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STEPHAN CO
Form 10-Q
November 14, 2003

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, 2003

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 ☒ NO ☐

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

YES ☐ NO ☒

Approximate number of shares of Common Stock outstanding
as of November 7, 2003:

4,410,577

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

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OF THE SECURITIES EXCHANGE ACT OF 1934
SEPTEMBER 30, 2003

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THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934
SEPTEMBER 30, 2003

CAUTIONARY STATEMENT FOR PURPOSES OF THE SAFE HARBOR

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PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This quarterly report contains certain "forward-looking" statements. The Stephan Co. (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; 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, applicable 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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	2003	2002
CURRENT ASSETS		
Cash and cash equivalents	\$12,188,533	\$ 10,785,995
Accounts receivable, net	2,140,923	1,451,299
Inventories	8,205,584	7,623,764
Income taxes receivable	53,774	65,378
Prepaid expenses and other current assets	570,870	357,829
TOTAL CURRENT ASSETS	23,159,684	20,284,265
CERTIFICATES OF DEPOSIT	5,920,000	6,752,500
PROPERTY, PLANT AND EQUIPMENT, net	1,768,748	2,004,465
GOODWILL, net	5,857,980	5,857,980
TRADEMARKS, net	8,664,809	8,664,809
DEFERRED ACQUISITION COSTS, net	321,273	391,365
OTHER ASSETS, net	2,872,969	3,699,657
TOTAL ASSETS	\$ 48,565,463 =====	\$ 47,655,041 =====

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

LIABILITIES AND STOCKHOLDERS' EQUITY

	September 30, 2003	December 31, 2002
CURRENT LIABILITIES		
Accounts payable and accrued expenses	\$ 2,606,443	\$ 2,018,236
Current portion of long-term debt	2,353,907	1,496,147
TOTAL CURRENT LIABILITIES	4,960,350	3,514,383

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DEFERRED INCOME TAXES, net	1,138,882	655,773
LONG-TERM DEBT	4,625,000	6,395,443
TOTAL LIABILITIES	10,724,232	10,565,599

COMMITMENTS AND CONTINGENCIES (NOTE 3)

STOCKHOLDERS' EQUITY

Common stock, \$.01 par value	44,106	44,106
Additional paid in capital	18,417,080	18,417,080
Retained earnings	20,731,608	19,979,819
	39,192,794	38,441,005
LESS:		
125,000 CONTINGENTLY RETURNABLE SHARES	(1,351,563)	(1,351,563)
TOTAL STOCKHOLDERS' EQUITY	37,841,231	37,089,442
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 48,565,463	\$ 47,655,041
	=====	=====

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,	
	2003	2002 (As Restated, See Note 1)
NET SALES	\$20,048,643	\$19,880,311
COST OF GOODS SOLD	11,248,070	11,579,796
GROSS PROFIT	8,800,573	8,300,515
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	7,285,559	6,741,986
OPERATING INCOME	1,515,014	1,558,529
OTHER INCOME (EXPENSE)		
Interest income	178,311	292,773
Interest expense	(287,374)	(374,232)
Royalty and other income	224,500	116,250
INCOME BEFORE INCOME TAXES AND CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	1,630,451	1,593,320

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INCOME TAX EXPENSE	614,027	621,405
INCOME BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	1,016,424	971,915
CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE, NET OF TAX BENEFIT OF \$1,662,911	-	(6,761,576)
NET INCOME/(LOSS)	\$ 1,016,424	\$ (5,789,661)
BASIC AND DILUTED EARNINGS/(LOSS) PER SHARE:		
INCOME BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	\$.24	\$.23
CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE	-	(1.58)
BASIC AND DILUTED EARNINGS/(LOSS) PER SHARE:	\$.24	\$ (1.35)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	4,308,832	4,285,577

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,	
	2003	2002 (As Restated, See Note 1)
NET SALES	\$ 6,698,288	\$ 6,721,107
COST OF GOODS SOLD	3,916,807	4,181,708
GROSS PROFIT	2,781,481	2,539,399
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	2,319,991	2,128,405
OPERATING INCOME	461,490	410,994
OTHER INCOME (EXPENSE)		
Interest income	50,981	106,182
Interest expense	(73,447)	(104,844)
Royalty and other income	199,500	45,000

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INCOME BEFORE INCOME TAXES	638,524	457,332
INCOME TAX EXPENSE	236,157	217,233
NET INCOME	\$ 402,367	\$ 240,099
	=====	=====
BASIC AND DILUTED EARNINGS PER SHARE	\$.09	\$.06
	=====	=====
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	4,308,832	4,285,577
	=====	=====

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,	
	2003	2002 (As Restated, See Note 1)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income/(loss)	\$ 1,016,424	\$ (5,789,661)
Adjustments to reconcile net income/(loss) to cash flows provided by operating activities:		
Depreciation	245,930	249,353
Amortization of intangible assets	70,092	70,098
Deferred income tax provision	483,109	(1,393,698)
Provision for doubtful accounts	75,249	63,925
Impairment loss on goodwill	-	8,424,487
Changes in operating assets and liabilities:		
Certificate of deposit	832,500	555,000
Accounts receivable	(764,873)	(393,315)
Inventories	(581,820)	(163)
Income taxes receivable	11,604	279,308
Prepaid expenses and other current assets	(213,041)	(369,913)

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Other assets	826,688	1,060,540
Accounts payable and accrued expenses	588,207	(248,460)
Total adjustments	1,573,645	8,297,162
Net cash flows provided by operating activities	2,590,069	2,507,501

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

	Nine Months Ended September 30,	
	2003	2002
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property, plant and equipment	(10,213)	(23,415)
Net cash flows used in investing activities	(10,213)	(23,415)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayments of long-term debt	(912,683)	(1,155,527)
Dividends paid	(264,635)	(264,635)
Net cash flows used in financing activities	(1,177,318)	(1,420,162)
INCREASE IN CASH AND CASH EQUIVALENTS	1,402,538	1,063,924
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	10,785,995	8,409,142
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$12,188,533 =====	\$ 9,473,066 =====
Supplemental Disclosures of Cash Flow Information:		
Interest paid	\$ 220,693 =====	\$ 402,748 =====

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Income taxes paid	\$ 88,629	\$ 173,699
	=====	=====

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, 2003 AND 2002

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 consolidated financial statements.

Information presented for the quarter and nine-month periods ended September 30, 2002 have been restated to reflect the adoption of a change in accounting principle, in accordance with Statement of Financial Accounting Standards ("SFAS") No. 142 (See NEW FINANCIAL ACCOUNTING STANDARDS elsewhere in Note 1).

The results of operations for the nine-month period ended September 30, 2003 is not necessarily indicative of the results to be achieved for the year ending December 31, 2003. The December 31, 2002 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, 2002, previously filed with the Securities and Exchange Commission.

Certain amounts previously reported in the 2002 financial statements and notes thereto were reclassified to conform to the 2003 presentation.

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. 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 financial statements and the reported amounts of revenues and

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expenses during the reporting period. Actual results could differ from those estimates and assumptions.

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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 held in interest bearing accounts as of September 30, 2003 and December 31, 2002 were approximately \$11,368,000 and \$10,121,000, respectively.

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, 2003	December 31, 2002
Raw materials	\$ 2,068,395	\$ 2,162,273
Packaging and components	2,989,272	3,100,917
Work in progress	355,118	328,976
Finished goods	5,509,163	5,579,290
	10,921,948	11,171,456
Less: Amount included in other assets, net	(2,716,364)	(3,547,692)
	\$ 8,205,584	\$ 7,623,764
	=====	=====

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 are raw materials, packaging and components inventory not anticipated to be utilized in less than one year.

BASIC AND DILUTED EARNINGS PER SHARE: Basic and diluted earnings per share are computed by dividing net income/(loss) by the weighted average number of shares of common stock outstanding. The weighted average number of shares outstanding for the nine and three-month periods ended September 30, 2003 and 2002, were 4,308,832 and 4,285,577, respectively. For the nine months ended September 30, 2003 and 2002, the Company had 664,620 and 693,648 outstanding stock options, respectively, a significant portion of which were anti-dilutive. The inclusion of dilutive stock options in the calculation of earnings per share did not have any

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

significant impact on the earnings per share amounts for the nine and three months ended September 30, 2003 and 2002, respectively.

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 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,	
	2003	2002	2003	2002
Net income/(loss), as reported	\$1,016	\$ (5,790)	\$ 402	\$ 240
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	124	234	41	78
Pro forma net income/(loss)	\$ 892	\$ (6,024)	\$ 361	\$ 162
Net income/(loss) per share:				
As reported	\$.24	\$ (1.35)	\$.09	\$.06
Pro forma	\$.21	\$ (1.41)	\$.08	\$.04

THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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NEW FINANCIAL ACCOUNTING STANDARDS: In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." These standards made changes to the accounting for business combinations, goodwill and 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 be tested for impairment at the reporting unit level upon adoption and at least annually thereafter. The initial step requires that the Company determine the fair value of each reporting unit and compare it to the carrying value, including goodwill, of the reporting unit. If the fair value exceeds the carrying value, no impairment loss would be recognized. However, if the carrying value of the reporting unit exceeds its fair value, the goodwill of the reporting unit may be impaired. The amount, if any, of the impairment would then be measured in the second step. As a result of the impairment review mandated by SFAS No. 142, the Company determined that the carrying value of certain goodwill and other intangible assets with indefinite lives was impaired, decreasing the carrying value of goodwill and other such intangible assets by approximately \$8,424,000 (\$6,762,000, net of taxes), effective in the quarter ended March 31, 2002. The above impairment charge impacted several different subsidiaries and divisions. Based upon information available to the Company, in general, goodwill and trademark valuations were performed using present value techniques involving estimates of future cash flows.

Amortization expense for deferred acquisition costs and other intangible assets subject to amortization, recorded as of December 31, 2002, is anticipated to be as follows: 2003: \$93,000; 2004: \$84,000; 2005: \$82,000; 2006: \$66,000; 2007: \$66,000.

In November 2002, the FASB issued FASB Interpretation ("FIN") No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," an interpretation of SFAS Nos. 5, 57 and 107 and rescission of FASB Interpretation No. 34. The interpretation requires certain disclosures to be made by a guarantor about its obligations under certain guarantees that it has issued. The Company does not have existing circumstances that would make this Interpretation relevant.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," clarifying certain implementation guidelines and incorporating clarifications of the definition of a derivative. The Company does not have existing circumstances that would make this Statement relevant.

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2003 AND 2002

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 standard establishes guidelines to classify a financial instrument more appropriately as a liability (or an asset in certain circumstances), rather than as equity. This statement is part of the FASB's liabilities

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and equities project relative to financial instruments. The Company does not have existing circumstances that would make this Statement relevant.

In January 2003, the FASB issued FIN No. 46, "Consolidation of Variable Interest Entities." FIN No. 46 provides accounting guidance for consolidating of off-balance sheet entities with certain characteristics (variable interest entities). The consolidation requirements apply to variable interest entities created after January 31, 2003 and to variable interest entities in which the Company maintains an interest after December 15, 2003. The Company does not have existing circumstances that would make this Statement relevant.

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 and Cumulative Effect of Change in Accounting Principle 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 and Cumulative Effect of Change in Accounting Principle by reportable segment (in thousands):

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 2: SEGMENT INFORMATION (continued)

	NET SALES		NET SALES	
	Nine Months		Three Months	
	Ended Sept. 30,		Ended Sept 30,	
	2003	2002	2003	2002
Professional	\$13,806	\$13,926	\$ 5,174	\$ 5,081
Retail	5,971	5,626	1,461	1,562
Manufacturing	5,198	5,401	1,538	1,543
Total	24,975	24,953	8,173	8,186

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Intercompany				
Manufacturing	(4,926)	(5,073)	(1,475)	(1,465)
Consolidated	<u>\$20,049</u>	<u>\$19,880</u>	<u>\$ 6,698</u>	<u>\$ 6,721</u>
	=====	=====	=====	=====

	INCOME/(LOSS) BEFORE INCOME TAXES AND CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE		INCOME/(LOSS) BEFORE INCOME TAXES	
	Nine Months Ended Sept. 30, 2003 2002		Three Months Ended Sept. 30, 2003 2002	
Professional	\$ 1,162	\$ 865	\$ 412	\$ 389
Retail	604	873	179	155
Manufacturing	(136)	(145)	48	(87)
Consolidated	<u>\$ 1,630</u>	<u>\$ 1,593</u>	<u>\$ 639</u>	<u>\$ 457</u>
	=====	=====	=====	=====

NOTE 3: COMMITMENTS AND CONTINGENCIES

In addition to the matters set forth below, the Company is involved in other litigation matters arising in the ordinary course of business. It is the opinion of management that none of such matters, at September 30, 2003, would likely, if adversely determined, have a material adverse effect on the Company's financial position, results of operations or cash flows.

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 3: COMMITMENTS AND CONTINGENCIES (continued)

The United States Court of Appeals for the Ninth Circuit entered an order on April 29, 2002 that, among other things, reversed the judgment of the United States District Court granting summary judgment in favor of New Image Laboratories, Inc. ("New Image") against the Company on New Image's contract claim for a price adjustment and on New Image's claim of breach of the implied covenant of good faith and fair dealing. In addition, the Ninth Circuit's opinion affirmed the lower court's ruling that on the present record New Image is not entitled to (i) damages equal to the diminution in the value of the Company's common stock price between the scheduled and actual disbursement dates or (ii) any attorney's fees. As a consequence of the Ninth Circuit's decision, the judgment granting New Image all 125,000 shares of the Company's common stock being held in escrow has been reversed and the case has been remanded back to the United States District Court for further proceedings. On May 28, 2002, New Image filed a Motion for Rehearing with the Ninth Circuit Court of Appeals and on June 26, 2002, the Court denied the petition for rehearing. A pretrial hearing scheduled in connection with the remaining claims of the parties has been postponed and settlement negotiations continue.

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On November 1, 2001, a private label customer filed a lawsuit against the Company alleging causes of action for breach of contract, declaratory judgment, and trademark infringement. The Company denied the allegations and has counter-sued the customer. The counterclaim seeks unspecified compensatory damages, interest, attorneys fees, costs and other relief on the breach of contract and anticipatory breach claims and, in excess of \$400,000 on an account stated claim. At this time, the Company is unable to predict the outcome of this matter.

In November 2002, a stockholder filed a lawsuit in the Circuit Court for the 17th Circuit of Florida in and for Broward County, styled Joan Rosoff ("Plaintiff") v. Frank F. Ferola, Shouky Shaheen, Leonard A. Genovese, Curtis Carlson, John DePinto, Thomas M. D'Ambrosio and The Stephan Co., Case Number 0222253, against the Company alleging certain breaches of fiduciary duties and responsibilities. The Company vigorously defended the claim and on July 15, 2003, the Plaintiff filed a notice of voluntary dismissal without prejudice.

Other than the above, there has been no material change in the status of any other pending litigation since the Company's last filing of its Annual Report on Form 10-K for the year ended December 31, 2002 with the Securities and Exchange Commission.

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 3: COMMITMENTS AND CONTINGENCIES (continued)

As previously reported, on April 16, 2002, the Company announced that the previously-formed Special Committee (consisting of two outside directors) had accepted a bid by a management-led group to purchase all of the shares of common stock of the Company not already owned by such group. The acquisition group's initial bid was to purchase all of the Company's common stock at \$4 per share in cash, which offer was later revised to \$4.50 per share with \$3.25 to be paid in cash, and \$1.25 to be paid by a 42-month, unsecured debt instrument providing for interest at an annual rate of 4 1/2%. To fund its payment obligations thereunder, the management group has committed to use its best efforts to establish a separate payment fund in an amount equal to 50% of the aggregate principal and interest amount due under the debt instrument. On September 19, 2003, at no cost to shareholders, the Company 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 will 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 include periodic accounting and reporting requirements, maintenance of certain business and financial ratios as well as restrictions on additional borrowings.

In late 2001 and during 2002 the Special Committee received from Curtis Rudolph, a shareholder of the Company, an indication of his interest

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in acquiring the common stock of the Company; however, no offer was forthcoming. In November 2002, Mr. Rudolph initiated an action in Florida state court (Broward County, Florida) seeking to obtain a review of certain "books and records" of the Company to which he claimed he was entitled as a shareholder of the Company. The Company had previously denied him access to those books and records due to his unwillingness to sign a non-disclosure agreement relating to the Company's non-public information in the standard form required of other potential bidders for the Company. In January 2003, pursuant to a settlement agreement with the Company, Mr. Rudolph agreed to execute the non-disclosure agreement. By letter dated January 13, 2003, Mr. Rudolph reiterated his interest in making a proposal to acquire the Company. On or about February 14, 2003, Mr. Rudolph submitted an unexecuted proposal to acquire substantially all of the assets and assume certain liabilities of the Company. The Special Committee rejected this proposal as it was unexecuted, contained certain unacceptable terms, was subject to unacceptable conditions, and was structured as an asset purchase rather than a stock purchase. In particular, the asset purchase structure presented substantial negative tax consequences to the Company and its shareholders and was deemed impractical. Under the circumstances, the Special Committee determined Mr. Rudolph's proposal to not be in the best interests of the Company's shareholders. The Board of

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 3: COMMITMENTS AND CONTINGENCIES (continued)

Directors, through its Special Committee, attempted to negotiate with Mr. Rudolph, but no further offer has been forthcoming.

On April 30, 2003, the Board of Directors approved a definitive merger agreement (the "Merger Agreement") pursuant to which the Company will be acquired 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 Agreement following approval by its Board of Directors based in part upon the unanimous recommendation of the Special Committee comprised of non-management and disinterested directors of the Company's Board of Directors. The Special Committee has received an opinion from SunTrust Robinson Humphrey that the merger consideration to be paid pursuant to the Merger Agreement is fair from a financial point of view to the stockholders other than the Acquisition Group. On October 24, 2003, the Company executed an Amended and Restated Merger Agreement extending certain dates and making minor changes to the original Merger Agreement.

If prior to the closing of the transactions contemplated by the Merger Agreement, as amended, the Special Committee concludes that its failure to provide information to, or engage in discussions with, third parties who are interested in acquiring the Company, would be inconsistent with its fiduciary duties to Stephan's stockholders, then the Special Committee may thereafter continue to provide information to, and engage in discussions and negotiations with, such interested parties. Under specified circumstances, Stephan has the right to terminate the Agreement and to enter into an agreement with a party proposing a competing transaction which is deemed superior to the transaction proposed by the Acquisition Group.

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Completion of the merger is subject to customary closing conditions, including stockholder approval, and the Agreement does include a financing contingency. The Special Committee has agreed to extend the closing date of the transaction to no later than March 15, 2004. As discussed above, the Company has secured a \$5,000,000 line of credit with Merrill Lynch, a portion of which may be used in the "going-private" transaction. Company stockholder approval will be solicited by means of a proxy statement, which will be mailed by the Company to stockholders upon completion of the required Securities and Exchange Commission filing and review process.

Independent legal counsel and investment banking advisors have been retained to advise the Special Committee in connection with the transaction. After incurring approximately \$450,000 of expenses through September 30, 2003, it is estimated that the remaining costs associated with this process will be in excess of \$250,000.

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THE STEPHAN CO. AND SUBSIDIARIES NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS QUARTERS ENDED SEPTEMBER 30, 2003 AND 2002

NOTE 3: COMMITMENTS AND CONTINGENCIES (continued)

In accordance with the terms of employment contracts with certain key officers, it is possible that management bonuses might be due to these individuals on the basis of projected net income for the year ended December 31, 2003. It is estimated that these bonuses could be in excess of \$2,500,000 and would be an additional expense for the year ended December 31, 2003.

As previously reported, due to the length of time for the going private transaction to be consummated, the Company has not submitted any matters to a vote of its security holders 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. In addition, the current composition of the Board of Directors and the current composition of the Audit Committee are in violation of AMEX rules. Due to the pending going private transaction (which will result in the Company no longer being an SEC-reporting company and its common stock will no longer be subject to listing on AMEX or any other public market), the Company has requested that AMEX grant it a waiver with respect to compliance with these AMEX rules. The continuing non-compliance with these AMEX rules could subject the Company to civil penalties, in addition to the possibility that the stock of the Company could be removed from listing.

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

RESULTS OF OPERATIONS

For the nine months ended September 30, 2003, net sales were \$20,049,000, compared to \$19,880,000 achieved in the corresponding nine months of 2002. The increase in net sales was principally due to increased sales of Quinsana Medicated Talc to the military as a result of the

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conflict in the Middle East, largely offset by a decline in net sales of the Professional and Manufacturing segments. As indicated in previous filings, we anticipated that this high level of talc sales would decline as the number of troops in the region stabilized and the war with Iraq ended. Talc sales to the military through September 2003 was over \$1,500,000, or over 7% of total sales for the nine months ended September 30, 2003. Since April 2003, sales of Quinsana Medicated Talc have returned to normal levels.

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THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934
SEPTEMBER 30, 2003 AND 2002

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

Gross profit for the nine months ended September 30, 2003, was 8,801,000 compared to gross profit of \$8,301,000 achieved for the corresponding nine-month period in 2002. Cost of sales for the nine months ended September 30, 2003 was \$11,248,000, when compared to the cost of sales of \$11,580,000 for the nine months ended September 30, 2002. Gross profit increased overall principally due to a higher sales volume and a change in the sales mix, with an overall increase in Retail sales as previously indicated. As a result, there was an increase in the gross profit margin, to 43.9% for the nine months ended September 30, 2003 from 41.8% for the nine months ended September 30, 2002.

Selling, general and administrative expenses for the nine months ended September 30, 2003 increased by \$544,000, to \$7,286,000, when compared to the corresponding 2002 nine-month period total of \$6,742,000. This increase was due, in large part, to expenses incurred in connection with the "going-private" transaction, and included a payment to SunTrust Robinson Humphrey for its fairness opinion. The Company continues its efforts to control selling, general and administrative expenses even with increased spending as a result of the Company's decision to evaluate strategic alternatives to enhance shareholder value, as discussed in Note 3 of the unaudited condensed consolidated financial statements; however, no assurance can be given that it can continue to keep reducing these expenses.

Interest expense for the nine months ended September 30, 2003 was \$287,000, a decrease of approximately \$87,000 from the \$374,000 incurred in the corresponding period of 2002, as a result of lower outstanding indebtedness and lower interest rates. Interest income of \$178,000 for the nine months ended September 30, 2003 was lower than the \$293,000 earned in the corresponding nine months of 2002. Although the Company had more cash invested in 2003, it received lower interest rates on its investments as overall interest rates remained lower than the previous year. Other income is comprised of royalty fees received from the licensing of Frances Denney products and, in accordance with the terms of a negotiated settlement with the Department of Transportation ("DOT") relative to the Tampa facility, a one-time payment to the Company in the net amount of \$187,000.

Income before the cumulative effect of a change in accounting principle for the nine months ended September 30, 2003 was \$1,016,000, compared to \$972,000 achieved for the nine months ended September 30, 2002.

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Basic and diluted earnings per share, before the cumulative effect of a change in accounting principle, were \$0.24 for the nine months ended September 30, 2003, compared to \$0.23 for the nine months ended September

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THE STEPHAN CO. AND SUBSIDIARIES QUARTERLY REPORT PURSUANT TO SECTION 13 OF THE SECURITIES EXCHANGE ACT OF 1934 SEPTEMBER 30, 2003 AND 2002

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

30, 2002, based on a weighted average number of shares of 4,308,832 and 4,285,577 for the nine months ended September 30, 2003 and 2002, respectively. The overall provision for income taxes decreased slightly on income that was \$37,000 higher than the corresponding nine-month period in 2002 as a result of the impact of state income taxes. Net income for the nine-month period ended September 30, 2003 was \$1,016,000 as compared to a net loss of \$5,790,000 for the nine-month period ended September 30, 2002.

For the three months ended September 30, 2003, net sales were \$6,698,000, compared to \$6,721,000 for the three months ended September 30, 2002, a decline of \$23,000. Sales of all segments were relatively flat, with a decline in the Retail segment offset by an increase in Professional sales. Gross profit for the three months ended September 30, 2003 was \$2,781,000, compared to gross profit of \$2,539,000 achieved for the corresponding three-month period in 2002 due to the favorable sales mix. The gross profit margin increased to 41.5% for the three months ended September 30, 2003, from 37.8% for the corresponding period in 2002 as discussed above.

Selling, general and administrative expenses for the three months ended September 30, 2003 increased by \$192,000, from \$2,128,000 to \$2,320,000, when compared to the corresponding three-month period of 2002, largely as a result of the going-private expenses discussed previously and increases in insurance and other taxes.

Interest income for the three-month period ended September 30, 2003 was \$51,000, a decrease of approximately \$55,000 when compared to \$106,000 earned in the corresponding three-month period of 2002, as a direct result of significantly lower interest rates. For the same reason, interest expense for the three-month period ended September 30, 2003 was \$73,000, a decrease of \$32,000 from the \$105,000 paid in the corresponding three-month period of 2002. Other income is comprised of a \$12,500 quarterly royalty fee from the licensing of Frances Denney products and the payment from the DOT as discussed above.

Income tax expense for the three months ended September 30, 2003 was \$236,000 compared to \$217,000, an increase of \$19,000 for the corresponding period in 2002. Net income of \$402,000 for the three months ended September 30, 2003, was a \$162,000 increase from net income of \$240,000 achieved in the three months ended September 30, 2002, largely as a result of a \$187,000 settlement with the DOT. Basic and diluted earnings per share were \$0.09 for the three months ended September 30, 2003 and \$0.06 for the three months ended September 30, 2002.

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THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934
SEPTEMBER 30, 2003 AND 2002

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

LIQUIDITY & CAPITAL RESOURCES

Cash and cash equivalents increased \$1,403,000 from December 31, 2002, to \$12,189,000 at September 30, 2003. Total cash of \$18,109,000 at September 30, 2003 includes \$5,920,000 of cash invested in certificates of deposit pledged as collateral for a bank loan. Accounts receivable were \$2,141,000 at September 30, 2003, a net increase of \$690,000 from the \$1,451,000 at December 31, 2002, due largely as a result of normally strong third quarter sales of Morris Flamingo-Stephan; inventories increased approximately \$582,000 from \$7,624,000 at December 31, 2002 to \$8,206,000 at September 30, 2003, principally as a result of an increase in purchases.

Total current assets at September 30, 2003 were \$23,160,000 compared to \$20,284,000 at December 31, 2002. Working capital increased \$1,429,000 when compared to December 31, 2002, due in large part to the increase in total cash and accounts receivable referred to above. In addition, prepaid insurance increased as a result of payments made for renewals in the third quarter, and the \$187,000 due from the DOT for the I-4 settlement. The Company does not anticipate any significant capital expenditures in the near term and management believes that there is sufficient cash on hand and working capital to satisfy upcoming requirements, including any funds that may be needed in connection with the going-private transaction.

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, 2002 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 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) EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES: Based upon an evaluation of the Company's disclosure controls and procedures, which was completed as of September 30, 2003 (the "Evaluation Date"), the Company's principal executive officer and chief financial officer have concluded that the disclosure controls and procedures in place were effective as of the Evaluation Date.

(b) CHANGES IN INTERNAL CONTROLS: To the best of the Company's knowledge and belief, there have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the Evaluation Date.

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THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
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SEPTEMBER 30, 2003 AND 2002

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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See Note 3 to the Financial Statements included in Part I, Item 1 for a discussion of legal proceedings.

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

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

Exhibit 31.1 Certification by the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 31.2 Certification by the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

Exhibit 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.

Exhibit 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.

(b) Reports on Form 8-K during the quarter ended September 30, 2003:

None

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.

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/s/ Frank F. Ferola

Frank F. Ferola
President and Chief Executive Officer
November 14, 2003

/s/ David A. Spiegel

David A. Spiegel
Chief Financial Officer
November 14, 2003