TOTAL LIABILITIES | 8,424,405 | 10,565,825 |
| | <hr/> | <hr/> |
| COMMITMENTS AND CONTINGENCIES (NOTE 3) | | |
| STOCKHOLDERS' EQUITY | | |
| Common stock, \$.01 par value | 43,898 | 44,106 |
| Additional paid in capital | 17,556,731 | 18,417,080 |
| Retained earnings | 11,807,510 | 20,387,432 |
| | <hr/> | <hr/> |
| | 29,408,139 | 38,848,618 |
| LESS: | | |
| 125,000 CONTINGENTLY RETURNABLE SHARES | - | (1,351,563) |
| | <hr/> | <hr/> |
| TOTAL STOCKHOLDERS' EQUITY | 29,408,139 | 37,497,055 |
| | <hr/> | <hr/> |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 37,832,544 | \$ 48,062,880 |
| | ===== | ===== |

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

| | Nine Months Ended September 30, | |
|--|---------------------------------|-----------------|
| | 2004 | 2003 |
| | <hr/> | <hr/> |
| NET SALES | \$18,819,564 | \$20,048,643 |
| COST OF GOODS SOLD | 10,977,964 | 11,248,070 |
| GROSS PROFIT | <hr/> 7,841,600 | <hr/> 8,800,573 |
| LESS OPERATING EXPENSES: | | |
| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES | 7,150,841 | 7,285,559 |
| COMPENSATION EXPENSE RESULTING FROM EXERCISE OF STOCK OPTIONS | 415,430 | - |
| | <hr/> | <hr/> |
| OPERATING INCOME | 275,329 | 1,515,014 |
| OTHER INCOME (EXPENSE) | | |

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| | | |
|-------------------------------|------------|--------------|
| Interest income | 145,616 | 178,311 |
| Interest expense | (73,176) | (287,374) |
| Royalty and other income, net | 320,245 | 224,500 |
| | <hr/> | <hr/> |
| INCOME BEFORE INCOME TAXES | 668,014 | 1,630,451 |
| INCOME TAX EXPENSE | 249,195 | 614,027 |
| | <hr/> | <hr/> |
| NET INCOME | \$ 418,819 | \$ 1,016,424 |
| | ===== | ===== |
| BASIC AND DILUTED | | |
| EARNINGS PER SHARE | \$.10 | \$.24 |
| | ===== | ===== |
| WEIGHTED AVERAGE NUMBER | | |
| OF SHARES OUTSTANDING | 4,335,336 | 4,308,832 |
| | ===== | ===== |

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

| | Three Months ended September 30, | |
|--------------------------------|----------------------------------|--------------|
| | 2004 | 2003 |
| | <hr/> | <hr/> |
| NET SALES | \$ 7,305,025 | \$ 6,698,288 |
| COST OF GOODS SOLD | 4,309,542 | 3,916,807 |
| | <hr/> | <hr/> |
| GROSS PROFIT | 2,995,483 | 2,781,481 |
| LESS OPERATING EXPENSES: | | |
| SELLING, GENERAL AND | | |
| ADMINISTRATIVE EXPENSES | 2,564,149 | 2,319,991 |
| COMPENSATION EXPENSE RESULTING | | |
| FROM EXERCISE OF STOCK OPTIONS | 415,430 | - |
| | <hr/> | <hr/> |
| OPERATING INCOME | 15,904 | 461,490 |
| OTHER INCOME (EXPENSE) | | |
| Interest income | 46,805 | 50,981 |
| Interest expense | (23,243) | (73,447) |
| Royalty and other income, net | 2,100 | 199,500 |
| | <hr/> | <hr/> |

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| | | |
|--|-----------|------------|
| INCOME BEFORE INCOME TAXES | 41,566 | 638,524 |
| INCOME TAX EXPENSE | 12,222 | 236,157 |
| | <hr/> | <hr/> |
| NET INCOME | \$ 29,344 | \$ 402,367 |
| | ===== | ===== |
| BASIC AND DILUTED EARNINGS PER SHARE | \$.01 | \$.09 |
| | ===== | ===== |
| WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING | 4,394,385 | 4,308,832 |
| | ===== | ===== |

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Nine Months Ended September 30, | |
|---|------------------------------------|--------------|
| | 2004 | 2003 |
| | <hr/> | <hr/> |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 418,819 | \$ 1,016,424 |
| | <hr/> | <hr/> |
| Adjustments to reconcile net income to cash flows provided by operating activities: | | |
| Depreciation | 118,631 | 245,930 |
| Amortization of intangible assets | 62,640 | 70,092 |
| Writedown of inventories | 100,000 | 20,660 |
| Compensation expense resulting from exercise of stock options | 415,430 | - |
| Deferred income tax provision | 269,187 | 483,109 |
| Provision for doubtful accounts | 61,323 | 75,249 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (954,554) | (764,873) |
| Inventories | 66,828 | (602,480) |
| Income taxes payable/receivable | (13,122) | 11,604 |
| Prepaid expenses and other current assets | 252,186 | (213,041) |
| Other assets | 437,320 | 826,688 |
| Accounts payable and accrued expenses | (232,712) | 588,207 |

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| | | |
|--|-----------|-----------|
| Total adjustments | 583,157 | 741,145 |
| Net cash flows provided by operating activities | 1,001,976 | 1,757,569 |

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Nine Months Ended September 30, | |
|---|------------------------------------|--------------|
| | 2004 | 2003 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property, plant and equipment | (42,541) | (10,213) |
| Net cash flows used in investing activities | (42,541) | (10,213) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Repayments of long-term debt | (2,164,773) | (912,683) |
| Dividends paid | (8,998,741) | (264,635) |
| Changes in certificates of deposit | 824,839 | 832,500 |
| Proceeds from exercise of stock options | 75,576 | - |
| Net cash flows used in financing activities | (10,263,099) | (344,818) |
| (DECREASE)/INCREASE IN CASH AND CASH EQUIVALENTS | (9,303,664) | 1,402,538 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 13,302,159 | 10,785,995 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 3,998,495 | \$12,188,533 |
| Supplemental Disclosures of Cash Flow Information: | | |
| Interest paid | \$ 175,918 | \$ 220,693 |
| Income taxes paid | \$ 69,659 | \$ 88,629 |

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Supplemental Disclosure of Non-Cash Investing and Financing Activities:

On August 20, 2004, 125,000 contingently returnable shares, carried at \$1,351,563, were retired and Common Stock and Additional Paid in Capital was reduced by the same amount in the aggregate.

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2004 AND 2003

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION: In the opinion of management, all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the financial position and results of operations of The Stephan Co. and Subsidiaries (the "Company") are reflected in these unaudited interim condensed consolidated financial statements.

The results of operations for the nine-month period ended September 30, 2004 is not necessarily indicative of the results to be achieved for the year ending December 31, 2004. The December 31, 2003 condensed consolidated balance sheet was derived from the audited consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America ("generally accepted accounting principles"). These interim financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2003, previously filed with the Securities and Exchange Commission.

NATURE OF OPERATIONS: The Company is engaged in the manufacture, sale and distribution of hair and personal care grooming products principally throughout the United States. Statement of Financial Accounting Standards ("SFAS") No. 131, "Disclosures About Segments of an Enterprise and Related Information", requires the reporting of segment information using a "management approach" as it relates to the operating segments of a business. The Company manages its business in three segments: (1) professional hair care products and distribution; (2) retail personal care products; and (3) manufacturing.

USE OF ESTIMATES: The preparation of condensed consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the condensed consolidated balance sheet and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

CASH AND CASH EQUIVALENTS: Cash and cash equivalents include cash, money market investment accounts and short-term municipal bonds having maturities of 90 days or less. The Company maintains cash deposits at certain financial institutions in amounts in excess of the federally insured limit. Cash and cash equivalents (including restricted cash) held

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in interest bearing accounts as of September 30, 2004 and December 31, 2003 were approximately \$7,678,000 and \$12,698,000, respectively.

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THE STEPHAN CO. AND SUBSIDIARIES
 NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 QUARTERS ENDED SEPTEMBER 30, 2004 AND 2003

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

INVENTORIES: Inventories are stated at the lower of cost (determined on a first-in, first-out basis) or market, and are as follows:

| | September 30, 2004 | December 31, 2003 |
|---|-----------------------|----------------------|
| Raw materials | \$ 1,971,670 | \$ 2,007,174 |
| Packaging and components | 2,492,354 | 2,612,798 |
| Work in progress | 292,438 | 257,476 |
| Finished goods | 4,872,608 | 5,338,369 |
| | 9,629,070 | 10,215,817 |
| Less: Amount included in other assets, net | (2,298,636) | (2,718,555) |
| | \$ 7,330,434 | \$ 7,497,262 |

Raw materials principally include surfactants, chemicals and fragrances used in the production process. Packaging materials include cartons, inner sleeves and boxes used in the actual product, as well as outer boxes and cartons used for shipping purposes. Components are the actual bottles or containers (plastic or glass), jars, caps, pumps and similar materials that become part of the finished product. Finished goods include hair dryers, electric clippers, lather machines, scissors and salon furniture.

Included in other assets is inventory not anticipated to be utilized within one year and is comprised primarily of packaging, components and finished goods. The Company reduces the carrying value of slow moving inventory that may ultimately become unusable or obsolete, taking into consideration anticipated carrying costs and estimated costs of disposal. For the nine months ended September 30, 2004, the Company recorded an additional write-down of \$100,000 for slow-moving and obsolete inventory.

BASIC AND DILUTED EARNINGS PER SHARE: Basic and diluted earnings per share are computed by dividing net income by the weighted average number of shares of common stock outstanding. For the nine months ended September 30, 2004 and 2003, the Company had 291,822 and 664,620 outstanding stock options, respectively, a significant portion of which were non-dilutive. The inclusion of dilutive stock options in the calculation of earnings per share did not have any significant impact on the earnings per share amounts for the nine and three months ended September 30, 2004 and 2003, respectively.

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THE STEPHAN CO. AND SUBSIDIARIES
 NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 QUARTERS ENDED SEPTEMBER 30, 2004 AND 2003

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

STOCK-BASED COMPENSATION: The Company adopted the disclosure requirements of SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternate methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation and to require prominent disclosures in both annual and interim financial statements about the methods of accounting for stock-based compensation and the effect of the method used on reported results. As permitted by SFAS No. 148 and 123, the Company continues to apply the accounting provisions of APB No. 25, "Accounting for Stock Issued to Employees," and related interpretations, with regard to the measurement of compensation cost for options granted under the Company's existing plans. No stock-based compensation cost, other than as discussed below, is reflected in net income/(loss) as all options granted under the plans had an exercise price not less than the market value of the underlying common stock on the date of grant. Had expense been recognized using the fair value method described in SFAS No. 123, using the Black-Scholes option-pricing model, the Company would have reported the following results of operations (in thousands, except per share amounts):

| | Nine Months Ended September 30, | | Three Months Ended Sept. 30, | |
|---|------------------------------------|----------|---------------------------------|--------|
| | 2004 | 2003 | 2004 | 2003 |
| Net income, as reported | \$ 419 | \$ 1,016 | \$ 29 | \$ 402 |
| Add: Stock-based compensation included in reported net income, net of related tax effects | 272 | | 272 | |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (371) | (124) | (308) | (41) |
| Pro forma net income/(loss) | \$ 320 | \$ 892 | \$ (7) | \$ 361 |
| | ===== | ===== | ===== | ===== |
| Net income/(loss) per share: | | | | |
| As reported | \$.10 | \$.24 | \$.01 | \$.09 |
| Pro forma | \$.07 | \$.21 | \$ (.00) | \$.08 |

THE STEPHAN CO. AND SUBSIDIARIES
 NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 QUARTERS ENDED SEPTEMBER 30, 2004 AND 2003

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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In the third quarter of 2004, officers of the Company exercised stock options utilizing the "cashless method" of exercise. As such, the Company recorded compensation expense in the amount of \$415,430. The following table summarizes the pro forma results of operations had the officers exercised their options utilizing cash.

For the nine months ended September 30, 2004:

| | Pro Forma | As Reported |
|----------------------------|------------|-------------|
| Operating income | \$ 690,759 | \$275,329 |
| Income before taxes | 1,083,444 | 668,014 |
| Income tax expense | 392,978 | 249,195 |
| Net Income | 690,466 | 418,819 |
| Diluted earnings per share | .16 | .10 |

For the three months ended September 30, 2004:

| | Pro Forma | As Reported |
|----------------------------|------------|-------------|
| Operating income | \$ 431,334 | \$ 15,904 |
| Income before taxes | 456,996 | 41,566 |
| Income tax expense | 156,005 | 12,222 |
| Net Income | 300,991 | 29,344 |
| Diluted earnings per share | .07 | .01 |

NEW FINANCIAL ACCOUNTING STANDARDS: In January 2003, the FASB issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), an interpretation of ARB 51. FIN 46, as revised in December 2003, provides guidance on identifying entities for which control is achieved through means other than through voting rights, variable interest entities ("VIE"), and how to determine when and which business enterprises should consolidate the VIE. In addition, FIN 46 requires both the primary beneficiary and all other enterprises with a significant variable interest in a VIE to make additional disclosures. The consolidation provisions of FIN 46 are effective immediately for variable interests in VIE's created after January 31, 2003. For variable interests in VIE's created before February 1, 2003, the provisions of FIN 46 are effective for the first interim or annual period ending after December 15, 2003. The adoption of FIN 46 did not require a change in accounting treatment since the Company has no investments in any VIE's.

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THE STEPHAN CO. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
QUARTERS ENDED SEPTEMBER 30, 2004 AND 2003

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". This statement establishes standards for the classification and measurement of financial instruments that possess characteristics similar to both liability and equity instruments. SFAS No. 150 also addresses the

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classification of certain financial instruments that include an obligation to issue equity shares. On October 29, 2003, the FASB voted to defer, for an indefinite period, the application of certain provisions of the guidance in SFAS No. 150 until it could consider some of the resulting implementation issues. The Company has adopted certain provisions of SFAS No. 150 which did not have a material impact on the Company's financial condition or results of operations. The Company does not believe the effect of the provisions of SFAS No. 150 that have been deferred to future periods will have a material impact on the Company's financial statements.

NOTE 2: SEGMENT INFORMATION

In accordance with the guidelines established by SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," the Company has identified three reportable operating segments based upon how its management evaluates its business. These segments are Professional Hair Care Products and Distribution ("Professional"), Retail Personal Care Products ("Retail") and "Manufacturing". The Professional segment has a customer base consisting generally of distributors that purchase the Company's hair products and beauty and barber supplies for sale to salons and barbershops. The customer base for the Retail segment consists of mass merchandisers, chain drug stores and supermarkets that sell products to end-users. The Manufacturing segment manufactures products for different subsidiaries of the Company and manufactures private label brands for customers.

The Company conducts operations principally in the United States and sales to international customers are not material to its consolidated net sales. Income Before Income Taxes as shown below reflects an allocation of corporate overhead expenses incurred by the Manufacturing segment. The following tables, in thousands, summarize Net Sales and Income Before Income Taxes (in thousands):

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2004 AND 2003

NOTE 2: SEGMENT INFORMATION (continued)

| | NET SALES | | NET SALES | |
|---------------|-----------------|----------|----------------|----------|
| | Nine Months | | Three Months | |
| | Ended Sept. 30, | | Ended Sept 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| Professional | \$13,897 | \$13,806 | \$ 5,293 | \$ 5,174 |
| Retail | 4,435 | 5,971 | 1,811 | 1,461 |
| Manufacturing | 4,194 | 5,198 | 1,431 | 1,538 |
| Total | 22,526 | 24,975 | 8,535 | 8,173 |

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Image's claim for diminution of the value of the shares held in escrow, in the amount of \$547,800, plus interest, was heard before a special master in late October 2004 and the parties are awaiting the special master's decision. In connection with the diminution claim, the parties have agreed that any recovery recommended by the special master shall be limited to the diminution in the value of 60,000 shares of the Company's stock. The parties have reserved the right to challenge and appeal the recommendation of the special master in the federal court.

In the fourth quarter of 2003, Sorbie Acquisition Co. ("SAC"), a wholly-owned subsidiary of the Company, and Trevor Sorbie International, Plc. ("TSI") commenced arbitration proceedings against each other before the American Arbitration Association in Pittsburgh, Pennsylvania. In TSI's statement of claim, TSI alleged claims for breach of contract, trademark infringement and breach of certain implied covenants. Specifically, TSI alleged that SAC owes past due royalty payments and interest. TSI also alleged that SAC breached the contract between the parties by various acts and omissions which diminished sales of Sorbie products and the value of the Sorbie trademarks. TSI further alleged that SAC has diverted product outside of SAC's territory. TSI sought damages in the amount of the royalties allegedly due, termination of the agreement between the parties and cancellation and forfeiture of SAC's rights in the Sorbie Trademarks. SAC denied the allegations raised in the TSI statement of claim. In SAC's statement of claim against TSI, SAC alleged causes of action for declaratory relief, diversion, breach of contract for failure to support the brand, trademark infringement and injunctive relief. SAC alleged that TSI had been engaged in diversion of TSI product into SAC's territory and that TSI and Trevor Sorbie failed to render assistance to SAC in violation

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2004 AND 2003

NOTE 3: COMMITMENTS AND CONTINGENCIES (continued)

of the parties' agreement. SAC further alleged that TSI and Trevor Sorbie engaged in intentional and detrimental infringement of SAC's exclusive rights in the Sorbie Trademarks and rights to publicity to the name, likeness and image of Trevor Sorbie in SAC's territory. Among other things, SAC alleged that Trevor Sorbie and TSI infringed SAC's rights by appearing at shows in North and South America that promoted Trevor Sorbie and non-SAC products. SAC sought damages for the diversion, infringement and permanent injunctive relief. In addition, SAC further alleged that TSI's claim for royalties is premised upon an incorrect reading of the agreement and is at odds with the method by which the parties have calculated royalties since the inception of the agreement. SAC has also filed a claim against Trevor Sorbie individually, premised upon his involvement in certain of the acts alleged above. On October 25, 2004, the arbitration panel returned an award in favor of TSI with respect to the royalties due, including interest, and in favor of SAC with respect to the infringement of SAC's rights to exclusive publicity in their territory. The panel did not affirm any of the other claims alleged by either of the parties to the action. The Company intends to appeal the decision on certain grounds, including an improper computation of the interest due on additional royalties, however the financial statements for the nine months ended September 30, 2004 reflect a liability of approximately \$720,000 for payment of the award. Also, SAC may incur additional interest from the date of the award. Due to the complexities of the issues involved,

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however, the Company is currently unable to predict the outcome of the appeal, including whether or not the appeal will be heard.

On April 30, 2003, the Board of Directors approved a definitive merger agreement (the "Merger Agreement") pursuant to which the Company would be acquired, in a "going-private" transaction, by Gunhill Enterprises, Inc., a wholly-owned subsidiary of Eastchester Enterprises, Inc. Eastchester Enterprises, Inc. is owned by Frank F. Ferola, Thomas M. D'Ambrosio, John DePinto and Shouky A. Shaheen (all of whom are current Board members) together with their affiliates (the "Acquisition Group"). The Company entered into the Merger Agreement following approval by its Board of Directors based in part upon the unanimous recommendation of the Special Committee comprised of two non-management and disinterested directors of the Company's Board of Directors. The Special Committee had received an opinion from SunTrust Robinson Humphrey that the consideration to be paid pursuant to the Merger Agreement was fair from a financial point of view to the stockholders other than the Acquisition Group.

On November 4, 2003, in connection with the "going-private" transaction, the Company filed a Preliminary Proxy with the Securities and Exchange Commission ("SEC"). The Company is currently in the process of responding to comment letters issued by the SEC as a result of its review

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2004 AND 2003

NOTE 3: COMMITMENTS AND CONTINGENCIES (continued)

of the Preliminary Proxy. When its review is complete, the SEC may require the Company to file an amended Form 10-K to enhance disclosures with respect to the non-current inventory. On August 25, 2004, the Merger Agreement was terminated and the Acquisition Group withdrew its offer to acquire the shares of Stephan common stock not owned by it and informed Stephan that it has decided not to pursue such an acquisition at this time.

Independent legal counsel and investment banking advisors were retained to advise the Special Committee in connection with the transaction. The Company incurred over \$650,000 of expenses through June 30, 2004. For the quarter ended September 30, 2004, the Company accrued an additional \$155,000 for expenses previously incurred by Eastchester Enterprises, in accordance with the terms of the Merger Agreement. In connection with the "going-private" transaction, the Company had previously entered into a Working Capital Management Account ("WCMA") agreement with Merrill Lynch Business Financial Services Inc., providing for the creation of a WCMA line of credit not to exceed \$5,000,000. Borrowings against the line of credit are to be collateralized by the Company's accounts receivable and inventories and the debt will bear a variable interest rate using a 1-month LIBOR rate plus 2.25%. The provisions of the credit line included periodic accounting and reporting requirements, maintenance of certain business and financial ratios as well as restrictions on additional borrowings. The credit line remains unused, and has been extended pending the satisfactory renegotiation of the terms, use of proceeds and amount of the credit line.

As previously reported, because the anticipated "going private" transaction commenced on or about March 2001 but subsequently withdrawn, the Company has not submitted any matters to a vote of its security holders

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since the Company's September 1, 2000 Annual Meeting. In accordance with the rules and regulations of the American Stock Exchange (AMEX), the Company was required to promptly notify its stockholders and AMEX, in writing, indicating the reasons for the failure to have a meeting and to use good faith efforts to ensure that an annual meeting is held as soon as reasonably practicable. The Company included annual meeting materials in its revised proxy statement, filed with the Securities and Exchange Commission on April 13, 2004. In a press release issued by the Company on October 29, 2004, the Company indicated that the next annual meeting of shareholders, previously set for November 10, 2004, has been delayed, and the Company expects to formally notify all shareholders of the definitive date and location of such meeting in the near future. The Company was required by AMEX to file a Corporate Governance Certification by October 31, 2004, but has been unable to do so because the composition of the Board of Directors and the Audit Committee does not meet the enhanced independent requirements of AMEX. On November 19, 2004, the Company received a warning

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NOTE 3: COMMITMENTS AND CONTINGENCIES (continued)

letter from AMEX indicating that the Company was deficient with respect to the above, in addition to not being in compliance with nominating committee requirements and a web-site posting (or other public notice) of a code of conduct and ethics for all directors, officers and employees. The Company has until December 31, 2004 to become compliant and as such, has been engaged in discussions and has been active in the process of re-constituting the Board of Directors to bring it into compliance with current AMEX guidelines, as well as formulating and implementing the appropriate policies and rules. As disclosed in previous filings, the above could subject the Company to civil penalties and/or the delisting of the Company's stock. The Company, based upon past discussions with AMEX and the Company's legal counsel, believes that none of the aforementioned issues are of a material nature and any penalties, if levied, would not be material to the Company's financial position or results of operations. However, if the Company's common stock is delisted from AMEX, it could adversely affect the liquidity and price of the Company's common stock, as well as the Company's ability to raise additional capital.

NOTE 4: SPECIAL DIVIDEND

On August 25, 2004, the Company announced that its Board of Directors approved the payment of a special dividend of \$2.00 per share to all shareholders of record as of September 8, 2004, paid on September 15, 2004 and amounting to \$8,779,606.

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

Nine months ended September 30, 2004 compared to nine months ended September 30, 2003.

RESULTS OF OPERATIONS

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For the nine months ended September 30, 2004, net sales were \$18,820,000, compared to \$20,049,000 achieved in the corresponding nine months of 2003. The overall decrease in sales was principally due to the return to a normal level of military orders for Quinsana Medicated Talc. As indicated in previous filings, the first and second quarters of 2003 were favorably impacted by military orders as troops were deployed to the Middle East conflict. In addition, and for largely the same reason as above, the gross margin for the nine months ended September 30, 2004 declined to 41.7% as compared to 43.9% for the nine months ended September 30, 2003. Sales of the other retail products also declined, but sales of

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

the Professional segment were up slightly, due to strong sales of hard goods offsetting declines in wet goods sales for the nine-month period ended September 30, 2004, when compared to the sales achieved for the corresponding nine-month period ended September 30, 2003. Sales of hotel and spa amenities (included in the Manufacturing and Other segment) also increased in this corresponding period.

Gross profit for the nine months ended September 30, 2004, was \$7,842,000 compared to gross profit of \$8,801,000 achieved for the corresponding nine-month period in 2003. Cost of sales for the nine months ended September 30, 2004 was \$10,978,000, when compared to the cost of sales of \$11,248,000 for the nine months ended September 30, 2003. Gross profit decreased overall for the reasons discussed above.

Selling, general and administrative expenses for the nine months ended September 30, 2004 decreased by \$135,000, to \$7,151,000, when compared to the corresponding 2003 nine-month period total of \$7,286,000. This decrease was due, in large part, to a decrease in expenses in connection with the "going-private" transaction, which was withdrawn on August 24, 2004, as well as a decline in officer payroll costs. The Company continues its efforts to control selling, general and administrative expenses; however, no assurance can be given that it can continue to keep reducing these expenses.

In the third quarter of 2004, officers of the Company exercised stock options utilizing the "cashless method" of exercise. As such, the Company recorded compensation expense in the amount of \$415,430 in conformity with accounting principles generally accepted in the United States of America ("GAAP").

Interest expense for the nine months ended September 30, 2004 was \$73,000, a decrease of approximately \$214,000 from the \$287,000 incurred in the corresponding period of 2003, primarily because the Company's obligation to Colgate-Palmolive was paid in full on April 2, 2004. As indicated in previously filed reports, on April 7, 2004, the Company and Colgate-Palmolive mutually agreed to settle all outstanding claims and issues between them. The net result of this settlement was a reduction of the outstanding obligation by approximately \$418,000. This amount is reflected in other income. Interest income of \$146,000 for the nine months

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ended September 30, 2004 was lower than the \$178,000 earned in the corresponding nine months of 2003. Although the Company had more cash invested in 2004, prior to the payment of the \$2.00 special dividend on September 15, 2004, it received lower interest rates on its investments as

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

overall interest rates remained low.

In addition to the Colgate-Palmolive settlement above, other income was impacted by the settlement of two lawsuits. In one case, the Company received payment of \$150,000 in connection with a customer's failure to perform on a purchase order issued by them to the Company. In July 2004, the Company also settled a portion of the New Image litigation by agreeing to pay New Image \$285,000 for 60,000 of the 125,000 shares of stock held in escrow. All 125,000 shares of stock were retired in the third quarter of 2004. Other income also includes royalty fees received from the licensing of Frances Denney products.

As a result of decrease in income for the nine-month period ended September 30, 2004, the provision for income taxes decreased \$365,000, to \$249,000 from the \$614,000 incurred for the corresponding period in 2003. Net income for the nine-month period ended September 30, 2004 was \$419,000, compared to \$1,016,000 for the nine months ended September 30, 2003. Basic and diluted earnings per share were \$0.10 for the nine months ended September 30, 2004, compared to \$0.24 for the nine months ended September 30, 2003, based on a weighted average number of shares of 4,335,336 and 4,308,832 for the nine months ended September 30, 2004 and 2003, respectively.

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 142 provides that goodwill and other intangible assets with indefinite lives will not be amortized, but will be tested for impairment at least annually. The Company adopted SFAS No. 142 on January 1, 2002. SFAS No. 142 requires that goodwill and other intangible assets be tested for impairment upon adoption and at least annually thereafter. Additionally, SFAS No. 142 dictates testing for impairment between annual tests if an event (as defined) occurs or circumstances change. The Company does not currently believe that any qualifying event or circumstance has occurred. However, one of the Company's reporting units has experienced a decline in sales during 2004. The reporting unit is actively developing various marketing alternatives, which are expected to result in sales and earnings beginning in the latter half of 2005 that the Company believes will eventually more than offset the decline in sales. The timing of such sales and earnings are primarily based upon the negotiation of certain distribution and sales agreements. Should the reporting unit incur a significant delay in developing the expanded marketing alternatives, the Company could be required to recognize an impairment of all or a portion of the reporting unit's goodwill or other intangible assets when the Company performs its annual test for impairment.

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

Three months ended September 30, 2004 compared to three months ended September 30, 2003.

For the three months ended September 30, 2004, net sales were \$7,305,000, compared to \$6,698,000 for the three months ended September 30, 2003, an increase of \$607,000. Sales for both the Professional and Retail segments were up in the third quarter, as were sales of hotel and spa amenities (included in the Manufacturing and Other segment). Gross profit for the three months ended September 30, 2004 was \$2,995,000, compared to gross profit of \$2,781,000 achieved for the corresponding three-month period in 2003. The gross profit margin, however, for the third quarter, decreased from 41.5% in 2003 to 41.0% in 2004. Although the gross profit increased as indicated above, the gross profit margin for this third quarter was adversely impacted by a \$100,000 additional write down of slow-moving and obsolete goods, on the basis of the Company's on-going and continuing evaluation of inventory.

Selling, general and administrative expenses for the three months ended September 30, 2004 increased by \$244,000, to \$2,564,000, from \$2,320,000 when compared to the corresponding three-month period of 2003. This increase is a result of going-private expenses incurred in the third quarter of 2004 and the award by the arbitration panel with respect to the SAC litigation. As discussed above, the exercise of options obligated the Company to record compensation expense in the amount of \$415,430 for the quarter ended September 30, 2004.

Interest income for the three-month period ended September 30, 2004 was \$47,000, a decrease of approximately \$4,000 when compared to \$51,000 earned in the corresponding three-month period of 2003. Interest expense for the three-month period ended September 30, 2004 was \$23,000, a decrease of \$50,000 from the \$73,000 charged in the corresponding three-month period of 2003, due in large part to the retirement of the Colgate debt discussed earlier. Other income was significantly lower in the third quarter of 2004 when compared to the quarter ended September 30, 2003 as a result of a settlement in 2003 with the Dept. of Transportation with respect to the Company's claim in connection with the widening of Interstate Highway 4.

Income tax expense for the three months ended September 30, 2004 was \$12,000 compared to \$236,000, a decrease of \$224,000 for the corresponding period in 2003. Net income of \$29,000 for the three months ended September 30, 2004, was a \$373,000 decrease from net income of \$402,000 achieved in the three months ended September 30, 2003. Basic and diluted earnings per share were \$0.01 for the three months ended September 30, 2004 and 2003,

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

based on a weighted average number of shares 4,394,385 and 4,308,832 for the three months ended September 30, 2004 and 2003, respectively.

LIQUIDITY & CAPITAL RESOURCES

Cash and cash equivalents decreased \$9,304,000 from December 31, 2003, to \$3,998,000 at September 30, 2004. Total cash of \$8,816,000 at September 30, 2004 includes restricted cash of \$4,818,000 pledged as collateral for a bank loan. Accounts receivable were \$2,338,000 at September 30, 2004, a net increase of \$955,000 from the \$1,445,000 at December 31, 2003, due largely as a result of normally strong third quarter sales of Morris Flamingo-Stephan. Overall, inventories decreased \$587,000 from \$10,216,000 at December 31, 2003 to \$9,629,000 at September 30, 2004. Inventory not anticipated to be utilized within one year made up a significant portion of the total decrease in inventory.

Total current assets at September 30, 2003 were \$14,199,000 compared to \$23,029,000 at December 31, 2003. Working capital decreased \$7,251,000 when compared to December 31, 2003, as a result of the payment of a special dividend of \$2.00 per share, paid on September 15, 2004. The Company does not anticipate any significant capital expenditures in the near term, other than the exposure in connection with the Sorbie litigation matter discussed previously, and management believes that there is sufficient cash on hand and working capital to satisfy upcoming requirements.

The Company does not have any off-balance sheet financing or similar arrangements.

NEW FINANCIAL ACCOUNTING STANDARDS

See Note 1 to the Financial Statements included in Part I, Item 1 for a discussion of new financial accounting standards.

DISCUSSION OF CRITICAL ACCOUNTING POLICIES

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results would differ significantly from those estimates if different assumptions were used or unexpected events transpire. Please see Item 7 in the Company's Annual Report on Form 10-K for the year ended December 31, 2003 filed with the Securities and Exchange Commission.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company does not participate in derivative or other financial instruments for which fair value disclosure would be required under SFAS

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No. 107. In addition, the Company does not invest in securities that would require disclosure of market risk, nor does it have floating rate loans or foreign currency exchange rate risks.

ITEM 4. CONTROLS AND PROCEDURES

(a) DISCLOSURE CONTROLS AND PROCEDURES: The Company's management, with the participation of the Company's chief executive officer and chief financial officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's chief executive officer and chief financial officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

(b) CHANGES IN INTERNAL CONTROLS: There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d - 15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The disclosure of the Company's legal proceedings set forth in Note 3 to the Financial Statements included in Part I, Item 1 are incorporated herein by reference.

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Other than the above, there has been no material change in the status of any other pending litigation since our last periodic report.

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

Repurchase of Equity Securities: In connection with a settlement agreement entered into in July 2004, with New Image Laboratories, Inc., as set forth in Note 3 to the Financial Statements included in Part I, Item 1, the Company repurchased 60,000 shares (at \$4.75 per share) of the Company's common stock for an aggregate amount of \$285,000 in August 2004.

The Company did not repurchase any shares of its common stock pursuant to publicly announced plans or programs and the Company does not presently have any such plans or programs

ITEM 5. OTHER MATTERS

The Company was required by the American Stock Exchange ("AMEX") to file a Corporate Governance Certification by October 31, 2004, but has been unable to do so because the composition of the Board of Directors and the Audit Committee does not meet the enhanced independent requirements of AMEX. On November 19, 2004, the Company received a warning letter from AMEX indicating that the Company was deficient with respect to the above, in addition to not being in compliance with nominating committee requirements and a web-site posting (or other public notice) of a code of conduct and ethics for all directors, officers and employees. The Company has until December 31, 2004 to become compliant and as such, has been engaged in discussions and has been active in the process of re-constituting the Board of Directors to bring it into compliance with current AMEX guidelines, as well as formulating and implementing the appropriate policies and rules.

ITEM 6. EXHIBITS

The exhibits required by this item are listed on the Exhibit Index attached hereto.

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SIGNATURES

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

THE STEPHAN CO.

/s/ Frank F. Ferola

Frank F. Ferola

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President and Chief Executive Officer
November 22, 2004

/s/ David A. Spiegel

David A. Spiegel
Chief Financial Officer
November 22, 2004

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EXHIBIT INDEX

| Exhibit Number | Exhibit Title |
|-------------------|--|
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer. |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer. |
| 32.1 | Certification by the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification by the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |