

FRANKLIN ELECTRONIC PUBLISHERS INC  
Form 10-K  
July 01, 2002

[LOGO] Franklin(R)  
Electronic Publishers  
[LOGO] ANNUAL REPORT  
March 31, 2002

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SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-K

Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of  
1934

For the fiscal year ended March 31, 2002

Commission File Number 0-14841

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FRANKLIN ELECTRONIC PUBLISHERS,  
INCORPORATED  
(Exact name of the registrant as specified in its charter)

|                  |                     |
|------------------|---------------------|
| Pennsylvania     | 22-2476703          |
| (State or other  | (I.R.S. Employer    |
| jurisdiction of  | Identification No.) |
| incorporation or |                     |
| organization)    |                     |

One Franklin Plaza, Burlington, New Jersey 08016-4907  
(Address of principal executive offices)

(609) 386-2500  
(Registrant's telephone number)

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Securities registered pursuant to Section 12(b) of the Exchange Act:

None

Securities registered pursuant Section 12(g) of the Exchange Act:

Common Stock, no par value

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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

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filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

As of June 21, 2002, 7,946,882 shares of common stock of the registrant were outstanding and the aggregate market value of common stock held by non-affiliates was approximately \$10,330,000.

The registrant's Proxy Statement for its 2002 annual meeting of shareholders is hereby incorporated by reference into Part III of this Form 10-K.

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## FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

### INDEX TO ANNUAL REPORT ON FORM 10-K FILED WITH THE SECURITIES AND EXCHANGE COMMISSION YEAR ENDED MARCH 31, 2002

#### ITEMS IN FORM 10-K

|  | PAGE |
|--|------|
|  | ---- |
| PART I   |      |
| ITEM 1. BUSINESS.....  | 1    |
| ITEM 2. PROPERTIES.....  | 11   |
| ITEM 3. LEGAL PROCEEDINGS.....   | 11   |
| ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.....                                   | 11   |
| PART II  |      |
| ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.....                 | 11   |
| ITEM 6. SELECTED FINANCIAL DATA.....   | 12   |
| ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS..... | 13   |
| ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.....   | 19   |
| ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.....  | 36   |
| PART III   |      |
| ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.....                                   | 37   |
| ITEM 11. EXECUTIVE COMPENSATION.....   | 38   |
| ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.....                       | 38   |
| ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.....                                       | 39   |
| PART IV  |      |
| ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K                           | 40   |
| Signatures.....  | 42   |

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discussed throughout this report, including, but not limited to, those that are stated as Franklin's belief or expectation or preceded by the word "should" or words of similar import are forward looking statements that involve risks to and uncertainties in Franklin's business, including, among other things, the timely availability and acceptance of new electronic books, organizers, and other electronic products, changes in technology, the impact of competitive electronic products, the management of inventories, Franklin's dependence on third party component suppliers and manufacturers, including those that provide Franklin-specific parts, and other risks and uncertainties that may be detailed from time to time in Franklin's reports filed with the Securities and Exchange Commission.

### PART I

#### ITEM 1. BUSINESS

Franklin Electronic Publishers, Incorporated ("Franklin" or the "Company") designs and develops handheld electronic information products, such as electronic books (sometimes known as "eBooks") and electronic organizers.

The Company believes it is the world's largest designer, developer and publisher of handheld electronic books, having sold more than twenty-seven million units since 1986. The Company's electronic books are battery-powered devices that incorporate the text of a reference work, general literature or databases and permit the user to read selected portions on a display screen. The Company owns or has licenses to publish and/or distribute in electronic format more than four thousand titles, including monolingual and bilingual dictionaries (such as Merriam-Webster's Tenth Collegiate Dictionary), the Bible, encyclopedias (such as the Concise Columbia Encyclopedia), entertainment-oriented publications, educational publications, medical publications (such as the Physicians' Desk Reference(R)) and general literature.

The Company marketed its first electronic book, the Spelling Ace(R), in 1986. The Company believes that the Spelling Ace was one of the first electronic books marketed in the United States. Beginning in 1987, Franklin began marketing increasingly sophisticated electronic versions of thesauruses and dictionaries and, in 1989, the Holy Bible.

In 1996, the Company acquired certain assets of the ROLODEX(R) Electronics product line and the associated trademark license. Under this license, the Company acquired the right to build and market databanks and organizers under the ROLODEX(R) Electronics mark. During the quarter ended March 31, 2002, the Company recorded a non-cash charge of approximately \$11.1 million to reflect the impairment of the value of the ROLODEX(R) Electronics mark.

In 1999, the Company introduced at retail an eBook produced by a third party for downloading content from the Internet. That product introduction initiated the Company's strategy of providing content for downloading from the Internet for all handheld products. In 2001, the Company introduced at retail its eBookMan product, a handheld electronic multimedia eBook device ("eBookMan") for downloading multimedia content from the Internet.

The Company has expended significant resources in connection with the development and introduction of the eBookMan product line. However, the retail market for handheld eBook readers has not developed and grown as anticipated, with sales to date of approximately 50,000 units, which is considerably less than was expected. During the year ended March 31, 2002, the Company incurred a loss of \$14.8 million from eBookMan operations, including a write down of inventory and certain other assets of \$9.9 million. As of March 31, 2002, the Company had inventory of eBookMan products with a carrying value of approximately \$1.5 million; all other assets pertaining to eBookMan have been written off.

In 2001, the Company formed a strategic alliance with Mobipocket, SA of Paris, France, which had been working on a cross platform solution of providing electronic content in a single file format to all portable and desktop devices. The Company believes this to be an important alliance, providing for Franklin's own proprietary, generally lower-priced devices to access more content but also enabling Franklin to leverage its content development and availability to include access to the more than 30 million personal digital assistant platforms and hundreds of millions of personal computers already in the market.

The Company was incorporated in 1983 in the Commonwealth of Pennsylvania as the successor to a business commenced in 1981. The Company's principal executive offices are located at One Franklin Plaza, Burlington, New Jersey 08016-4907, and its telephone number is (609) 386-2500.

#### Competitive Advantages

The Company believes that it has the following competitive advantages:

- . Efficient and Cost-Effective Manufacturing Process. Franklin controls the entire manufacturing process of its products, from design to sale, but does not own actual manufacturing facilities. This "virtual manufacturing" model enables the Company to produce its products in the most cost-effective manner by allowing the Company to outsource the manufacturing and assembly functions to third parties which meet the Company's cost and quality specifications. In this way, the Company maintains a high degree of flexibility and adaptability in its product sourcing operations with minimal capital invested.
- . Strong Share in Electronic Books. Franklin believes that it is the preeminent company in the handheld electronic reference market, with leading positions in the United States and key international markets. The Company believes that it has dominant market share in North America, Europe and Australia, as well as a major presence in the Middle East. Over the past fifteen years, Franklin has sold more than twenty-seven million units worldwide.
- . Breadth and Strength of Distribution. The Company distributes its products through 45,000 retail outlets in more than fifty countries and through the Internet and catalog mailings direct to customers. The Company also uses direct channels to serve multiple markets, such as the professional, educational and customized application markets. In the professional market, Franklin has achieved considerable success with its electronic format medical publications. In the educational market, the Company's electronic books are used in schools throughout the United States. Due to the success of its electronic Bible, the Company has also achieved substantial sales in the religious market, with Franklin products currently distributed through Christian-affiliated bookstores.
- . Technological Leadership in eBooks. Franklin has significant expertise in providing high quality content and functionality through cost-effective hardware designs of electronic information products. The Company designs and has manufactured for its use proprietary microprocessors. The Company's products combine sophisticated technology with a user-friendly interface designed for convenient and rapid retrieval of data. Franklin's ability to compress data and to design systems that permit quick and intelligent information retrieval enables it to offer compact products with high functionality. For example, the

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Company stores the almost three thousand page Physicians' Desk Reference, which fills up twenty megabytes of memory space, into the memory space of only five megabytes which also includes sophisticated search and retrieval functionality. The Company has been able to manufacture higher performance products at lower cost due in part to declining prices of ROM chips. The Company's vertically integrated research and development effort, devoted to developing both the hardware and software for its products, also enables it quickly to utilize cost-minimizing technologies. As a result, the cost of Franklin's products to consumers has decreased over the years to prices approaching those of print versions of reference publications, offering consumers added value at attractive price points.

- . Long-standing Relationships and Licenses with Many Top Publishers. The Company has electronic rights to over 200 reference titles, including several versions of English and bilingual dictionaries,

2

Bibles, and the Physicians' Desk Reference. The Company obtains its licenses from a variety of well-established publishers such as Merriam-Webster, Harper/Collins, and Bertelsmann. While many of these licenses are exclusive, all are supported by long-standing relationships with the publishers, providing Franklin with a significant competitive advantage. In the past year the Company has increased the scope of its license to publish and/or distribute e-Books to over 4,000 titles which include well known publishers such as St. Martin's Press, McGraw Hill, AOL Time Warner and others.

### Business Strategies

Franklin was the first, and strives to be the best, in electronic books. The Company's strategy to fulfill that mission is to leverage its leading market position by exploiting the following opportunities:

- . Consumer Driven Product Development and Marketing. While the Company has built strong distribution for its major products, it believes that further opportunities lie in its ability to take a more marketing driven approach to product development. The Company believes a better understanding of its customers will allow it to boost sales, lower costs, accelerate sell through at retail and lead to successful new product introductions. The Company is investigating ways to better market its North American products in the education, Hispanic, bible and travel markets. The Company is expanding its consumer research to better understand its customers' needs to be able to expand its solution-based product offerings in these markets.
- . Use of the Internet to Distribute Content to Handhelds. The Company distributes e-Books on its web page (franklin.com) and other third party websites in electronic form for downloading to a wide variety of leading handheld platforms, including to those using the Palm OS operating system and Microsoft Pocket PC/Windows CE operating system as well as to the Company's own handheld electronic books. In this way, the Company expects to leverage its expertise in refining reference data with its competitive advantages in developing and distributing handheld products to reach a broader installed base. The Company has developed an Internet-enabled hardware platform to provide for portable use of content delivered from the Company's website and other third party websites.
- . Continuing Upgrade of Core Products. The Company's core product line

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continues to represent the major portion of its revenue. Dictionaries, spell correctors and Bibles have been the Company's mainstream consumer electronics products. The Company intends to continue to upgrade and enhance its core products.

- . Investment in Marketing. The Company believes that a major opportunity lies in broadening consumer awareness of the handheld eBook category in order to generate mass market interest in the Company's products. To date, the Company has engaged in limited advertising on the national or local levels.
- . International Markets. The Company has had success in selling its products directly through wholly-owned, local subsidiaries in selected international markets, and through distributors in other markets. Because of the slowed growth in some international markets over the past two fiscal years, the Company is concentrating its sales efforts in key markets. The Company anticipates that its international sales will continue to provide a significant portion of its revenues.
- . Exploitation of OEM and Licensing Opportunities. OEM (or "Original Equipment Manufacturer") opportunities are business agreements pursuant to which the Company develops products for resale by its partners. The Company has such agreements in the medical publishing and international markets and will seek to broaden its activities to other vertical markets. The Company believes its OEM business can be expanded as the Company upgrades existing and develops new open system platforms. The Company licenses its technology to preeminent companies such as Adobe Systems, Inc. and Palm, Inc.

### Risk Factors

The Company believes that the most significant risks to its business involve those set forth below.

- . Dependence on New Products and Titles. The Company depends to a certain extent on the introduction of successful new products and titles to generate sales growth and replace declining

3

revenues from certain older products and titles. The Company currently has several new products and titles under development; however, significant development efforts for a number of the Company's proposed new products and titles will be required prior to their commercialization. A significant delay in the introduction of a new product or title could have a material adverse effect on the ultimate success of the product or title. In addition, if revenues from new products and titles fail to replace declining revenues from certain existing products and titles, the Company's operating results and growth could be adversely affected. There can be no assurance that new products and titles currently under development will be introduced on schedule, that they will generate significant revenues, or that the Company will be able to introduce additional new products and titles in the future.

The Company has expended significant resources in connection with the development and introduction of its eBookMan product line, which commenced shipping in the fourth quarter of fiscal 2001. To date, consumer demand for eBookMan products has not met expectations. During the year ended March 31, 2002, Franklin incurred a loss of \$14.8 million from eBookMan operations, including a write down of inventory and certain

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other assets of \$9.9 million. As of March 31, 2002, the Company had inventory of eBookMan products with a carrying value of approximately \$1.5 million. All other assets pertaining to eBookMan have been written off.

As a result of declining sales of the Company's ROLODEX(R) Electronics products over the last several years, during the quarter ended March 31, 2002, the Company recorded a non-cash charge of approximately \$11.1 million to reflect the impairment of the value of the ROLODEX(R) Electronics mark.

- . Inventory Management. The Company's lead times are necessarily long because of the custom nature of certain components and because most of its components are manufactured, and its platforms are assembled, in Asia. Accordingly, production and procurement planning are critically related to the Company's anticipated sales volume. Any significant deviation from projected future sales could result in material shortages or surpluses of inventory. Shortages could cause the Company's distribution base to shrink as customers turn to the Company's competitors. Inventory surpluses could cause cash flow and other financial problems, which might cause the Company to liquidate inventory at a loss as was the case with eBookMan products. There can be no assurance that the Company's forecasts of demand for its products will be accurate. Inaccurate forecasts, or unsuccessful efforts by the Company to cope with surpluses or shortages, could have a material adverse effect on the Company's business.
- . Changes in Technology. In general, the computer industry, both with respect to software and hardware, is subject to rapidly changing technology. Accordingly, the technology underlying the Company's products may similarly be subject to change. The introduction of products embodying new technologies and the emergence of new industry standards could exert price pressure on the Company's existing products or render such products unmarketable or obsolete. The Company's ability to anticipate changes in technology and industry standards and to develop and introduce new and enhanced products, as well as additional applications for existing products, in each case on a timely and cost-effective basis, will be a critical factor in the Company's ability to grow and remain competitive. There can be no assurance that technological changes will not materially adversely affect the Company's business.
- . Competition. The consumer electronics and handheld product markets are highly competitive and characterized by rapid technological advances and the regular introduction of new products or enhancements of existing products. The Company believes it faces various degrees of competition at different price points in these markets. Competitive factors include product quality and reliability, price, performance, marketing and distribution capability, service and reputation. There can be no assurance that companies currently in the consumer electronics or handheld product markets will not enter the markets in which the Company currently markets its products. There can be no assurance that other companies, currently in the consumer electronics industry, will not enter the electronic book market. Many of such companies have greater capital, research and development, marketing and distribution resources than the Company. If new competitors emerge on the existing market

becomes more competitive, the Company could experience significant

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pressure on prices and margins.

- . Dependence on Key Suppliers. Certain integrated circuits essential to the functioning of the Company's products are manufactured by a relatively small number of overseas suppliers. Missed, late or erratic deliveries of custom integrated circuits and other parts could materially adversely impact the timing of new product deliveries as well as the Company's ability to meet demand for existing products. If any one of the integrated circuit suppliers were unable to meet its commitments to the Company on a timely basis, such failure could have a material adverse effect on the Company's business.
- . Intellectual Property Rights. The Company owns utility and design patents in the United States and elsewhere on its electronic books. There can be no assurance (i) that the claims allowed under any patents will be sufficiently broad to protect the Company's technology, (ii) that the patents issued to the Company will not be challenged, invalidated or circumvented or (iii) as to the degree or adequacy of protection any patents or patent applications will afford. The Company also claims proprietary rights in various technologies, know-how, trade secrets and trademarks which relate to its principal products and operations, none of which rights is the subject of patents or patent applications in any jurisdiction. There can be no assurance as to the degree of protection these rights may or will afford the Company. One of the Company's patents is currently the subject of an action for declaratory judgment of non-infringement brought by one of the Company's competitors. See "Legal Proceedings."
- . International Sales and Currency Fluctuations. The Company expects that international sales will continue to constitute a material portion of the Company's business. The Company's international business is subject to various risks common to international activities, including political and economic instability and the need to comply with export laws, tariff regulations and regulatory requirements. There can be no assurance that political or economic instability in any given country or countries will not have an adverse impact on the Company's overall operations. Because approximately 30% of the Company's sales are made in currencies other than the U.S. dollar, the Company is subject to the risk of fluctuation in currency values from period to period. The risk associated with fluctuations in currency values can be expected to increase to the extent the Company expands its international operations.

### Products

#### Electronic Books

Franklin currently markets more than 200 electronic books in various categories, including thesauruses, dictionaries, bilingual dictionaries, the Bible, and educational and medical publications. Different versions of the Company's electronic reference products use different databases and provide various levels of functionality.

#### Dictionaries

Franklin's electronic spelling products (the "Spelling Ace(R)" line) operate as phonetic spelling error detectors and correctors, puzzle solvers, word list builders and word finders. These products permit the user to obtain the correct spelling of a word that the user does not know how to spell correctly. For example, if the user phonetically types in "krokodyl," the book will display a list of seven words including, as the first choice, "crocodile." The Company markets various versions in the Spelling Ace line incorporating different databases. The most popular version is based on a list of over 80,000 American



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English words licensed to the Company by Merriam-Webster.

The Company's top-of-the-line electronic dictionary is Merriam-Webster's Collegiate Dictionary which is sold for use in the BOOKMAN and eBookMan lines of products and which contains over 195,000 words and their definitions, parts of speech, hyphenation points and different word forms (inflections). All of the Company's electronic dictionaries provide phonetic spelling correction and many provide thesaurus features as

5

well. For example, if a user enters the word "baffled," the thesaurus will display eleven different synonyms, including "frustrated," "disappointed" and "foiled."

The Company markets versions of its dictionaries that include speech synthesis circuitry (based on text to speech technology in which algorithms are used to convert text into sound) which allows the Company's products to pronounce, in computer generated speech, relevant words contained in the various databases. The Company also has developed and sold audible products that use digitally recorded and compressed speech, which sounds more like a human voice.

The Company's line of products also includes bilingual dictionaries. Each contains more than 200,000 words in both English and either Spanish, French, German, Arabic or Hebrew, and each provides complete translations, definitions, verb conjugations and a gender guide, and plays a variety of language learning games to help teach the language. The Spanish/English dictionary is marketed in versions with and without speech synthesis for both Spanish and English words. Each of the other bilingual dictionaries is equipped with speech synthesis for the English words. The Company currently markets a French/German dictionary and bilingual dictionaries for several other languages, including other language pairs that do not include English, such as German/Italian and French/Spanish.

Franklin has a speaking dictionary designed to facilitate use by blind, visually impaired or learning disabled individuals, as well as others with special needs. This dictionary incorporates speech technology which pronounces every word at user adjustable volumes and speeds. In addition, this dictionary is equipped with full audio feedback, which allows every key on the keyboard to speak its letter or function. Other features include a keyboard with high-contrast lettering and raised locator dots, a large high-contrast screen with adjustable fonts and headphones.

### Children's Products

Since 1990, the Company has successfully sold children's versions of its reference products, such as a children's dictionary based on the word list from Webster's Elementary Dictionary. In 1997, the Company introduced a new line of children's products which includes the Homework Wiz electronic dictionary with a text-to-speech voice synthesizer enabling the product to speak words and definitions.

### The Bible

Franklin's electronic Holy Bible is a handheld edition of the entire text of the Bible, which allows for retrieval of text by searches based on single words, word groups or synonyms. For example, a search for the words "valley" and "shadow" will retrieve the Twenty-third Psalm. Because of its built-in ability to conduct full-text word searches, the Franklin Bible is a fully automated concordance. The Company sells the Bible on its BOOKMAN platform and

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on cards designed for use with its BOOKMAN platform. The Company sells both the King James and the New International versions of the Bible, as well as a children's version of the Bible, and markets a Bible question-and-answer card. The Company also sells a speaking version of its King James Bible.

### Medical Publications

The Company develops and markets a broad range of titles for health care professionals for use on a variety of handheld platforms.

The Pocket PDR(TM) Medical Book System comes with two card slots and a broad range of titles. The platform uses Franklin's proprietary microprocessor and has an 8-line screen which is particularly useful when accessing and viewing drug information monographs. Available book cards for the Pocket PDR(TM) Medical Book System include the Physicians' Desk Reference, The Merck Manual, The Washington Manual of Medical Therapeutics, The Medical Letter Handbook of Adverse Drug Interactions, and Griffith's Five-Minute Clinical Consult.

6

In the 2001 fiscal year, the Company launched an eBookMan device targeted towards the healthcare community which is bundled with two leading drug references on multimedia memory cards (MMC): the 2001 Physicians' Desk Reference for physicians distributed by Medical Economics, a division of Thomson Healthcare, and the 2001 American Hospital Formulary Service distributed by the American Society of Health-System Pharmacists to hospital-based pharmacists. The 2002 Physicians' Desk Reference is available for eBookMan devices as a download from the Internet. The Company has developed a 2002 version of the card for the American Society of Health System Pharmacists.

The Company's development of certain medical titles for use in a variety of handheld platforms continued during the 2002 fiscal year. Most titles available for the Medical Book System were developed for the Palm OS operating system, both as downloads and as Springboard modules for the Visor platform, as well as for the Microsoft Windows CE operating systems. The titles are available for download at franklin.com.

### Entertainment Titles

The Company sells a Crossword Puzzle Solver electronic book which provides correct spelling for over 250,000 words and phrases from Merriam-Webster's Official Crossword Puzzle Dictionary for use by word puzzle enthusiasts. The Company is investigating making certain entertainment titles available for downloading from its website into a variety of handheld platforms and currently offers a series of downloadable crossword puzzles for Palm OS compatible devices.

### International Titles

The Company has developed and produced British English versions of its American English electronic reference products for international markets, particularly the United Kingdom and Australia. The Company has monolingual electronic reference products for the French market and eBook products for the German-speaking market. The Company has omnibus agreements for publishing electronic reference products with two major European publishers, Bertelsmann and Havas, under which Franklin has developed titles in handheld electronic platforms and ROM cards. Havas publishes dictionaries, thesauruses, encyclopedias and other works under the following well known French trademarks: Le Robert, Larousse, Nathan, Dalloz, Masson and Bouquins.

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Through a Company subsidiary, Proximity Technology, Inc., the Company designs linguistic software that performs spelling error detection and correction, thesaurus and dictionary functions in conjunction with databases of words in 20 languages and dialects. The Company licenses this software for use in computers of all sizes, as well as on the Internet.

### Electronic Organizers

In 1997, the Company began to sell a line of organizers and databanks under the ROLODEX(R) trademark which had been licensed by the Company late in 1996. Since acquiring the ROLODEX(R) Electronics product line, the Company has updated and improved both low priced databanks, that allow users to store and retrieve names and telephone numbers, and higher priced and more advanced personal organizers, that can interface with desktop PCs. During the quarter ended March 31, 2002, the Company recorded a non-cash charge of approximately \$11.1 million for the impairment of the value of the ROLODEX(R) Electronics mark.

### Internet Enabled Content and Devices

The Company offers versions of certain reference works, including the Physicians' Desk Reference and the Bible, from its website, franklin.com, for downloading to handheld devices using the Palm OS operating system and Microsoft Windows CE operating system. The three eBookMan models feature large 240x200 pixel displays that display 87% more information than today's most popular handhelds. Users can adjust the font size or switch the display to landscape mode for easy reading. All three models use natural handwriting recognition and include

7

an eBook Reader, an audio book player, an MP3 compatible music player, an address book, a date book, a to-do book and a memo book. Each eBookMan model is equipped with a USB port for connection to a PC (an optional serial connection is also available) and features optional memory expansion through industry standard multimedia memory cards.

The Company has expended significant resources in connection with the development and introduction of the eBookMan product line, which commenced shipping in the fourth quarter of fiscal 2001. However, the retail market for handheld eBook readers has not developed and grown as anticipated, with sales to date of approximately 50,000 units, which is considerably less than was expected. During the year ended March 31, 2002, the Company incurred a loss of \$14.8 million from eBookMan operations including write down of inventory and certain other assets of \$9.9 million. As of March 31, 2002, the Company had inventory of eBookMan products with a carrying value of approximately \$1.5 million. All other assets pertaining to eBookMan have been written off.

### Research And Development And Content Acquisition

The Company has a group of approximately thirty persons that perform research and development relating to new electronic products as well as improvements to existing products. The Company focuses its hardware development efforts on creating new platforms.

The Company maintains a full-time internal development group of hardware and software engineers dedicated to the critical function of developing proprietary microprocessors and VLSIs that integrate the Company's proprietary microprocessor or general purpose microprocessors and custom design circuits

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for electronic products. Through this extensive effort, the Company is able to reduce the cost of components for its platforms and cards on an ongoing basis. The Company regularly engages in programs to redesign its platforms and to develop new VLSIs for its products. The Company has also contracted for software development work in Russia, India and the Far East.

### Manufacturing

The Company arranges for the assembly of its products by placing purchase orders with established third-party manufacturers in China, Malaysia and Thailand. The Company believes that it could locate alternate manufacturers for its products if any of its current manufacturers is unable, for any reason, to meet the Company's needs.

The Company designs certain custom integrated circuits, which are manufactured by third parties for use in the Company's products. Franklin also creates the mechanical, electronic and product design for its hardware platforms and designs and owns the tools used in the manufacture of its products. The Company's electronic products are based on the Company's proprietary microprocessor or general purpose microprocessors and custom-designed ROM chips and general purpose static random access memory chips. The Company designs VLSIs that integrate its proprietary or general purpose microprocessors and custom-designed circuits in order to reduce the cost of the components in its platform. In order to minimize the effect of any supplier failing to meet the Company's needs, the Company generally attempts to source these parts from multiple manufacturers. In those cases where the Company chooses to use a single source for economic reasons, alternative suppliers are generally available.

The Company utilizes its office in Hong Kong to facilitate component procurement and manufacturing. On-site quality control inspection of electronic products is conducted by its employees in China, Malaysia and Thailand. The Company's products are generally shipped at the Company's expense to its facility in New Jersey, where the Company maintains inspection, quality control, packaging, warehousing and repair operations for distribution in the United States, and to similar facilities in Europe and elsewhere for its foreign operations.

8

### Sales And Marketing

Franklin's products are marketed domestically through the Company's own sales and marketing force and through independent sales representative organizations, which are supervised by the Company's internal sales department.

#### Consumer Sales

Franklin's products are sold in over 30,000 retail establishments in the United States. These are comprised of mass market retailers, discount chains, bookstores, independent electronic stores, department stores and catalog companies such as The Sharper Image. Consumers can also order products directly from Franklin by calling 1-800-BOOKMAN or by visiting the Company's website at franklin.com. The Company sells through several large retail chains, including Radio Shack, Staples, Office Depot, Target and Best Buy.

Franklin commonly participates in and provides financial assistance for its retailers' promotional efforts, such as in-store displays, catalog and general newspaper advertisements. The Company promotes its products with advertisements in magazines and newspapers. The Company also promotes its products at trade

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shows, including the Consumer Electronics Show, and advertises in trade magazines.

### International Sales

The Company sells its products worldwide through its wholly-owned local subsidiaries and a network of independent distributors. Franklin has subsidiaries in the United Kingdom, France, Canada, Germany, Mexico and Australia, that market and distribute the Company's products, including those specifically developed for these markets.

### OEM Markets

The Company produces custom products for third parties. The Company has developed custom products including the Larousse Copiloto for a Spanish print encyclopedia publisher as well as a speaking version of the alMawrid, an Arabic-English bilingual dictionary for sale in the Middle East. The Company continues to pursue opportunities for custom versions of its products.

### Patents, Trademarks And Copyrights

The Company owns more than twenty United States utility and design patents on its electronic reference products and a number of international patents on its products. The Company actively pursues the acquisition and enforcement of patent rights and, in furtherance thereof, maintains an ongoing program to apply for and prosecute patent applications and to enforce its rights in patents that issue therefrom.

Franklin owns certain trademark rights, including "Franklin(R)", "BOOKMAN(R)", "eBookMan", "Spelling Ace(R)", "Wordmaster(R)", "Next Century(R)" and "Language Master" and has an exclusive license for the mark ROLODEX(R) Electronics in the United States and various foreign countries.

Copyrights to certain word lists incorporated in the Company's electronic books are the property of the Company's licensors. The Company owns copyrights in certain programs and algorithms used in, as well as the compilations of, its electronic books. See "Legal Proceedings."

### Competition

The Company is the market leader for handheld electronic books. The Company's main domestic competitor in the electronic book category is Seiko Instruments USA Inc. ("Seiko"), which markets spelling correctors, thesauruses and dictionaries. The Company faces various degrees of competition at different price

9

points in the consumer market. The Company's major competitor, Seiko, focuses primarily on the modestly-priced end of the market. The Company's main international competitors are Lexibook, which markets French monolingual spelling correctors, thesauruses and dictionaries in France, and Hexaglot, which markets German-centric bilinguals and translators in Germany.

Competitive factors for electronic reference products are product quality and reliability, functionality, price, performance, speed of retrieval, quality of underlying databases, quality of spelling correction, portability, marketing and distribution capability, service and corporate reputation. The Company believes it is the leader in respect of each such factor.

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The Company's reference products enjoy a reputation for quality resulting from their content, hardware design and easy-to-use applications. The Company's reference products are characterized by their capacity to permit the user to define the kind of information being sought and to provide information responsive to the user's request.

Sharp Electronics, Casio, and Royal are the Company's primary competitors in electronic organizers. Competitive factors for electronic organizers and personal computer companion products are size, product quality and reliability, functionality, price, performance, marketing and distribution capability and corporate reputation. The Company believes that it competes effectively in the electronic organizer market in respect of each of these factors.

A number of prominent electronics manufacturers, including Palm Inc., Handspring, Inc., 3Com, Sharp Electronics Corporation, Casio, Royal, Psion, LG Electronics, Gemstar TV Guide International Group and Hewlett-Packard Company, market palmtop personal organizer products, personal digital assistants, electronic books, computer peripherals, or general usage personal computers that offer varying degrees of electronic reference capabilities and personal information management functions. Many competitors in this market have greater capital, research and development, marketing and distribution resources than the Company and there can be no assurance that the Company can successfully compete in this market.

### Employees

As of June 19, 2002, the Company employed approximately 145 persons in the United States, approximately 27 persons in Asia, and approximately 50 persons in international sales and marketing subsidiaries. None of the Company's employees is represented by a union. The Company believes its relations with its employees are satisfactory.

### EXECUTIVE OFFICERS OF THE REGISTRANT

See Item 10 for information regarding the Company's executive officers.

\* \* \*

Merriam-Webster's is a trademark of Merriam-Webster, Inc.; Physicians' Desk Reference and Pocket PDR are trademarks of Medical Economics Data, a division of Medical Economics Company, Inc.; Palm is a trademark of Palm Inc.; Windows is a trademark of Microsoft Corporation; Handspring and Visor are trademarks of Handspring, Inc; and ROLODEX(R) is a registered trademark of Berol Corporation, a division of Newell Rubbermaid Inc.

Except for the historical information contained herein, the matters discussed throughout this report, including, but not limited to, those that are stated as Franklin's belief or expectation or preceded by the word "should" or words of similar import are forward looking statements that involve risks to and uncertainties in Franklin's business, including, among other things, the timely availability and acceptance of new electronic books, organizers, and other electronic products, changes in technology, the impact of competitive electronic products, the management of inventories, Franklin's dependence on third party component suppliers and manufacturers, including those that provide Franklin-specific parts, and other risks and uncertainties that may be detailed from time to time in Franklin's reports filed with the Securities and Exchange Commission.

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### ITEM 2. PROPERTIES

The Company owns a 90,000 square foot corporate headquarters in Burlington, New Jersey. The Company believes this facility will satisfy its foreseeable needs for office, laboratory and warehousing space.

### ITEM 3. LEGAL PROCEEDINGS

In April 2002, LeapFrog Enterprises, Inc. of Emeryville, California filed an action for declaratory judgment of non-infringement of the Company's United States Patent entitled "Word Spelling and Definition Educational Device." Franklin's patent, issued in 1993, covers electronic language skills teaching aid machines and systems to aid in the teaching of language skills, such as the Company's Homework Wiz(R) products. The Company believes that LeapFrog's filing for declaratory judgment will have no adverse financial effect on Franklin. In April 2002, the Company filed a patent infringement claim against LeapFrog alleging that LeapFrog's products infringe on the Company's patent.

The Company is subject to other litigation from time to time arising in the ordinary course of its business. The Company does not believe that any such litigation is likely, individually or in the aggregate, to have a material adverse effect on the financial condition of the Company.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS--NONE

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's common stock is traded on the American Stock Exchange (the "AMEX") under the symbol "FEP." Prior to June 18, 2001, the Company's common stock was traded on the New York Stock Exchange (the "NYSE"). The following table sets forth the range of the high and low closing sales prices as reported by the NYSE and the AMEX, as applicable, for the last two fiscal years:

| Quarter Ended        | Sales    |        |
|----------------------|----------|--------|
|                      | High     | Low    |
| June 30, 2000.....   | 9.5      | 5.3125 |
| September 30, 2000.. | 12.375   | 7.5    |
| December 31, 2000..  | 11.875   | 4.25   |
| March 31, 2001.....  | 7.140625 | 3.00   |
| June 30, 2001.....   | 4.20     | 2.50   |
| September 30, 2001.. | 2.60     | 1.20   |
| December 31, 2001..  | 2.00     | 1.10   |
| March 31, 2002.....  | 2.74     | 1.40   |

The approximate number of holders of record of the common stock as of June 14, 2002 was 900.

The Company has not declared cash dividends on the common stock and does not have any plans to pay any cash dividends on the common stock in the foreseeable future. The Board of Directors of the Company anticipates that any earnings that might be available to pay dividends on the common stock will be retained to finance the business of the Company and its subsidiaries.

## ITEM 6. SELECTED FINANCIAL DATA

The following tables should be read in conjunction with the consolidated financial statements of the Company and the notes thereto and the "Management's Discussion and Analysis of Financial Condition and Results of Operation" section appearing elsewhere herein.

|  | Year Ended March 31, |          |          |             |           |
|--|----------------------|----------|----------|-------------|-----------|
|  | 2002                 | 2001     | 2000     | 1999        | 1998      |
| Statements Of Operations Data                            |                      |          |          |             |           |
| Sales.....   | \$ 71,025            | \$79,966 | \$97,078 | \$104,435   | \$100,747 |
| Cost of Sales.....                                       | 41,416               | 45,568   | 61,223   | 81,209      | 56,866    |
| Write-down of eBookman Inventory and Product Costs.....  | 8,622                | --       | --       | --          | --        |
| Gross Margin.....  | 20,987               | 34,398   | 35,855   | 23,226      | 43,881    |
| Expenses:  |                      |          |          |             |           |
| Sales and marketing.....                                 | 21,090               | 17,668   | 21,397   | 29,570      | 22,810    |
| Research and development.....                            | 3,952                | 3,973    | 4,215    | 5,740       | 5,537     |
| General and administrative.....                          | 9,456                | 9,752    | 11,746   | 20,283      | 12,912    |
| Trademark impairment.....                                | 11,147               | --       | --       | --          | --        |
| Total operating expenses.....                            | 45,645               | 31,393   | 37,358   | 55,593      | 41,259    |
| Operating Income (Loss).....                             | (24,658)             | 3,005    | (1,503)  | (32,367)    | 2,622     |
| Interest expense.....                                    | (1,514)              | (1,712)  | (3,086)  | (3,554)     | (3,385)   |
| Interest and investment income.....                      | 158                  | 217      | 355      | 674         | 1,883     |
| Other, net.....  | (622)                | (596)    | (1,162)  | (656)       | (590)     |
| Gain on Sale of REX.....                                 | --                   | --       | 8,072    | --          | --        |
| Income (Loss) Before Income Taxes.....                   | (26,636)             | 914      | 2,676    | (35,903)    | 530       |
| Income Tax (Benefit) Provision.....                      | --                   | --       | --       | (5,712)     | (899)     |
| Net Income (Loss).....                                   | \$ (26,636)          | \$ 914   | \$ 2,676 | \$ (30,191) | \$ 1,429  |
| Preferred Stock Dividend.....                            | 267                  | --       | --       | --          | --        |
| Net Income (Loss) Applicable to Common Stockholders..... | \$ (26,903)          | \$ 914   | \$ 2,676 | \$ (30,191) | \$ 1,429  |
| Net Income (Loss) Per Common Share:                      |                      |          |          |             |           |
| Basic.....   | \$ (3.38)            | \$ 0.12  | \$ 0.34  | \$ (3.81)   | \$ 0.18   |
| Diluted.....   | \$ (3.38)            | \$ 0.11  | \$ 0.34  | \$ (3.81)   | \$ 0.18   |
| Weighted Average Common Shares:                          |                      |          |          |             |           |
| Basic.....   | 7,948                | 7,922    | 7,861    | 7,923       | 8,069     |
| Diluted.....   | 7,948                | 8,217    | 7,931    | 7,923       | 8,156     |

At March 31,



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|                            | 2002   | 2001     | 2000     | 1999     | 1998      |
|----------------------------|--------|----------|----------|----------|-----------|
| Balance Sheet Data         |        |          |          |          |           |
| Working Capital.....       | 12,164 | \$26,871 | \$20,777 | \$ 4,142 | \$ 74,783 |
| Total Assets.....          | 47,302 | 80,028   | 70,060   | 107,320  | 136,188   |
| Long-term Liabilities..... | 11,459 | 13,947   | 11,690   | 1,541    | 45,089    |
| Shareholders' Equity.....  | 24,308 | 50,278   | 46,138   | 43,045   | 74,746    |

12

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

For the year ended March 31, 2002, the Company incurred a net loss of \$26.6 million, or \$3.38 per share, compared with net income of \$.9 million or \$.12 per share, in the prior year. The current year's loss resulted primarily from a loss of \$14.8 million from the Company's eBookMan(R) operations, a charge of \$11.1 million for impairment of the value of the ROLODEX(R) Electronics trademark, severance accruals of \$.5 million, consolidation and restructuring costs of European subsidiaries of \$.5 million, and a prior year tax assessment in a Belgian subsidiary of \$.3 million.

Net income for the year ended March 31, 2001, was \$.9 million, or \$.12 per share, compared with net income of \$2.7 million, or \$.34 per share, in the prior year. Results for the year were negatively affected, in part, by a \$2.6 million decrease in technology licensing revenue, a \$5.4 million decline in sales of ROLODEX(R) Electronics organizer products, and a \$2.2 million decrease in sales of reference products in the United Kingdom.

Results of Operations

The following table summarizes the Company's historical results of operations as a percentage of sales for fiscal 2002, 2001, and 2000:

|                                | Year Ended March 31, |          |          |
|--------------------------------|----------------------|----------|----------|
|                                | 2002                 | 2001     | 2000     |
| Sales:                         |                      |          |          |
| Domestic.....                  | \$46,657             | \$50,374 | \$64,075 |
| International.....             | 24,368               | 29,592   | 33,003   |
| Total Sales.....               | \$71,025             | \$79,966 | \$97,078 |
|                                | =====                | =====    | =====    |
| As a Percentage of Total Sales |                      |          |          |
| Domestic.....                  | 65.7                 | 63.0     | 66.0     |
| International.....             | 34.3                 | 37.0     | 34.0     |
| Sales.....                     | 100.0%               | 100.0%   | 100.0%   |
| Cost of Sales.....             | 70.5                 | 57.0     | 63.1     |
| Gross Margin.....              | 29.5                 | 43.0     | 36.9     |

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|  |         |       |       |
|--|---------|-------|-------|
| Expenses:                                    |         |       |       |
| Sales and Marketing.....                     | 29.7    | 22.1  | 22.0  |
| Research and Development.....                | 5.6     | 5.0   | 4.3   |
| General and Administrative.....              | 13.3    | 12.2  | 12.1  |
| Trademark Impairment.....                    | 15.7    | --    | --    |
|  | -----   | ----- | ----- |
| Total operating expenses.....                | 64.3    | 39.3  | 38.5  |
|  | -----   | ----- | ----- |
| Operating Income (Loss).....                 | (34.7)  | 3.8   | (1.5) |
| Interest expense.....                        | (2.1)   | (2.1) | (3.2) |
| Interest and Investment income.....          | 0.2     | 0.3   | 0.4   |
| Other, net.....                              | (0.9)   | (0.7) | (1.2) |
| Gain on sale of REX.....                     | --      | --    | 8.3   |
|  | -----   | ----- | ----- |
| Income (Loss) Before Income Taxes.....       | (37.5)  | 1.1   | 2.8   |
| Income Tax (Benefit) Provision.....          | --      | --    | --    |
|  | -----   | ----- | ----- |
| Net Income (Loss).....                       | (37.5)  | 1.1   | 2.8   |
|  | -----   | ----- | ----- |
| Preferred stock dividend.....                | (0.4)   | --    | --    |
| Net income (loss) applicable to common stock | (37.9%) | 1.1%  | 2.8%  |
|  | =====   | ===== | ===== |

13

Year Ended March 31, 2002, Compared With Year Ended March 31, 2001

A comparative summary of operations for the Company's core business (Reference and ROLODEX(R) Electronics products) and eBookMan product lines is shown below.

|   | Year Ended March 31, 2002 |             |             | Year Ended March 31, 2001 |            |          |
|---|---------------------------|-------------|-------------|---------------------------|------------|----------|
|   | Core                      | eBookMan    | Total       | Core                      | eBookMan   | Total    |
|   | -----                     | -----       | -----       | -----                     | -----      | -----    |
| Sales.....  | \$ 68,544                 | \$ 2,471    | \$ 71,025   | \$74,757                  | \$ 5,209   | \$79,966 |
| Cost of Sales.....                                      | 38,566                    | 2,850       | 41,416      | 41,135                    | 4,433      | 45,568   |
| Write-down of eBookMan Inventory and Product Costs..... | --                        | 8,622       | 8,622       | --                        | --         | --       |
|   | -----                     | -----       | -----       | -----                     | -----      | -----    |
| Total Cost of Sales.....                                | 38,566                    | 11,472      | 50,038      | 41,135                    | 4,433      | 45,568   |
|   | -----                     | -----       | -----       | -----                     | -----      | -----    |
| Gross Margin.....                                       | 29,988                    | (9,001)     | 20,987      | 33,622                    | 776        | 34,398   |
| Operating Expenses.....                                 | 29,389                    | 5,109       | 34,498      | 26,867                    | 4,526      | 31,393   |
| Trademark Impairment.....                               | 11,147                    | --          | 11,147      | --                        | --         | --       |
|   | -----                     | -----       | -----       | -----                     | -----      | -----    |
|   | 40,536                    | 5,109       | 45,645      | 26,867                    | 4,526      | 31,393   |
|   | -----                     | -----       | -----       | -----                     | -----      | -----    |
| Operating Income (Loss).....                            | (10,548)                  | (14,110)    | (24,658)    | 6,755                     | (3,750)    | 3,005    |
| Interest and Other.....                                 | (1,263)                   | (715)       | (1,978)     | (2,091)                   | --         | (2,091)  |
|   | -----                     | -----       | -----       | -----                     | -----      | -----    |
| Net Income (Loss).....                                  | \$ (11,811)               | \$ (14,825) | \$ (26,636) | \$ 4,664                  | \$ (3,750) | \$ 914   |
|   | =====                     | =====       | =====       | =====                     | =====      | =====    |

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Sales for the year ended March 31, 2002, were \$71.0 million compared with \$79.9 million in the prior year. The primary reasons for the decline in sales were lower European sales of \$4.4 million (\$3.1 million reference, \$1.2 million eBookMan, and \$.1 million other), a decrease of \$1.9 million in Medical Division sales attributable to increased competition with lower hardware sales as the business shifted to downloading medical titles from the Internet, a reduction in Australian sales of \$.6 million because of lower eBookMan sales, and lower U.S. consumer sales of Rolodex(R) Electronic products, \$1.0 million, and eBookMan products, \$.5 million.

Gross margin in the current year was \$21.0 million, or 29.5%, of sales compared with \$34.4 million, or 43.0%, of sales in the prior period. The lower gross margin resulted primarily from the write-down of \$8.6 million of eBookMan inventory and related product costs, \$.5 million of eBookMan price protection and \$4.3 million from lower sales. The gross margin on the Company's core reference and ROLODEX(R) Electronics product lines was \$30.0 million, or 43.6%, compared with \$33.6 million, or 44.9%, in the prior period. The higher gross margin percentage in the prior period resulted primarily from the absorption of \$.7 million of overhead expense by the eBookMan products in that period. The core business gross margin was approximately the same in both periods without the allocation to eBookMan.

Operating expenses increased to \$34.5 million from \$31.4 million last year. The increase was primarily attributable to an increase in selling expenses of \$3.4 million to \$21.1 million from \$17.7 million resulting from higher advertising, promotion, and trade show expenses relating to eBookMan products of \$1.0 million, an increase in salaries of \$.9 million resulting primarily from \$.5 million of severance pay, and higher staffing levels for eBookMan, increased core business advertising allowances of \$.6 million, and the accrual of a prior year Belgian tax of \$.3 million.

Research and development expense was \$4.0 million in both years. Last year's expense was net of \$3.1 million of capitalized expenses while the current year's expense was net of \$1.1 million of capitalized expenses.

General and administrative expense decreased to \$9.4 million from \$9.7 million in the prior year. The decrease results primarily from lower salary and fringe expense of \$.5 million, lower depreciation and amortization of \$.2 million, and provision for bad debts of \$.2 million offset by warehouse costs of \$.2 million from outsourcing some European warehouses and increased professional fees of \$.3 million necessitated by staff turnover in Europe in the current year. Prior year expenses were reduced as a result of a favorable settlement in litigation brought by the Company.

14

Interest expense declined from \$1.7 million in the year ended March 31, 2002 to \$1.5 million for the year ended March 31, 2001 because of the prepayment of \$8.4 million of 12-1/2% Senior Notes in December 2001 and then meeting credit needs with the Company's Revolving Credit Facility with an effective rate of 6%.

Year Ended March 31, 2001 Compared With Year ended March 31, 2000

Sales for the year ended March 31, 2001 were \$80 million compared with sales of \$97.1 million in the prior year. During the year ended March 31, 2000 the Company sold its REX product line and discontinued its Rocket eBook product line, which accounted for sales of \$6.1 million and \$1.8 million, respectively, in the year ended March 31, 2000. The decrease in sales from the prior year is

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also attributable to a \$2.6 million decrease in technology licensing revenue, a \$5.4 million decline in sales of ROLODEX Electronics organizer products, a \$2.2 million decrease in sales of reference products in the United Kingdom and a \$.7 million decrease in sales by Voice Powered Technology International, Inc. ("VPTI"), the Company's 82% owned subsidiary. In addition, the continuing weakness in foreign currencies against the US dollar accounted for an approximately \$3.0 million reduction in sales. These decreases were partially offset by \$5.2 million of sales of eBookMan which was introduced in the fiscal year ended March 31, 2001.

Gross margin for the year ended March 31, 2001 was \$34.4 million, or 43%, compared with \$35.9 million, or 37% in the prior year. The primary reasons for the gross margin percentage increase for the year ended March 31, 2001 were the inclusion in the prior year of an inventory writedown and price protection of \$2.6 million in connection with the discontinued Rocket eBook product line and the incurrence in the prior year of costs associated with the transition to new upgraded reference and ROLODEX(R) Electronics product lines. In addition, during the year ended March 31, 2001, lower margin ROLODEX(R) Electronic products represented 16% of sales compared with 19% of sales in the prior period.

Total operating expenses decreased from \$37.4 million in the year ended March 31, 2000 to \$31.4 million in the year ended March 31, 2001. Sales and marketing expense decreased by \$3.7 million, or 17%, to \$17.7 million. The decrease in sales and marketing expense resulted primarily from a \$1.4 million reduction in expenses that vary directly with sales such as commissions, allowances and freight, a \$1 million reduction in expenses related to development of the Company's website, and lower personnel expenses of \$.7 million.

Research and development expense in the year ended March 31, 2001 decreased to \$4.0 million from \$4.2 million in the prior year as a \$1.1 million increase in personnel costs and a \$.5 million increase in outside development costs were offset by the capitalization of \$3.0 million (including \$2.2 of capitalized costs relating to the new eBookMan platform) of research and development costs in the year ended March 31, 2001 compared with \$1.5 million in the prior year.

General and administrative expense decreased by \$2 million, or 17%, to \$9.7 million for the year ended March 31, 2001. The reduction in general and administrative expense was primarily due to a \$.9 million decrease in amortization of deferred computer software and patents, a \$.4 million decrease in accounts receivable provisions and a \$.5 million reduction in expenses incurred by VPTI.

Interest expense declined from \$3.1 million in the year ended March 31, 2000 to \$1.7 million for the year ended March 31, 2001 due to lower debt levels during the 2001 fiscal year. Other, net consists of transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the US dollar.

Because of net operating loss carryforwards, income taxes have been offset by a reduction in the income tax valuation allowance.

### Inflation and Currency Transactions

Inflation had no significant effect on the operations of the Company for the three years ended March 31, 2002. However, competitive pressures and market conditions in the future may limit the Company's ability to increase prices to compensate for general inflation or increases in prices charged by suppliers.

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The Company's operating results may be affected by fluctuations in currency exchange rates. During the years ended March 31, 2001 and 2002, the Company entered into several foreign exchange forward contracts with financial institutions to limit its exposure to currency fluctuation loss on sales made by its European subsidiaries.

### Seasonality

The Christmas selling season (October, November and December) and the "back to school" season (mid-August to mid-September) are the strongest selling periods for the Company's products. The timing of the publication of new books may also significantly affect revenues and cause quarterly revenues and earnings fluctuations.

The following table sets forth unaudited net sales for each of the Company's last twelve fiscal quarters:

|             | Quarter Ended<br>June 30                 | Quarter Ended<br>September 30 | Quarter Ended<br>December 31 | Quarter Ended<br>March 31 |
|-------------|--|-------------------------------|------------------------------|---------------------------|
|             | -----<br>(dollars in thousands)<br>----- |                               |                              |                           |
| Fiscal 2002 | \$16,009                                 | \$18,714                      | \$23,284                     | \$13,018                  |
| Fiscal 2001 | 17,052                                   | 20,511                        | 22,434                       | 19,969                    |
| Fiscal 2000 | 19,936                                   | 30,445                        | 31,397                       | 15,300                    |

### Future Income Tax Benefits

The Company has income tax benefits of \$18.5 million which can be utilized against future earnings. Further, as a result of the VPTI acquisition, the Company has additional future income tax benefits of \$9.3 million which can be utilized against future earnings of VPTI. The Company has provided an income tax valuation allowance of \$22.1 million against these tax assets. The remaining \$5.7 million balance represents the amount that the Company believes that it can reasonably expect to utilize in the foreseeable future.

### Liquidity and Capital Resources

The Company had cash and cash equivalents of \$2.5 million at March 31, 2002 compared with \$2.8 million at March 31, 2001.

During the year ended March 31, 2002, the Company paid all of its 12-1/2% Senior Notes outstanding in the amount of \$10.4 million.

In March 2001, Dr. James H. Simons, the Company's Chairman of the Board, subscribed to 3,500 share of the Company's Series A 10% Convertible Preferred Stock ("Convertible Preferred Stock") in consideration for the payment of \$3,500,000 which was made in April 2001. No placement agent was used in connection with this transaction. Each share of Convertible Preferred Stock has a stated value ("Stated Value") of one thousand dollars.

The Convertible Preferred Stock may be converted at any time at the election of the holder thereof. Each share of Convertible Preferred Stock is initially convertible into that number of shares of common stock as is determined by dividing the Stated Value by \$5 (the "Conversion Price") which amounts to 753,375 shares of common stock at the present time.

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If at any time while the Convertible Preferred Stock is outstanding the Company sells publicly or privately (i) shares of its common stock (other than any shares of common stock that may be issued pursuant to the Company's Restricted Stock Plan or any successor thereto or upon the exercise of any options theretofore or thereafter granted by the Company to employees, directors or consultants), (ii) securities convertible into shares of its common stock, or (iii) options or warrants (other than options issued to employees, directors or consultants)

16

to purchase shares of its common stock or securities convertible into shares of its common stock at a sale, conversion, or exercise price per share, as the case may be, less than the Conversion Price then in effect, the Conversion Price shall be reset to the sale, conversion or exercise price per share, as the case may be.

In December 1999, the Company entered into a \$25 million secured financing facility which originally was scheduled to expire on December 7, 2002. In January 2002 the maturity of the secured financing facility was extended to December 7, 2004. Borrowings under the revolving credit facility bear interest at the bank's prime rate (4.75% at March 31, 2002) plus 3/4%, and the real property and equipment advances under the facility in the amount of \$4.3 million bear interest at the rate of prime plus 1-1/2%. The facility contains certain financial covenants and restrictions on indebtedness, dividend payments, business combinations, and other related items. As of March 31, 2002, no amounts were available for paying dividends. Borrowings are collateralized by substantially all assets of the Company. As of March 31, 2002 the Company had an outstanding balance of \$10.1 million under the facility and is in compliance with all covenants.

Management believes that cash flow from operations and the secured financing facility will be adequate to provide for the Company's liquidity and capital needs for the foreseeable future.

The Company has no material commitments for capital expenditures in the next twenty-four months.

### Critical Accounting Policies and Estimates

Management's discussion and analysis of financial condition and results of operations are based upon the Company's consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures. On an ongoing basis, the Company evaluates its estimates and judgments based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. The Company annually reviews its financial reporting and disclosure practices and accounting policies to ensure that its financial reporting and disclosures provide accurate and transparent information relative to the current economic and business environment. The Company believes that of its significant accounting policies (see summary of significant accounting policies more fully described on Note 2 of notes to our consolidated financial statements), the following policies involve a higher degree of judgment and/or complexity:

eBookman assets--The Company periodically reviews the eBookman assets relative to physical and historical factors, economic factors and industry

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trends. During the year ended March 31, 2002, the Company recorded a write-down of eBookman assets in the amount of \$9,874. As of March 31, 2002 the Company had inventory of eBookman products with a carrying value of approximately \$1.5 million. All other assets pertaining to eBookman have been written off.

Asset impairment--In assessing the recoverability of the Company's fixed assets, goodwill and other non-current assets, the Company considers changes in economic conditions and makes assumptions regarding estimated future cash flows and other factors. During the year ended March 31, 2002, the Company recorded a charge for impairment in value of its ROLODEX(R) Electronics trademark of \$11,147.

### Recent Accounting Pronouncements

In June 2001, The Financial Accounting Standards Board (FASB) issued SFAS No.141, Business Combinations, and SFAS No.142, Goodwill and Other Intangible Assets. The Company is required to adopt SFAS No.141 for all business combinations completed after June 30, 2001. This standard requires that business combinations initiated after June 30, 2001, be accounted for under the purchase method. Goodwill and other intangible assets that resulted from business combinations before July 1, 2001, must be reclassified to conform to the requirements of SFAS No. 142, as of the statement adoption date.

17

The Company will adopt SFAS No.142 at the beginning of April 2002 for all goodwill and other intangible assets recognized in the Company's statement of financial position as of April 1, 2002. This standard changes the accounting for goodwill from an amortization method to an impairment-only approach, and introduces a new model for determining impairment charges.

The Company estimates that the implementation of these standards will reduce amortization expense by approximately \$300 per year. The Company will no longer amortize goodwill.

The Company's Intangible Assets are stated at fair value after an impairment charge as stated in Note 2.

Additionally, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations" and SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" during 2001. SFAS No. 143 related to obligations which generally are incurred in connection with the ownership of real property. SFAS No. 144 superseded SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and the accounting and reporting provisions of Accounting Principles Board Opinion No.30, "Reporting the Results of Operations and Transactions," "Reporting the Effects of Disposal of a Segment of a Business," and "Extraordinary, Unusual and Infrequently Occurring Events and Transactions" for the disposal of a segment of a business. SFAS No. 144 also amended Accounting Research Bulletin No. 51, "Consolidated Financial Statements," to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The Company believes the adoption of these standards will have no material impact on its financial condition, results of operations or cash flows.

In April 2002, the FASB issued SFAS No. 145. This Statement rescinds FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt, and an amendment of that Statement, FASB Statement No. 64, Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements. This Statement also rescinds FASB Statement No. 44, Accounting for Intangible Assets of Motor Carriers. This Statement amends FASB Statement No. 13, Accounting for Leases, to eliminate an

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inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. This Statement also amends other existing authoritative pronouncements. The Company does not expect this Statement to have any material impact on its financial statements.

18

### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

#### INDEX TO FINANCIAL STATEMENTS

|  | Page |
|--|------|
|  | ---- |
| Independent Auditor's Report.....              | 20   |
| Consolidated Statements of Operations          |      |
| Years ended March 31, 2002, 2001 and 2000.     | 21   |
| Consolidated Balance Sheets                    |      |
| March 31, 2002 and 2001.....                   | 22   |
| Consolidated Statements of Cash Flows          |      |
| Years ended March 31, 2002, 2001 and 2000.     | 23   |
| Consolidated Statement of Shareholders' Equity |      |
| Years ended March 31, 2002, 2001 and 2000.     | 24   |
| Notes to Consolidated Financial Statements     |      |
| Years ended March 31, 2002, 2001 and 2000.     | 25   |

19

#### INDEPENDENT AUDITORS' REPORT

Shareholders and Directors of  
Franklin Electronic Publishers, Incorporated  
Burlington, New Jersey 08016

We have audited the accompanying consolidated balance sheets of Franklin Electronic Publishers, Incorporated and subsidiaries as of March 31, 2002 and March 31, 2001 and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years ended March 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.



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In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Franklin Electronic Publishers, Incorporated and subsidiaries as of March 31, 2002 and March 31, 2001, and the results of its operations and cash flows for each of the three years ended March 31, 2002 in conformity with accounting principles generally accepted in the United States.

/s/RADIN, GLASS & CO., LLP  
Certified Public Accountants

New York, New York  
June 12, 2002

20

### FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

#### CONSOLIDATED STATEMENT OF OPERATIONS (in thousands, except for per share data)

|   | Year Ended March 31, |          |          |
|---|----------------------|----------|----------|
|   | 2002                 | 2001     | 2000     |
| Sales.....  | \$ 71,025            | \$79,966 | \$97,078 |
| Cost of Sales.....                                  | 41,416               | 45,568   | 61,223   |
| Write-down of eBookMan Inventory and product costs. | 8,622                | --       | --       |
| Gross Margin.....                                   | 20,987               | 34,398   | 35,855   |
| Expenses:   |                      |          |          |
| Sales and marketing.....                            | 21,090               | 17,668   | 21,397   |
| Research and development.....                       | 3,952                | 3,973    | 4,215    |
| General and administrative.....                     | 9,456                | 9,752    | 11,746   |
| Trademark impairment.....                           | 11,147               | --       | --       |
| Total operating expenses.....                       | 45,645               | 31,393   | 37,358   |
| Operating Income (Loss).....                        | (24,658)             | 3,005    | (1,503)  |
| Interest expense.....                               | (1,514)              | (1,712)  | (3,086)  |
| Interest and investment income.....                 | 158                  | 217      | 355      |
| Other, net.....                                     | (622)                | (596)    | (1,162)  |
| Gain on Sale of REX.....                            | --                   | --       | 8,072    |
| Income (Loss) Before Income Taxes.....              | (26,636)             | 914      | 2,676    |
| Income Tax (Benefit) Provision.....                 | --                   | --       | --       |
| Net Income (Loss).....                              | \$ (26,636)          | \$ 914   | \$ 2,676 |
| Preferred Stock Dividend.....                       | 267                  | --       | --       |
| Net Income (Loss) Applicable To Common Stockholders | \$ (26,903)          | \$ 914   | \$ 2,676 |
| Net Income (Loss) Per Common Share:                 |                      |          |          |
| Basic.....  | \$ (3.38)            | \$ 0.12  | \$ 0.34  |

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|                                 |           |         |         |
|---------------------------------|-----------|---------|---------|
| Diluted.....                    | \$ (3.38) | \$ 0.11 | \$ 0.34 |
|                                 | =====     | =====   | =====   |
| Weighted Average Common Shares: |           |         |         |
| Basic.....                      | 7,948     | 7,922   | 7,861   |
|                                 | =====     | =====   | =====   |
| Diluted.....                    | 7,948     | 8,217   | 7,931   |
|                                 | =====     | =====   | =====   |

See notes to consolidated financial statements.

21

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS  
(in thousands, except share data)

|  | March 31  | March 31  |
|--|-----------|-----------|
|  | 2002      | 2001      |
|  | -----     | -----     |
| Assets   |           |           |
| Current Assets:  |           |           |
| Cash and cash equivalents (Note 3).....  | \$ 2,497  | \$ 2,497  |
| Accounts receivable, less allowance for doubtful accounts of \$1,112 and \$1,161.... | 6,932     | 6,932     |
| Preferred stock subscriptions receivable.....  | --        | --        |
| Inventories (Note 4).....  | 11,107    | 11,107    |
| Income tax receivable.....   | 809       | 809       |
| Prepays and other assets.....  | 2,354     | 2,354     |
|  | -----     | -----     |
| Total Current Assets.....  | 23,699    | 23,699    |
|  | -----     | -----     |
| Property and Equipment (Note 5).....   | 6,988     | 6,988     |
|  | -----     | -----     |
| Other Assets:  |           |           |
| Deferred income tax asset (Note 12).....   | 5,700     | 5,700     |
| Trademark (Note 2).....  | 2,263     | 2,263     |
| Advance royalties and licenses.....  | 580       | 580       |
| Software development costs.....  | 2,583     | 2,583     |
| Other assets (Note 6).....   | 5,489     | 5,489     |
|  | -----     | -----     |
| Total Other Assets.....  | 16,615    | 16,615    |
|  | -----     | -----     |
| Total Assets.....  | \$ 47,302 | \$ 47,302 |
|  | =====     | =====     |
| Liabilities and Shareholders' Equity   |           |           |
| Current Liabilities:   |           |           |
| Accounts payable and accrued expenses (Note 7).....                                  | \$ 11,409 | \$ 11,409 |
| Notes payable (Note 8).....  | --        | --        |
| Current portion of long-term liabilities--Other.....                                 | 35        | 35        |
|  | -----     | -----     |
| Total Current Liabilities.....   | 11,444    | 11,444    |
|  | -----     | -----     |
| Long-Term Liabilities (Note 8):  |           |           |
| Notes payable.....   | --        | --        |
| Revolving credit facility.....   | 10,138    | 10,138    |

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|  |           |
|--|-----------|
| Other liabilities.....   | 1,412     |
| Total Long-Term Liabilities.....   | 11,550    |
| Shareholders' Equity (Note 11):  |           |
| Preferred stock, \$2.50 par value, authorized 10,000,000 shares, 3,767 issued and outstanding (\$3,767 liquidation value)..... | 3,745     |
| Preferred stock subscribed.....  | --        |
| Common stock, no par value, authorized 50,000,000 shares, issued and outstanding, 7,946,882 and 7,952,882 shares.....          | 49,978    |
| Retained earnings (deficit).....   | (28,255)  |
| Foreign currency translation adjustment (Note 2).....  | (1,160)   |
| Total Shareholders' Equity.....  | 24,308    |
| Total Liabilities and Shareholders' Equity.....  | \$ 47,302 |

See notes to consolidated financial statements.

22

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS  
(in thousands)

|   | Year Ended Ma |         |
|---|---------------|---------|
|   | 2002          | 2001    |
| Cash Flows From Operating Activities:                                 |               |         |
| Net Income (Loss).....  | \$ (26,636)   | \$ 914  |
| Adjustments to Reconcile Net Income (Loss)                            |               |         |
| To Net Cash Provided by Operating Activities                          |               |         |
| Depreciation and amortization.....                                    | 5,282         | 5,228   |
| Non-cash interest expense.....  | 75            | 180     |
| Provision for losses on accounts receivable.....                      | 330           | 201     |
| Provision for inventory revaluation.....                              | --            | --      |
| Provision for eBookMan inventory, assets and obligations.....         | 9,874         | --      |
| Loss (gain) on disposal of property and equipment.....                | (64)          | 5       |
| Trademark write-down.....   | 11,147        | --      |
| Stock options issued for services.....                                | 314           | 255     |
| Gain on sale of REX.....  | --            | --      |
| Source (use) of cash from change in operating assets and liabilities: |               |         |
| Accounts receivable.....  | 4,907         | (1,407) |
| Inventories.....  | 3,508         | (7,145) |
| Prepays and other assets.....   | (458)         | (1,806) |
| Accounts payable and accrued expenses.....                            | (2,698)       | 3,572   |
| Other, net.....   | (23)          | (4)     |
| Net Cash Provided by (Used in) Operating Activities.....              | 5,558         | (7)     |
| Cash Flows From Investing Activities:                                 |               |         |
| Purchase of property and equipment.....                               | (1,089)       | (1,735) |
| Proceeds from sale of property and equipment.....                     | 289           | --      |

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|  |          |          |
|--|----------|----------|
| Software development costs.....                          | (1,116)  | (3,052)  |
| Proceeds from sale of REX line.....                      | --       | --       |
| Redemption of investments in limited partnerships.....   | --       | --       |
| Enterprise Resource system costs.....                    | (3,240)  | (369)    |
| Change in other assets.....                              | (24)     | (429)    |
|  | -----    | -----    |
| Net Cash Provided by (Used in) Investing Activities..... | (5,180)  | (5,585)  |
|  | -----    | -----    |
| Cash Flows From Financing Activities:                    |          |          |
| Principal payments of mortgage.....                      | --       | --       |
| Principal payments of Senior Notes.....                  | (10,404) | (2,000)  |
| Proceeds from revolving credit facility.....             | 6,074    | 4,064    |
| Proceeds from issuance of common shares.....             | --       | 244      |
| Proceeds from issuance of preferred shares.....          | 3,478    | --       |
| Other liabilities.....                                   | (233)    | 14       |
|  | -----    | -----    |
| Net Cash (Used in) Provided by Financing Activities..... | (1,085)  | 2,322    |
|  | -----    | -----    |
| Effect of Exchange Rate Changes on Cash.....             | 369      | (794)    |
|  | -----    | -----    |
| Decrease in Cash and Cash Equivalents.....               | (338)    | (4,064)  |
| Cash and Cash Equivalents at Beginning of Period.....    | 2,835    | 6,899    |
|  | -----    | -----    |
| Cash and Cash Equivalents at End of Period.....          | \$ 2,497 | \$ 2,835 |
|  | =====    | =====    |
| Supplemental Data:                                       |          |          |
| Cash paid during the year:                               |          |          |
| Income taxes.....  | \$ 12    | \$ 20    |
| Interest.....  | \$ 1,439 | \$ 1,532 |

See notes to consolidated financial statements.

23

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY  
(in thousands, except for share data)

|   | Common Stock |          | Preferred Stock |        | Retained   | Accumu  |
|---|--------------|----------|-----------------|--------|------------|---------|
|   | Shares       | Amount   | Shares          | Amount | Earnings   | Oth     |
|   | -----        | -----    | -----           | -----  | -----      | Compreh |
|   |              |          |                 |        |            | Inco    |
|   | -----        | -----    | -----           | -----  | -----      | -----   |
| Balance--March 31, 1999.....  | 7,832,955    | \$48,784 | --              | \$ --  | \$ (4,942) | \$ (    |
| Issuance of common shares under employee<br>stock option plan.....  | 40,259       | 153      |                 |        | --         |         |
| Issuance of shares and amortization of<br>deferred compensation expense for shares<br>issued for services (unearned portion<br>\$47)..... | 19,250       | 16       |                 |        | --         |         |
| Value of stock options granted.....   | --           | 75       |                 |        | --         |         |
| Shares issued under banked vacation stock<br>plan.....  | 22,476       | 110      |                 |        | --         |         |
| Income for the period.....  | --           | --       |                 |        | 2,676      |         |
| Foreign currency translation adjustment...  | --           | --       |                 |        | --         |         |

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|  |           |          |       |         |            |       |
|--|-----------|----------|-------|---------|------------|-------|
| Balance--March 31, 2000.....   | 7,914,940 | 49,138   | --    | --      | (2,266)    | (     |
| Issuance of common shares under employee stock option plan.....  | 37,942    | 244      |       |         | --         |       |
| Issuance of shares and amortization of deferred compensation expense for shares issued for services (unearned portion \$26)..... | --        | 21       |       |         | --         |       |
| Value of stock options granted.....  | --        | 255      |       |         | --         |       |
| Preferred stock subscribed.....  |           |          | 3,500 | 3,500   |            |       |
| Income for the period.....   | --        | --       |       |         | 914        |       |
| Foreign currency translation adjustment...   | --        | --       |       |         | --         | (     |
| Balance--March 31, 2001.....   | 7,952,882 | 49,658   | 3,500 | 3,500   | (1,352)    | (1,   |
| Issuance of shares and amortization of deferred compensation expense for shares issued for services (unearned portion \$4).....  | (6,000)   | 6        |       |         | --         |       |
| Value of stock options granted.....  | --        | 314      |       |         | --         |       |
| Preferred stock dividend.....  |           |          | 267   | 267     | (267)      |       |
| Costs incurred in issuance of preferred stock.....   |           |          |       | (22)    |            |       |
| Loss for the period.....   | --        | --       |       |         | (26,636)   |       |
| Foreign currency translation adjustment...   | --        | --       |       |         | --         |       |
| Balance--March 31, 2002.....   | 7,946,882 | \$49,978 | 3,767 | \$3,745 | \$(28,255) | \$(1, |

\* Comprehensive income, i.e., net income (loss), plus, or less, the change in foreign currency balance sheet translation adjustments, totaled \$(26,268) in 2002, \$120 in 2001, and \$2,739 in 2000.

See notes to consolidated financial statements.

24

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(In thousands, except share and per share data)

1. Line of Business

Franklin Electronic Publishers, Incorporated and its wholly-owned subsidiaries (the "Company") design, develop, publish, and distribute handheld electronic information products, such as electronic books (sometimes known as eBooks), organizer products and related software. Other activities represent less than 10% of sales, operating income and identifiable assets.

2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, after elimination of intercompany accounts and transactions. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates

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and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### Inventories

Inventories are valued at the lower of cost or market determined by the first-in, first-out method of accounting.

### Property and Equipment

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the assets, ranging from three to five years for furniture, equipment, tooling and computer software purchased and 40 years for building and improvements.

Leasehold improvements are amortized over the term of the lease or the estimated life of the improvement, whichever is shorter. When assets are sold or retired, their cost and related accumulated depreciation are removed from the appropriate accounts. Any gains or losses on dispositions are recorded in current operations. Maintenance and minor repairs are charged to operations as incurred.

### Trademark

The ROLODEX(R) Electronics trademark is carried at fair value, which was determined by the discounted cash flow method. During the year ended March 31, 2002, the Company recorded a charge for impairment in value of the trademark of \$11,147.

### Other Assets

Other Assets primarily includes Goodwill and Enterprise Resource System Software. Goodwill of purchased businesses is recorded at cost less amortization through March 31, 2002. Enterprise Resource System Software is being amortized over its estimated useful life.

### Freight Billed

The Company recognizes amounts billed to a customer in a sale transaction related to shipping and handling as revenue earned for the goods provided and is classified as sales revenue.

25

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)  
(In thousands, except share and per share data)

### Revenue

The Company recognizes revenue when it is realized. The Company considers revenue realized when the product has been shipped or the services have been provided to the customer, and collectibility is reasonably assured. The Company's sales are made with right of return or exchange for defective products within one year from the original retail purchase. Revenue is reduced for estimated customer returns and other allowances. The Company provides for

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the cost of refurbishing returned products.

### Price Protection

The Company maintains a policy of providing price protection to its dealers under which the Company issues credits in the event it reduces its prices. These credits are generally computed by multiplying either the number of units purchased within ninety days prior to the price reduction or the number of units on hand at retail at the time of the price reduction by the dollar amount of the price reduction. A provision for the related reduction in sales is made at such time as the Company determines that a price reduction will be effective or is reasonably anticipated.

### Software Development Costs

The capitalization of such costs and the related amortization is in accordance with SFAS No. 86. Software costs, which are capitalized after technological feasibility is established, totaled \$1,083, \$3,052 and \$1,500 for the fiscal years ended March 31, 2002, 2001, and 2000, respectively.

Amortization included in the accompanying Consolidated Statement of Operations for fiscal years ended March 31, 2002, 2001, and 2000, was \$4,034, \$2,025 and \$1,989, respectively. Amortization for the year ended March 31, 2002 includes a writedown of eBookMan related costs of \$1,760.

### Advertising Costs

Advertising costs are expensed as incurred except for direct response advertising, the costs of which are deferred and amortized over the period the related sales are recorded.

### Fair Value of Financial Instruments

The carrying amounts reported in the balance sheet for cash, trade receivables, accounts payable and accrued expenses approximate fair value based on the short-term maturity of these instruments. The carrying amount of the Company's borrowings under the Senior Notes and revolving credit facility approximates fair value.

### Foreign Currency Translation

Unrealized gains and losses resulting from translating foreign subsidiaries' assets and liabilities into U.S. dollars are deferred in an equity account on the balance sheet until such time as the subsidiary is sold or liquidated.

As of March 31, 2002 the Company had one outstanding foreign exchange contract entered into with a financial institution to limit its exposure to loss, resulting from fluctuations in the value of the Euro. The market value of this contract was \$(29) on March 31, 2002 and a loss for the same amount was recorded during the

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)  
(In thousands, except share and per share data)

period. The duration of these contracts does not exceed one year. As of March 31, 2001 the Company had three outstanding foreign exchange contracts with a

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market value of \$74.

### Accounting for Long-Lived Assets

The Company reviews long-lived assets, certain identifiable assets and any goodwill related to those assets for impairment whenever circumstances and situations change such that there is an indication that the carrying amounts may not be recoverable. At March 31, 2002, the Company believes that there has been no impairment of its long-lived assets other than the trademark asset referred to above.

### Income Taxes

The Company utilizes the liability method of accounting for income taxes. Under the liability method, deferred taxes are determined based on the difference between the financial statement and tax basis of assets and liabilities using tax rates in effect in the years in which the differences are expected to reverse.

### Earnings (Loss) Per Share

Earnings (Loss) per common share are computed by dividing income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period. The earnings per common share computation, assuming dilution, gives effect to all potential dilutive common shares during the period. The computation assumes that the outstanding stock options and warrants were exercised and that the proceeds were used to purchase common shares of the Company.

### Stock Based Compensation

The Company accounts for stock transactions in accordance with APB Opinion No. 25, "Accounting For Stock Issued To Employees." Accordingly, no compensation is recorded on the issuance of employee stock options at fair market value.

### Reclassifications

Certain reclassifications have been made to the prior years' financial statements to conform to the current year presentation. These reclassifications had no effect on previously reported results of operations or retained earnings.

### 3. Cash and Cash Equivalents

The Company classifies as cash equivalents highly liquid investments with maturities of less than ninety days.

### 4. Inventories

Inventories consist of:

|                   | March 31, |          |
|-------------------|-----------|----------|
|                   | 2002      | 2001     |
| Finished products | \$ 8,950  | \$16,033 |
| Component parts.. | 2,157     | 4,846    |
|                   | -----     | -----    |
|                   | \$11,107  | \$20,879 |



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FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)  
(In thousands, except share and per share data)

5. Property and Equipment

Property and equipment consist of:

|   | March 31, |          |
|---|-----------|----------|
|   | 2002      | 2001     |
|   | -----     | -----    |
| Land.....                                 | \$ 803    | \$ 843   |
| Building and improvements.....            | 5,353     | 5,599    |
| Furniture and equipment.....              | 7,174     | 7,040    |
| Tooling.....                              | 6,388     | 5,766    |
| Computer software purchased.....          | 2,459     | 2,366    |
|   | -----     | -----    |
|   | 22,177    | 21,614   |
| Accumulated depreciation and amortization | 15,189    | 13,963   |
|   | -----     | -----    |
|   | \$ 6,988  | \$ 7,651 |
|   | =====     | =====    |

6. Other Assets

Other Assets consist of:

|                                     | March 31, |         |
|-------------------------------------|-----------|---------|
|                                     | 2002      | 2001    |
|                                     | -----     | -----   |
| Trademarks & Patents.....           | \$ 261    | \$ 336  |
| Goodwill.....                       | 1,408     | 1,842   |
| Enterprise Resource System Software | 3,175     | 369     |
| Other.....                          | 645       | 808     |
|                                     | -----     | -----   |
|                                     | \$5,489   | \$3,355 |
|                                     | =====     | =====   |

7. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses consist of:

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|  | March 31, |          |
|--|-----------|----------|
|  | 2002      | 2001     |
| Trade accounts payable.....                        | \$ 3,324  | \$ 7,125 |
| Accrued payroll, bonus, payroll benefits and taxes | 2,015     | 1,811    |
| Accrued restructuring costs.....                   | --        | 37       |
| Accrued sales allowances.....                      | 2,357     | 1,553    |
| Accrued royalties.....                             | 346       | 555      |
| Accrued expenses - other.....                      | 3,367     | 2,566    |
|  | -----     | -----    |
|  | \$11,409  | \$13,647 |
|  | =====     | =====    |

28

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)  
(In thousands, except share and per share data)

8. Long-Term Liabilities

Long-term liabilities consist of:

|                           | March 31, |          |
|---------------------------|-----------|----------|
|                           | 2002      | 2001     |
| Senior Notes payable..... | --        | \$10,329 |
| Revolving credit facility | \$10,138  | 4,064    |
| Other.....                | 1,447     | 1,710    |
|                           | -----     | -----    |
|                           | 11,585    | 16,103   |
| Less current portion..... | 35        | 2,156    |
|                           | -----     | -----    |
|                           | \$11,550  | \$13,947 |
|                           | =====     | =====    |

During the year ended March 31, 2002, the Company prepaid all of its Senior Notes in the amount of \$10,404.

The maturities of long-term liabilities for the five years after March 31, 2002 are as follows:

| Years Ending March 31, |            |
|------------------------|------------|
| -----                  |            |
| 2003..                 | 35 2006 28 |
| 2004..                 | 28 2007 28 |

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2005.. 10,166

In December 1999, the Company entered into a \$25,000 secured financing facility which originally expired on December 7, 2002. In January 2002 the maturity of the secured financing facility was extended to December 7, 2004. Borrowings under the facility bear interest at the bank's prime rate (4.75% at March 31, 2001) plus 3/4%, the real property and equipment advances under the facility in the amount of \$4,313 bear interest at the rate of prime plus 1-1/2%. The facility contains certain financial covenants and restrictions on indebtedness, dividend payments, business combinations, and other related items. As of March 31, 2002 no amounts were available for paying dividends. Borrowings are collateralized by substantially all assets of the Company. As of March 31 2002 the Company had an outstanding balance of \$10,138 under the facility and is in compliance with all covenants.

9. Advertising and Media Costs

Advertising costs for the years ended March 31, 2002, 2001 and 2000 were \$6,611, \$5,725 and \$6,412, respectively. Deferrals of direct response advertising were not material.

10. Commitments

Lease Commitments

Rent expense under all operating leases was \$795, \$866 and \$1,111 for the years ended March 31, 2002, 2001 and 2000, respectively. The future minimum rental payments to be made under non-cancellable operating leases, principally for facilities, as of March 31, 2002 were as follows:

| Years Ending March 31, |            |
|------------------------|------------|
| -----                  |            |
| 2003.. \$394           | 2006 \$112 |
| 2004.. \$319           | 2007 \$112 |
| 2005.. \$ 234          |            |

29

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)  
(In thousands, except share and per share data)

Royalty Agreements

The Company acquires the rights to reference works and databases from various publishers and technology companies under renewable contracts of varying terms. Royalties and license fees are based on a per unit charge or as a percentage of revenue from products utilizing such databases or software licenses.

Litigation

The Company is subject to litigation from time to time arising in the

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ordinary course of its business. The Company does not believe that any such litigation is likely, individually or in the aggregate, to have a material adverse effect on the financial condition of the Company.

### 11. Shareholders' Equity

#### Restricted Stock Plan and Unearned Portion of Common Stock Issued for Services

The Company maintains a Restricted Stock Plan which provides for the grant of shares of common stock for services. The shares are subject to a restriction on transfer which requires the holder to remain employed by the Company for up to three years in order to receive the shares. As of March 31, 2002 under the Plan, 12,450 shares of common stock were available for distribution by the Board of Directors.

#### Employee Stock Options

Under the 1998 Plan, 2,500,000 shares of common stock have been reserved for issuance. The Plan authorizes the Company to grant options to purchase shares of common stock to key employees, consultants and outside directors of the Company.

The Plan provides for granting of options to purchase shares of common stock at not less than the fair market value on the date of grant for incentive stock options and at not less than 75% of the fair market value on the date of grant for non-incentive stock options. An option may not be granted for a period in excess of ten years from the date of grant. Options are not transferable by the optionee other than upon death.

Under the terms of the Plan, an employee may deliver shares of common stock as payment for options being exercised. The shares are valued at the closing price on the date of exercise.

During the years ended March 31, 2002 and 2001, respectively, the company granted 100,000 and 74,500 options to persons performing consulting services for the company. The options were valued at a total of \$207 and \$437 using the Black-Scholes option-pricing model with the expense being amortized over the vesting period of the options. The current year's results of operations include \$314 of expense related to these options.

#### Accounting for Employee Stock Options

No compensation expense is recognized for options granted at fair market value in the results of operations for its stock option plan. For disclosure purposes, the fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for stock options granted during the years ended March 31, 2002, 2001, and 2000, respectively: annual dividends of \$0.00 for all years, expected volatility of 85.8%, 110.8%, and 116.0%, risk-free interest rate of 4.6%, 5.8% and 5.8% and expected life of five years for all grants. The number of shares granted, the weighted-

30

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)  
(In thousands, except share and per share data)

average exercise price and weighted average fair value of the stock options

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granted during the years ended March 31, 2002, 2001, and 2000 was as follows:

|   | Number<br>of Shares<br>Granted | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Fair<br>Value |
|---|--------------------------------|---|---------------------------------------|
| Year ended March 31, 2000:                |                                |   |                                       |
| Exercise price equals market value.....   | 217,000                        | \$5.71                                    | \$4.75                                |
| Exercise price greater than market value. | 489,000                        | \$4.00                                    | \$2.38                                |
| Exercise price less than market value.... | 27,000                         | \$5.69                                    | \$4.95                                |
|   | 733,000                        | \$4.57                                    | \$3.17                                |
|   | =====                          | =====                                     | =====                                 |
| Year ended March 31, 2001:                |                                |   |                                       |
| Exercise price equals market value.....   | 554,354                        | \$7.35                                    | \$6.07                                |
| Exercise price greater than market value. | 84,000                         | \$8.50                                    | \$4.26                                |
| Exercise price less than market value.... | 25,000                         | \$6.81                                    | \$8.70                                |
|   | 663,354                        | \$7.47                                    | \$5.94                                |
|   | =====                          | =====                                     | =====                                 |
| Year ended March 31, 2002                 |                                |   |                                       |
| Exercise price equals market value.....   | 399,053                        | \$2.22                                    | \$1.59                                |
| Exercise price greater than market value. | 528,714                        | \$3.78                                    | \$1.28                                |
|   | 927,767                        | \$3.11                                    | \$1.42                                |
|   | =====                          | =====                                     | =====                                 |

If the Company recognized compensation cost for the employee stock option plan in accordance with SFAS No. 123, the Company's pro-forma net income (loss) and earnings (loss) per share would have been \$(28.1) million and \$(3.54) in 2002, \$(0.2) million and \$(0.02) in 2001, and \$1.5 million and \$.19 in 2000.

The following table summarizes the changes in options outstanding and the related price ranges for shares of common stock:

| Stock Options                 |           |                                    |
|-------------------------------|-----------|------------------------------------|
|                               | Shares    | Weighted Average<br>Exercise Price |
| Outstanding at March 31, 1999 | 1,589,730 | 15.13                              |
| Granted.....                  | 733,000   | 4.57                               |
| Exercised.....                | (40,259)  | 3.81                               |
| Expired or cancelled.....     | (553,763) | 20.24                              |
|                               | 1,728,708 | 9.28                               |
| Outstanding at March 31, 2000 | 1,728,708 | 9.28                               |
| Granted.....                  | 663,354   | 7.47                               |
| Exercised.....                | (37,942)  | 7.08                               |
| Expired or cancelled.....     | (227,275) | 10.74                              |
|                               | 2,126,845 | 8.60                               |
| Outstanding at March 31, 2001 | 2,126,845 | 8.60                               |
| Granted.....                  | 927,767   | 3.11                               |
| Exercised.....                | --        | --                                 |
| Expired or cancelled.....     | (411,138) | 8.66                               |

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-----  
 Outstanding at March 31, 2002 2,643,474 6.66  
 =====

31

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)  
 (In thousands, except share and per share data)

The following table summarizes information about stock options outstanding at March 31, 2002:

| Range of Exercise Prices | Options Outstanding |   |                                 | Options Exercisable |                                 |
|--------------------------|---------------------|---|---------------------------------|---------------------|---------------------------------|
|                          | Number Outstanding  | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable  | Weighted Average Exercise Price |
| \$ 1.30-\$ 2.80          | 338,553             | 9.51  | \$ 2.09                         | --                  | \$ --                           |
| 3.01- 3.50               | 450,214             | 9.91  | \$ 3.48                         | --                  | \$ --                           |
| 4.00- 4.88               | 426,263             | 6.81  | \$ 4.11                         | 217,910             | \$ 4.05                         |
| 5.00- 6.81               | 325,000             | 6.18  | \$ 5.56                         | 129,375             | \$ 5.79                         |
| 7.50                     | 404,951             | 7.78  | \$ 7.50                         | 186,238             | \$ 7.58                         |
| 8.50- 11.81              | 393,641             | 5.24  | \$ 9.83                         | 376,016             | \$ 9.78                         |
| 12.38- 31.63             | 304,852             | 3.31  | \$16.02                         | 304,852             | \$16.02                         |
|                          | -----               |   |                                 | -----               |                                 |
| \$ 1.30-\$31.63          | 2,643,474           |   |                                 | 1,214,391           |                                 |
|                          | =====               |   |                                 | =====               |                                 |

Options exercisable and the weighted average exercise price at March 31, 2001 and March 31, 2000 were 1,066,241 options and \$10.90, and 927,042 options and \$12.44, respectively.

Effective March 31, 2001 the Chairman of Franklin's Board of Directors, Dr. James H. Simons, subscribed for 3500 shares of the Company's Series A 10% Convertible Preferred Stock in consideration for the payment of \$3,500. The preferred shares are convertible into common stock at a conversion price of \$5.00 per share and bear dividends at the rate of 10% per year, payable in additional shares of the Convertible Preferred Stock every six months. Payment for the subscribed shares was received by the Company in April 2001.

12. Income Taxes

The components of the net deferred income tax asset are the following:

| March 31, |       |
|-----------|-------|
| 2002      | 2001  |
| -----     | ----- |
|           |       |
| -----     | ----- |

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|  |          |          |
|--|----------|----------|
| US loss carryforward--Franklin.....                    | \$11,460 | \$ 7,385 |
| US loss carryforward--VPTI.....                        | 9,284    | 9,284    |
| Foreign loss carryforward.....                         | 197      | 217      |
| Inventory valuation allowances.....                    | 3,886    | 2,570    |
| Trademark impairment charge, net of prior amortization | 2,692    | --       |
| Other items (taxable) deductible in future years--net. | 315      | (924)    |
|  | -----    | -----    |
|  | 27,834   | 18,532   |
| Deferred income tax valuation allowance.....           | 22,134   | 12,832   |
|  | -----    | -----    |
|  | \$ 5,700 | \$ 5,700 |
|  | =====    | =====    |

Deferred income taxes result from temporary differences between income tax and financial reporting computed at the effective income tax rate. A valuation allowance has been provided to reduce the deferred income tax asset to the amount which is expected more likely than not to be realized.

The loss carryforward of Voice Powered Technology International, Inc. ("VPTI") can be offset against future taxable income of VPTI and of Franklin under certain circumstances. The deferred asset relating to VPTI's loss carryforward has been offset by a valuation allowance.

32

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)  
(In thousands, except share and per share data)

There was no provision for income taxes during the periods.

The reconciliation of income taxes shown in the financial statements and amounts computed by applying the Federal income tax rate of 35% for the years ended March 31, 2002, 2001 and 2000 is as follows:

|                                      | Year Ended March 31, |        |          |
|--------------------------------------|----------------------|--------|----------|
|                                      | 2002                 | 2001   | 2000     |
|                                      | -----                | -----  | -----    |
| Income before income taxes.....      | \$ (26,636)          | \$ 914 | \$ 2,676 |
|                                      | =====                | =====  | =====    |
| Computed expected tax.....           | (9,322)              | 320    | 936      |
| Effect of non-deductable expenses... | 50                   | 41     | --       |
| Change in valuation allowance.....   | 9,272                | (361)  | (936)    |
|                                      | -----                | -----  | -----    |
| Provision (benefit) for income taxes | --                   | --     | --       |
|                                      | =====                | =====  | =====    |

Effective April 1, 1997, the Company filed elections with the Internal Revenue Service to treat most of its foreign subsidiaries as divisions of the parent for U.S. income tax reporting.

The loss carry forwards and expiration dates are the following:

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|              | Amounts  | Expiration<br>Dates |
|--------------|----------|---------------------|
|              | -----    | -----               |
| Franklin--US | \$31,800 | 2022                |
| VPTI.....    | \$26,600 | to 2012             |
| Foreign..... | \$ 900   | to 2010             |

13. Operations

Under SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information," the Company's operations are treated as one operating segment, as it only reports profit and loss information on an aggregate basis to the chief operating decision maker of the Company. Information about the Company's product sales and major customers are as follows:

|                        | March 31, |          |          |
|------------------------|-----------|----------|----------|
| Product Sales          | 2002      | 2001     | 2000     |
| -----                  | -----     | -----    | -----    |
| Reference.....         | \$55,939  | \$61,460 | \$69,858 |
| ROLODEX(R) Electronics | 11,652    | 13,062   | 18,348   |
| eBookMan.....          | 2,471     | 5,209    | --       |
| REX.....               | --        | --       | 6,143    |
| Rocket eBook.....      | --        | --       | 1,764    |
| Other.....             | 963       | 235      | 965      |
|                        | -----     | -----    | -----    |
| Total Sales.....       | \$71,025  | \$79,966 | \$97,078 |
|                        | =====     | =====    | =====    |

Approximate foreign sources of revenues including export sales were as follows:

|                     | March 31, |          |          |
|---------------------|-----------|----------|----------|
| Product Sales       | 2002      | 2001     | 2000     |
| -----               | -----     | -----    | -----    |
| Europe.....         | \$17,255  | \$21,702 | \$26,247 |
| Other International | 7,113     | 7,890    | 6,756    |



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For the fiscal years ended March 31, 2002, 2001 and 2000, no customer accounted for more than 10% of the Company's revenues.

For the fiscal year ended March 31, 2002, five suppliers accounted for more than 10% of the Company's purchases of inventory. The five suppliers individually accounted for 19.3%, 13.6%, 13.3%, 12.9% and 11.2% of inventory purchases.

### eBookman Product Line

For the year ended March 31, 2002 the company lost \$14,825 from its eBookman operations. The loss included inventory write-downs of \$6,265, write-off of capitalized software development costs, royalties, licenses and other assets of \$3,179 and accrued price protection of \$430. For the year ended March 31, 2001, the eBookman operating loss was \$3,750. As of March 31, 2002, the Company had eBookman inventory with a carrying value of \$1,500. The company believes it will be able to recover this amount primarily through direct sales to certain customers.

### Sale of REX Product Line

In September 1999 the Company sold its REX product line for \$13,250 and the assumption of related liabilities. The Company realized a gain of \$8,072 on the sale. The assets sold consisted primarily of inventory with a carrying value of approximately \$5,000 and the Company's trademarks, copyrights, contract rights and other assets used in connection with the REX business.

### Restructuring Costs

During the year ended March 31, 2002, costs for the consolidation of Western European Operations approximating \$456 were charged to expense. Severance of \$815 was expensed during the year for changes in management and staff reductions.

### 14. Web Site Development Costs

In accordance with EITF 00-2, "Accounting for Web Site Development Costs" the Company has capitalized \$25 of its web site development costs for the year ended March 31, 2002. No web site development costs were incurred during the years ended March 31, 2001 and 2000, which would be capitalized under EITF 00-2.

### 15. Recent Accounting Pronouncements

In June 2001, The Financial Accounting Standards Board (FASB) issued SFAS No.141, Business Combinations, and SFAS No.142, Goodwill and Other Intangible Assets. The Company is required to adopt SFAS No.141 for all business combinations completed after June 30, 2001. This standard requires that business combinations initiated after June 30, 2001, be accounted for under the purchase method. Goodwill and other intangible assets that resulted from business combinations before July 1, 2001, must be reclassified to conform to the requirements of SFAS No. 142, as of the statement adoption date.

The Company will adopt SFAS No.142 at the beginning of April 2002 for all goodwill and other intangible assets recognized in the Company's statement of financial position as of April 1, 2002. This standard changes the accounting for goodwill from an amortization method to an impairment-only approach, and introduces a new model for determining impairment charges.

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FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)  
(In thousands, except share and per share data)

The Company estimates that the implementation of these standards will reduce amortization expense by approximately \$300 per year. The Company will no longer amortize goodwill.

The Company's Intangible Assets are stated at fair value after an impairment charge as stated in Note 2.

Additionally, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations" and SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" during 2001. SFAS No. 143 related to obligations which generally are incurred in connection with the ownership of real property. SFAS No. 144 superseded SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and the accounting and reporting provisions of Accounting Principles Board Opinion No.30, "Reporting the Results of Operations and Transactions," "Reporting the Effects of Disposal of a Segment of a Business," and "Extraordinary, Unusual and Infrequently Occurring Events and Transactions" for the disposal of a segment of a business. SFAS No. 144 also amended Accounting Research Bulletin No. 51, "Consolidated Financial Statements," to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The Company believes the adoption of these standards will have no material impact on its financial condition, results of operations or cash flows.

In April 2002, the FASB issued SFAS No. 145. This Statement rescinds FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt, and an amendment of that Statement, FASB Statement No. 64, Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements. This Statement also rescinds FASB Statement No. 44, Accounting for Intangible Assets of Motor Carriers. This Statement amends FASB Statement No. 13, Accounting for Leases, to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. This Statement also amends other existing authoritative pronouncements. The Company does not expect this Statement to have any material impact on its financial statements.

35

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)  
(In thousands, except share and per share data)

16. Summarized Quarterly Financial Data (Unaudited)

|             | Quarter Ended |              |             |          |
|-------------|---------------|--------------|-------------|----------|
|             | June 30       | September 30 | December 31 | March 31 |
| Fiscal 2002 |               |              |             |          |

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|   |          |          |          |            |
|---|----------|----------|----------|------------|
| Net sales.....                                | \$16,009 | \$18,714 | \$23,284 | \$ 13,018  |
| Gross margin.....                             | 6,647    | 3,839    | 11,034   | (569)      |
| Net income (loss).....                        | (2,045)  | (5,963)  | 1,203    | (20,186)C. |
| Net income (loss) per share:                  |          |          |          |            |
| Earnings per common share.....                | (.26)    | (.75)    | .15      | (2.54)     |
| Earnings per common share--assuming dilution. | (.26)    | (.75)    | .15      | (2.54)     |

Fiscal 2001

|   |          |          |          |           |
|---|----------|----------|----------|-----------|
| Net sales.....                                | \$17,052 | \$20,511 | \$22,434 | \$ 19,969 |
| Gross margin.....                             | 7,460    | 8,812    | 9,639    | 8,487     |
| Net income (loss).....                        | 433      | 208      | 524      | (251)     |
| Net income (loss) per share:                  |          |          |          |           |
| Earnings per common share.....                | 0.05     | 0.03     | 0.07     | (0.03)    |
| Earnings per common share--assuming dilution. | 0.05     | 0.02     | 0.06     | (0.03)    |

Fiscal 2000

|   |           |          |          |           |
|---|-----------|----------|----------|-----------|
| Net sales.....                                | \$19,936  | \$30,445 | \$31,397 | \$ 15,300 |
| Gross margin.....                             | 4,893     | 10,759   | 12,214   | 7,989     |
| Net income (loss).....                        | (8,607)A. | 9,748B.  | 2,060    | (525)     |
| Net income (loss) per share:                  |           |          |          |           |
| Earnings per common share.....                | (1.10)    | 1.24     | 0.26     | (0.07)    |
| Earnings per common share--assuming dilution. | (1.10)    | 1.24     | 0.26     | (0.07)    |

- 
- A. The loss of \$8.6 million in the quarter ended June 30, 1999 includes an inventory writedown and price protection \$2.6 million in connection with the Rocket eBook, \$2.3 million in connection with the transition to the new upgraded product lines and restructuring charges of \$1.1 million, which include severance related to a 15% reduction in personnel effected during the June 1999 quarter and expenses related to the closing of certain of the Company's foreign subsidiaries.
- B. See Note 13.
- C. After a charge of \$11,147 for impairment in value of the Rolodex(R) Electronics trademark, a charge of \$9,874 in the year and \$5,673 in the quarter for write-down of eBookMan(R) inventory and other related assets, and charges of \$1,325 for severance payments, costs of consolidation of European operations and a prior year Belgian tax assessment.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE--NONE

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The following table sets forth information with respect to the Company's Executive Officers.

| NAME              | AGE | POSITION   |
|-------------------|-----|--|
| ----              | --- | -----  |
| Barry J. Lipsky   | 51  | President and Chief Executive Officer; Director                                |
| Gregory J. Winsky | 52  | Executive Vice President, Business Development, General Counsel, and Secretary |

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Arnold D. Levitt 65 Senior Vice President, Chief Financial Officer; Treasurer  
Andrew D. Horsfall 42 Vice President, Worldwide Sales and Marketing

Mr. Lipsky joined the Company as Vice President in February 1985. He was elected Executive Vice President of the Company in 1997, Interim President and Chief Operating Officer in April 1999 and President and Chief Executive Officer in May 1999. Mr. Lipsky is a director of Voice Powered Technology International, Inc., an approximately 82% owned subsidiary of the Company.

Mr. Winsky was elected Vice President and Secretary of the Company in June 1984, was elected Senior Vice President in January 1993 and was elected Executive Vice President in July 1999. Mr. Winsky is Chief Executive Officer and a director of Voice Powered Technology International, Inc., an approximately 82% owned subsidiary of the Company.

Mr. Levitt joined the Company in May 1999 as Interim Chief Financial Officer and Treasurer and was elected Senior Vice President, Chief Financial Officer and Treasurer of the Company in September 1999. Mr. Levitt has been engaged in consulting as a chief financial officer or senior business adviser for companies in a variety of industries since 1996. Prior to these consulting arrangements, Mr. Levitt was Executive Vice President and Chief Operating Officer of WIC Gaming Supply Corp. Mr. Levitt has owned or was employed as a chief financial officer of a number of companies and also worked in public accounting. Mr. Levitt is Chief Financial Officer and a director of Voice Powered Technology International, Inc., an approximately 82% owned subsidiary of the Company.

Mr. Horsfall joined the Company in April 2002 as Vice President, Worldwide Sales and Marketing. From November 1994 to June 1999 he managed the Company's sales and marketing subsidiary in Australia and during 2000 he acted as a sales and marketing consultant to the Company.

Additional information called for by Item 10 is set forth under the heading "Election of Directors" in the Company's Proxy Statement for its 2002 annual meeting of stockholders (the "2002 Proxy Statement"), which is incorporated herein by this reference.

37

### ITEM 11. EXECUTIVE COMPENSATION

Information called for by Item 11 is set forth under the heading "Executive Compensation" in the 2002 Proxy Statement, which is incorporated herein by this reference.

### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

#### Equity Compensation Plan Information

The following table gives information about the Company's common stock, no par value ("Common Stock") that may be issued upon the exercise of options, warrants and rights under all of the Company's existing equity compensation plans as of March 31, 2002, including the Company's 1988 Stock Option Plan, the Company's 1998 Stock Option Plan, the Company's Restricted Stock Plan, the Company's Sales Representative Stock Option Plan and various Stock Option Agreements to which the Company is a party.

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| Plan Category  | (a)<br>Number of<br>securities to be<br>issued upon<br>exercise of<br>outstanding<br>options, warrants<br>and rights | (b)<br>Weighted average<br>exercise price of<br>outstanding<br>options, warrants<br>and rights | (c)<br>Number of<br>securities remaining<br>available for future<br>issuance under<br>equity compensation<br>plans (excluding<br>securities reflected<br>in column (a)) |
|--|--|--|---|
| Equity compensation plans<br>approved by security holders...     | 2,393,474  | \$6.83   | 537,003   |
| Equity compensation plans not<br>approved by security holders(1) | 263,750  | \$4.83   | 312,450   |
| Total.....   | 2,657,224<br>=====   | \$6.63   | 849,453<br>=====  |

(1) Includes (i) the Company's Restricted Stock Plan, (ii) the Company's Sales Representative Stock Option Plan, and (iii) the Stock Option Agreements entered into between the Company and each of Arnold D. Levitt, Gerard Klauer Mattison and Peter Yianilos, each of which is described below.

Restricted Stock Plan

The Company maintains a Restricted Stock Plan which provides for the grant of shares of Common Stock for services. The shares are subject to a restriction on transfer which requires the holder to remain employed by the Company for up to three years in order to receive the shares. As of March 31, 2002, under the Restricted Stock Plan, 12,450 shares of Common Stock were available for distribution by the Board of Directors.

Sales Representative Stock Option Plan

In an effort to provide an incentive to the Company's sales representatives to continue to sell, and increase sales of, the Company's products and to attract new sales representatives to sell the Company's products, in March 2002 the Board of Directors adopted the Sales Representative Stock Option Plan (the "Sales Representative Plan"). Pursuant to the Sales Representative Plan, the Company will grant options to those of its sales representatives who elect to participate in the Sales Representative Stock Option Program ("Program").

The Company has authorized under the Sales Representative Plan options to purchase 300,000 shares of Common Stock. Commencing July 1, 2002, for each calendar year that a sales representative elects to participate in the Program, the Company will grant to such sales representative, within 30 days following the end of each calendar quarter during such calendar year, an option to purchase the number of shares of Common Stock as shall equal the product of (x) .005 and (y) the aggregate net sales of the Company's products effected by such sales representative in such sales representative's geographic territory during the preceding calendar quarter.

The exercise price for each option that is granted with respect to sales of the Company's products in calendar year 2002 will be \$1.40 per share (the fair market value of a share of Common Stock on the last trading day of 2001), and the exercise price for each option that is granted with respect to sales of the

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Company's products in each calendar year following 2002 will be the fair market value of a share of Common Stock on the last trading day of the preceding calendar year.

Each option granted under the Sales Representative Plan will be exercisable commencing on the first anniversary of the date of its grant and will automatically terminate on the fourth anniversary of the date of grant.

In consideration of the Company's agreement to issue options pursuant to the Program, for each calendar year that a sales representative elects to participate in the Program, the sales commission percentage otherwise payable to such sales representative with respect to such sales representative's sales of the Company's products will be reduced by 1%.

Participation in the Program will be offered to the Company's sales representatives following effectiveness of a registration statement that will be filed with respect to the options issueable pursuant to the Sales Representative Plan and with respect to the shares of Common Stock issueable upon exercise of such options.

### Stock Option Agreements

In July 1999, in connection with the hiring of Arnold D. Levitt, our Senior Vice President, the Company entered into a Stock Option Agreement pursuant to which the Company granted Mr. Levitt an option to purchase 50,000 shares of Common Stock at an exercise price of \$4.00 per share, the fair market value of the Common Stock on the date of grant. Options with respect to one-fourth of the shares become exercisable on each of the first, second, third and fourth anniversaries of the date of grant.

In May 2001, in connection with the retention of New York investment bank Gerard Klauer Mattison (GKM) as its financial advisor, the Company entered into an Agreement pursuant to which the Company granted GKM a warrant to purchase 100,000 shares of Common Stock at an exercise price of \$5.00 per share. The fair market value of the Common Stock on the date of grant was \$3.10 per share.

In August 1999, in connection with entering into a consulting agreement with Peter Yianilos, an engineering consultant, the Company entered into a Stock Option Agreement pursuant to which the Company granted Mr. Yianilos an option to purchase 50,000 shares of Common Stock at an exercise price of \$4.00 per share, the fair market value of the Common Stock on the date of grant. The option vested in its entirety on February 16, 2001. In June 2000, the Company entered into an additional Stock Option Agreement with Mr. Yianilos pursuant to which the Company granted Mr. Yianilos an option to purchase an additional 50,000 shares of Common Stock at an exercise price of \$7.50 per share, the fair market value of the Common Stock on the date of grant. This option vested in its entirety on June 24, 2001.

Additional information called for by Item 12 is set forth under the heading "Security Ownership of Certain Beneficial Owners and Management" in the 2002 Proxy Statement, which is incorporated herein by this reference.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information called for by Item 13 is set forth under the heading "Certain Relationships and Related Transactions" in the 2002 Proxy Statement, which is incorporated herein by this reference.

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## PART IV

### ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

Financial statements and schedules filed as a part of this report are listed on the "Index to Financial Statements" contained herein. All other schedules are omitted because (i) they are not required under the instructions, (ii) they are inapplicable or (iii) the information is included in the financial statements. During the Quarter ended March 31, 2002, the Company filed Reports on Form 8-K on each of January 3, 2002 and March 12, 2002.

#### EXHIBITS

##### EXHIBITS NO.

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- 3.01 -- Certificate of Incorporation of Franklin (Incorporated by reference to Exhibit 3.01 Registration Statement on Form S-1, File No. 3-6612 (the "Company's 1986 S-1 Registration Statement"))
- 3.02 -- Articles of Amendment to the Certificate of Incorporation of Franklin (Incorporated by reference to Exhibit 3.02 to the Company's 1990 report on Form 10-K for the year ended March 31, 1990 (the "Company's 1990 10-K"))
- 3.03 -- Amended and Restated Statement of Rights and Preferences of Series A 10% Convertible Preferred Stock (Incorporated by reference to the Exhibit to the Company's Report on Form 8-K filed May 23, 2001)
- 3.04 -- By-laws of Franklin (Incorporated by reference to Exhibit 3.02 to the Company's 1986 Registration Statement)
- 3.05 -- Amendment to By-laws of Franklin (Incorporated by reference to Exhibit A to the Company's Proxy Statement relating to the 1987 Annual Meeting of Shareholders)
- 3.06 -- Amendment to By-laws of Franklin (Incorporated by reference to Exhibit 3.05 to the Company's 1990 10-K)
- 10.01 -- Standard form of Sales Representative Agreement (Incorporated by reference to Exhibit 10.01 to the Company's 1986 S-1 Registration Statement)
- 10.02\*\* -- Franklin Restricted Stock Plan, as amended (Incorporated by reference to Exhibit 10.02 to the Company's report on Form 10-K for the year ended March 31, 1987)
- 10.03\*\* -- Franklin 1988 Stock Option Plan as Amended and restated effective as of July 24, 1996 (Incorporated by reference to the Company's Proxy Statement relating to the 1996 Annual Meeting of Shareholders)
- 10.04 -- Loan and Security Agreement dated as of December 7, 1999 among Banc of America Commercial Finance Corp., Franklin, Franklin Electronic Publishers (Europe) Ltd., Franklin Electronic Publishers (Deutschland) GmbH (Incorporated by reference to the Company's Report on Form 8-K filed on December 14, 1999)
- 10.05\*\* -- Franklin 1998 Stock Option Plan as Amended and Restated effective July 20, 2001 (Incorporated by reference to Exhibit 4 to the Company's Registration Statement on Form S-8 filed on August 27, 2001)
- 10.06\*\* -- Stock Option Agreement dated July 28, 1999 between the Company and Arnold D. Levitt (Incorporated by reference to Exhibit 4(e) to the Company's Registration Statement on Form S-8 filed on December 14, 1999)

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10.07\*\* -- Stock Option Agreement dated August 16, 1999 between the Company and Peter N. Yianil  
(Incorporated by reference to Exhibit 4(g) to the Company's Registration Statement  
S-8 filed on December 14, 1999)

40

EXHIBITS NO.  
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10.08\*\*\* -- Sales Representative Stock Option Plan

10.09\*\*\* -- Sales Representative Stock Option Program

21+ -- List of subsidiaries of the Company

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\*\* Management contract or compensatory plan or arrangement required to be filed  
as an exhibit to this form pursuant to Item 14(c) of this report.

++ To be filed at a later date.

+ Filed herewith.

41

SIGNATURES

PURSUANT TO THE REQUIREMENTS OF SECTION 13 OR 15(D) 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.

FRANKLIN ELECTRONIC PUBLISHERS, INCORPORATED

Dated: June 26, 2002

By: /s/ BARRY J. LIPSKY

-----  
Barry J. Lipsky  
PRESIDENT AND CHIEF EXECUTIVE OFFICER

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES EXCHANGE ACT OF 1934, THIS  
REPORT HAS BEEN SIGNED BELOW BY THE FOLLOWING PERSONS ON BEHALF OF THE  
REGISTRANT AND IN THE CAPACITIES AND ON THE DATES INDICATED.

| Signature<br>-----                              | Title<br>----- | Date<br>----- |
|---|----------------|---------------|
| /s/ EDWARD H. COHEN<br>-----<br>Edward H. Cohen | Director       | June 25, 2002 |
| /s/ BARRY J. LIPSKY<br>-----<br>Barry J. Lipsky | Director       | June 26, 2002 |



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|   |   |               |
|---|---|---------------|
| -----<br>Leonard M. Lodish                          | Director  | June , 2002   |
| /s/ JAMES MEISTER<br>-----<br>James Meister         | Director  | June 24, 2002 |
| /s/ HOWARD L. MORGAN<br>-----<br>Howard L. Morgan   | Director  | June 26, 2002 |
| -----<br>Jerry R. Schubel                           | Director  | June , 2002   |
| -----<br>James H. Simons                            | Director  | June , 2002   |
| /s/ WILLIAM H. TURNER<br>-----<br>William H. Turner | Director  | June 26, 2002 |
| /S/ ARNOLD D. LEVITT<br>-----<br>Arnold D. Levitt   | Senior Vice President, Chief<br>Financial Officer and<br>Treasurer (Principal<br>Financial and Accounting<br>Officer) | June 26, 2002 |