

KOSS CORP
Form 10-Q
May 15, 2014
Index

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the quarterly period ended March 31, 2014

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 0-3295

KOSS CORPORATION
(Exact Name of Registrant as Specified in its Charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

39-1168275
(I.R.S. Employer Identification No.)

4129 North Port Washington Avenue, Milwaukee,
Wisconsin
(Address of principal executive offices)

53212
(Zip Code)

Registrant's telephone number, including area code: (414) 964-5000

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No

At May 9, 2014, there were 7,382,706 shares outstanding of the registrant's common stock.

Index

KOSS CORPORATION
 FORM 10-Q
 March 31, 2014

INDEX

| | Page |
|--|------|
| <u>PART I FINANCIAL INFORMATION</u> | |
| <u>Item 1. Financial Statements</u> | 1 |
| <u>Condensed Consolidated Statements of Operations (Unaudited) for the Three and Nine Months Ended March 31, 2014 and 2013</u> | 3 |
| <u>Condensed Consolidated Balance Sheets as of March 31, 2014 (Unaudited) and June 30, 2013</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows (Unaudited) for the Nine Months Ended March 31, 2014 and 2013</u> | 5 |
| <u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u> | 6 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 12 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 16 |
| <u>Item 4. Controls and Procedures</u> | 16 |
| <u>PART II OTHER INFORMATION</u> | |
| <u>Item 1. Legal Proceedings</u> | 17 |
| <u>Item 1A. Risk Factors</u> | 17 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 17 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 17 |
| <u>Item 4. Mine Safety Disclosures</u> | 17 |
| <u>Item 5. Other Information</u> | 17 |
| <u>Item 6. Exhibits</u> | 17 |

IndexPART I
FINANCIAL INFORMATION

Item 1. Financial Statements

KOSS CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-------------|-------------------|--------------|
| | March 31 | | March 31 | |
| | 2014 | 2013 | 2014 | 2013 |
| Net sales | \$4,300,373 | \$8,302,113 | \$17,648,927 | \$25,859,006 |
| Cost of goods sold | 3,206,738 | 4,998,121 | 12,321,111 | 16,546,236 |
| Impairment of capitalized software, inventory and related items | — | — | 4,535,747 | — |
| Gross profit | 1,093,635 | 3,303,992 | 792,069 | 9,312,770 |
| Operating expenses: | | | | |
| Selling, general and administrative expenses | 2,354,337 | 3,111,919 | 7,925,186 | 9,134,158 |
| Unauthorized transaction related costs and recoveries, net | (231,162) | 152,001 | (827,707) | (1,043,070) |
| Total operating expenses | 2,123,175 | 3,263,920 | 7,097,479 | 8,091,088 |
| Income (loss) from operations | (1,029,540) | 40,072 | (6,305,410) | 1,221,682 |
| Other income (expense): | | | | |
| Interest expense | 65,536 | 16,786 | 49,737 | (39,719) |
| Income (loss) before income tax provision (benefit) | (964,004) | 56,858 | (6,255,673) | 1,181,963 |
| Income tax provision (benefit) | (938,883) | (58,583) | (2,857,113) | 361,681 |
| Net income (loss) | \$(25,121) | \$115,441 | \$(3,398,560) | \$820,282 |
| Income (loss) per common share: | | | | |
| Basic | \$— | \$0.02 | \$(0.46) | \$0.11 |
| Diluted | \$— | \$0.02 | \$(0.46) | \$0.11 |
| Dividends declared per common share | \$0.06 | \$0.06 | \$0.18 | \$0.18 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

IndexKOSS CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

| | (Unaudited) March 31, 2014 | June 30, 2013 |
|--|-------------------------------|---------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$2,749,204 | \$859,636 |
| Accounts receivable, less allowance for doubtful accounts of \$60,815 and \$43,405, respectively | 2,349,391 | 12,185,162 |
| Inventories | 9,667,701 | 10,501,172 |
| Prepaid expenses and other current assets | 339,795 | 465,589 |
| Deferred income taxes | 1,646,931 | 1,171,453 |
| Total current assets | 16,753,022 | 25,183,012 |
| Equipment and leasehold improvements, net | 2,045,669 | 2,337,982 |
| Other assets: | | |
| Product software development expenditures, net | — | 2,673,291 |
| Deferred income taxes | 2,391,158 | 419,530 |
| Cash surrender value of life insurance | 4,942,627 | 4,612,842 |
| Total other assets | 7,333,785 | 7,705,663 |
| Total assets | \$26,132,476 | \$35,226,657 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$2,044,806 | \$2,685,748 |
| Accrued liabilities | 3,547,273 | 4,705,454 |
| Dividends payable | 442,962 | 442,962 |
| Income taxes payable | 284,585 | 2,732,524 |
| Total current liabilities | 6,319,626 | 10,566,688 |
| Long-term liabilities: | | |
| Deferred compensation | 2,172,372 | 2,375,550 |
| Derivative liability | — | 154,745 |
| Other liabilities | 448,990 | 740,000 |
| Total long-term liabilities | 2,621,362 | 3,270,295 |
| Total liabilities | 8,940,988 | 13,836,983 |
| Stockholders' equity: | | |
| Common stock, \$0.005 par value, authorized 20,000,000 shares; issued and outstanding 7,382,706 shares | 36,914 | 36,914 |
| Paid in capital | 3,792,869 | 3,263,608 |
| Retained earnings | 13,361,705 | 18,089,152 |
| Total stockholders' equity | 17,191,488 | 21,389,674 |

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| | | |
|--|--------------|--------------|
| Total liabilities and stockholders' equity | \$26,132,476 | \$35,226,657 |
|--|--------------|--------------|

The accompanying notes are an integral part of these condensed consolidated financial statements.

4

Index

KOSS CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

| | Nine Months Ended | |
|--|-------------------|--------------|
| | March 31 | |
| | 2014 | 2013 |
| Operating activities: | | |
| Net income (loss) | \$(3,398,560 |) \$820,282 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Recoveries of previously written off accounts | (102,567 |) (632 |
| Loss on disposals of fixed assets | — | 124,480 |
| Impairment of capitalized software, inventory and related items | 4,535,747 | — |
| Depreciation of equipment and leasehold improvements | 569,027 | 628,110 |
| Amortization of product software development expenditures | 364,539 | 1,160,392 |
| Stock-based compensation expense | 516,829 | 440,533 |
| Provision for (benefit from) deferred income taxes | (2,434,674 |) 410,656 |
| Change in cash surrender value of life insurance | (86,486 |) (15,604 |
| Deferred compensation | (357,923 |) 181,873 |
| Net changes in operating assets and liabilities (see note 13) | 4,336,319 | (1,206,136 |
| Cash provided by operating activities | 3,942,251 | 2,543,954 |
| Investing activities: | | |
| Life insurance premiums paid | (243,299 |) (258,638 |
| Purchase of equipment and leasehold improvements | (480,497 |) (432,750 |
| Product software development expenditures | — | (67,738 |
| Cash used in investing activities | (723,796 |) (759,126 |
| Financing activities: | | |
| Dividends paid to stockholders | (1,328,887 |) (1,328,887 |
| Cash used in financing activities | (1,328,887 |) (1,328,887 |
| Net increase in cash and cash equivalents | 1,889,568 | 455,941 |
| Cash and cash equivalents at beginning of period | 859,636 | 50,027 |
| Cash and cash equivalents at end of period | \$2,749,204 | \$505,968 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

Index

KOSS CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2014
 (Unaudited)

1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The condensed consolidated balance sheet of Koss Corporation (the "Company") as of June 30, 2013 has been derived from audited financial statements. The unaudited condensed consolidated financial statements presented herein are based on interim amounts. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America ("U.S. GAAP") have been condensed or omitted. In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made. The operating results for the nine months ended March 31, 2014 are not necessarily indicative of the operating results that may be experienced for the full fiscal year ending June 30, 2014.

In the three months ended December 31, 2013, the Company formed Koss U.K. Limited to comply with certain European Union (EU) requirements. The entity is non-operating and holds no assets.

These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Registrant's Annual Report on Form 10-K for the fiscal year ended June 30, 2013.

2. UNAUTHORIZED TRANSACTION RELATED COSTS AND RECOVERIES

In 2009, the Company learned of significant unauthorized transactions, details of which have been disclosed in depth in the Company's previous periodic reports filed with the SEC. The unauthorized transaction related recoveries, net line in the Condensed Consolidated Statements of Operations is comprised of legal defense costs, legal fees related to certain claims against third parties (see Note 15), and recoveries related to the unauthorized transactions which are summarized below. For the three and nine months ended March 31, 2014 and 2013, these costs and recoveries were as follows:

| | Three Months Ended March 31 | | Nine Months Ended March 31 | |
|---|--------------------------------|-------------|-------------------------------|----------------|
| | 2014 | 2013 | 2014 | 2013 |
| Legal fees incurred | \$86,391 | \$180,295 | \$306,375 | \$332,608 |
| Recoveries: | | | | |
| Insurance proceeds | — | (692 |) — | (15,014 |
| Proceeds from asset forfeitures | (317,553 |) (27,602 |) (1,134,082 |) (1,360,664 |
| Total recoveries | (317,553 |) (28,294 |) (1,134,082 |) (1,375,678 |
| Unauthorized transaction related cost and recoveries, net | \$(231,162 |) \$152,001 | \$(827,707 |) \$(1,043,070 |

Index

3. IMPAIRMENT OF CAPITALIZED SOFTWARE, INVENTORY AND RELATED ITEMS

The Company recorded an impairment to the condensed consolidated statement of operations line item titled "Impairment of capitalized software, inventory and related items" in the three months ended December 31, 2013. The impairment is detailed in the following table:

| | Three Months Ended March 31, 2014 | Nine Months Ended March 31, 2014 |
|---|--------------------------------------|-------------------------------------|
| Product software development expenditures | \$— | \$2,308,752 |
| Inventories | — | 1,759,710 |
| Product design costs and assumed liabilities | — | 263,503 |
| Tooling | — | 203,782 |
| Impairment of capitalized software, inventory and related items | \$— | \$4,535,747 |

The Company determined that the capitalized software will be replaced by a new architecture being developed, which began in the three months ended December 31, 2013. As a result, the remaining value was expensed as of December 31, 2013. In conjunction with the review of the capitalized software, it was determined that certain inventory items were obsolete or the Company had quantities that are not expected to be used over the product forecast period. These inventory items are included net of expected recoveries. Product design costs and assumed liabilities to wrap up the current architecture design were expensed. The Company will incur future costs for the continued development, software code and product launch of the WiFi-based products. Tooling related to products that are no longer expected to be launched was expensed.

4. INVENTORIES

The components of inventories at March 31, 2014 and June 30, 2013 were as follows:

| | March 31, 2014 | June 30, 2013 |
|----------------------------------|----------------|---------------|
| Raw materials | \$5,985,289 | \$5,019,597 |
| Work-in process | 68,755 | — |
| Finished goods | 6,631,929 | 6,690,301 |
| | 12,685,973 | 11,709,898 |
| Allowance for obsolete inventory | (3,018,272) |) (1,208,726) |
| Total inventories | \$9,667,701 | \$10,501,172 |

5. PRODUCT SOFTWARE DEVELOPMENT EXPENDITURES

The Company follows the guidance of ASC 985-20 "Costs of Software to be Sold, Leased, or Marketed" when capitalizing software development costs associated with software embedded in or to be incorporated into its products. The cost of purchased software technology is capitalized and stated at the lower of unamortized cost or expected net realizable value. Software is subject to rapid technological obsolescence and future revenue estimates supporting the capitalized software cost can be negatively affected based upon competitive products, services and pricing. Such adverse developments could reduce the estimated net realizable value of our product software development costs and could result in impairment or a shorter estimated life. Such events would require us to take a charge in the period in which the event occurs or to increase the amortization expense in future periods and would have a negative effect on our results of operations. At a minimum, we review for impairment on a quarterly basis. The Company launched a

new product offering utilizing this software in the fourth quarter of fiscal year 2012 and began amortizing the related capitalized software costs.

7

Index

In the quarter ended December 31, 2013, management determined that the existing product software technology will be superseded. As such, the product software development expenditures were fully impaired in the quarter ended December 31, 2013. The remaining asset value of \$2,308,752 was charged to the Condensed Consolidated Statement of Operations line item titled "Impairment of capitalized software, inventory and related items." The following table reflects capitalized software amortization and impairment related expense for the three and nine months ended March 31, 2014 and 2013.

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-----------|-------------------|-------------|
| | March 31 | | March 31 | |
| | 2014 | 2013 | 2014 | 2013 |
| Product software development expenditures charged to: | | | | |
| Cost of goods sold | \$— | \$397,926 | \$364,539 | \$1,160,392 |
| Impairment of capitalized software, inventory and related items | — | — | 2,308,752 | — |
| Total software expense | \$— | \$397,926 | \$2,673,291 | \$1,160,392 |

Accumulated amortization and impairment as of March 31, 2014 totaled \$4,374,477. Accumulated amortization as of June 30, 2013 totaled \$1,701,185.

Software development costs expended to supersede the previous product software technology will be expensed as incurred and charged to research and development.

6. INCOME TAXES

For the nine months ended March 31, 2014, the company recorded an income tax benefit of \$2,857,113, compared to an income tax expense of \$361,681 for the nine months ended March 31, 2013. The decrease in the company's tax expense for the nine months ended March 31, 2014 relative to the prior year resulted primarily from pre-tax book losses and the effective settlement of uncertain tax benefits. The Company files income tax returns in the United States (Federal), Wisconsin (State) and various other state jurisdictions. Tax years open to examination by tax authorities under the statute of limitations include fiscal years 2011 through 2013 for Federal and fiscal years 2010 through 2013 for most state jurisdictions.

The Company's unrecognized tax benefits, excluding interest and penalties, were \$150,000 as of March 31, 2014 and \$696,113 as of June 30, 2013. All of the Company's unrecognized tax benefits as of March 31, 2014, if recognized, would impact the effective tax rate.

7. CREDIT FACILITY

On May 12, 2010, the Company entered into a secured credit facility with JPMorgan Chase Bank, N.A. ("Lender"). The Credit Agreement dated May 12, 2010 between the Company and the Lender ("Credit Agreement") provides for an \$8,000,000 revolving secured credit facility with interest rates either ranging from 0.0% to 0.75% over the Lender's most recently publicly announced prime rate or 2.0% to 3.0% over LIBOR, depending on the Company's leverage ratio. The Company pays a fee of 0.3% to 0.45% for unused amounts committed in the credit facility. On July 24, 2013, the Credit Agreement was amended to extend the expiration to July 31, 2015. In addition to the revolving loans, the Credit Agreement also provides that the Company may, from time to time, request the Lender to issue letters of credit for the benefit of the Company of up to a sublimit of \$2,000,000 and subject to certain other limitations. The loans may be used only for general corporate purposes of the Company.

The Credit Agreement contains certain affirmative, negative and financial covenants customary for financings of this type. The negative covenants include restrictions on other indebtedness, liens, fundamental changes, certain investments, asset sales, sale and leaseback transactions and transactions with affiliates, among other restrictions. The financial covenants include a minimum current ratio, minimum tangible net worth and maximum leverage ratio requirements. The Company and the Lender also entered into the Pledge and Security Agreement dated May 12, 2010 under which the Company granted the Lender a security interest in substantially all of the Company's assets in connection with the Company's obligations under the Credit Agreement. The balance on this facility was \$0 as of March 31, 2014 and June 30, 2013.

Index

8. INTEREST EXPENSE

The Company incurs interest expense primarily related to its secured credit facility (see Note 7) and to its liabilities for its tax positions related to the unauthorized transactions. As the tax returns have been settled and statutes have closed, the accrued interest expense on certain items has been reversed. Interest expense detail was as follows for the three and nine months ended March 31, 2014 and 2013, respectively:

| | Three Months Ended March 31 | | Nine Months Ended March 31 | |
|---|--------------------------------|-----------|-------------------------------|------------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest benefit (expense) on secured credit facility | \$— | \$(4,614) | \$587 | \$(37,249) |
| Interest expense for tax positions related to unauthorized transactions | — | (11,941) | (16,386) | (35,821) |
| Interest reversals for tax positions related to unauthorized transactions | 65,536 | 33,742 | 65,536 | 33,742 |
| Other interest expense | — | (401) | — | (391) |
| Interest expense | \$65,536 | \$16,786 | \$49,737 | \$(39,719) |

9. INCOME (LOSS) PER COMMON AND COMMON STOCK EQUIVALENT SHARE

Basic income (loss) per share is computed based on the weighted-average number of common shares outstanding. The weighted-average number of common shares outstanding was 7,382,706 for the quarters ended March 31, 2014 and 2013. When dilutive, stock options are included in income (loss) per share as share equivalents using the treasury stock method. For the periods ended March 31, 2014 and 2013, there were no common stock equivalents related to stock option grants that were included in the computation of the weighted-average number of shares outstanding for diluted income (loss) per share. Shares issuable upon the exercise of outstanding options of 2,186,000 and 1,944,308 were excluded from the diluted weighted-average common shares outstanding for the periods ended March 31, 2014 and 2013, respectively, as they would be anti-dilutive.

10. DIVIDENDS DECLARED

On February 13, 2014, the Company declared a quarterly cash dividend of \$0.06 per share for the stockholders of record on March 31, 2014, to be paid April 15, 2014. Such dividend payable has been recorded as of March 31, 2014. At the Board of Directors meeting in May 2014, the Board of Directors determined that based on the financial results, the Company would not declare a quarterly cash dividend for the quarter ending June 30, 2014.

11. STOCK OPTIONS

The Company recognizes stock-based compensation expense for options granted under both the 1990 Flexible Incentive Plan and the 2012 Omnibus Incentive Plan. The stock-based compensation relates to stock options granted to employees, non-employee directors and non-employee consultants. In the nine months ended March 31, 2014, options to purchase 445,000 shares were granted under the 2012 Omnibus Incentive Plan at a weighted average exercise price of \$5.64. In the nine months ended March 31, 2013, options to purchase 430,000 shares were granted under the 2012 Omnibus Incentive Plan at a weighted average exercise price of \$5.29. Stock-based compensation expense during the three and nine months ended March 31, 2014 was \$172,477 and \$516,829, respectively. Stock-based compensation expense during the three and nine months ended March 31, 2013 was \$146,592 and \$440,533, respectively.

Index

12. STOCK PURCHASE AGREEMENTS

The Company has an agreement with its Chairman, John C. Koss, in the event of his death, at the request of the executor of his estate, to repurchase his Company common stock from his estate. The Company does not have the right to require the estate to sell stock to the Company. As such, this arrangement is accounted for as a written put option with the fair value of the put option recorded as a derivative liability.

As of March 31, 2014, John C. Koss did not hold a material amount of Company stock. As such, there is no exposure that the executor of John C. Koss' estate may require the Company to repurchase a material amount of stock in the event of his death. The fair value of the written put option at March 31, 2014 and June 30, 2013 was \$0 and \$154,745, respectively. The repurchase price is 95% of the fair market value of the common stock on the date that notice to repurchase is provided to the Company. The total number of shares to be repurchased will be sufficient to provide proceeds which are the lesser of \$2,500,000 or the amount of estate taxes and administrative expenses incurred by the Chairman's estate. The Company may elect to pay the purchase price in cash or may elect to pay cash equal to 25% of the total amount due and to execute a promissory note for the balance, payable over four years, at the prime rate of interest. The Company maintains a \$1,150,000 life insurance policy to fund a substantial portion of this obligation.

13. ADDITIONAL CASH FLOW INFORMATION

The net changes in cash as a result of changes in operating assets and liabilities consist of the following:

| | Nine Months Ended | |
|---|-------------------|--------------|
| | March 31 | |
| | 2014 | 2013 |
| Accounts receivable | \$9,938,339 | \$1,708,703 |
| Inventories | (926,239 |) (593,051 |
| Prepaid expenses and other current assets | 125,794 | (411,807 |
| Income taxes payable | (2,447,939 |) — |
| Accounts payable | (904,445 |) (1,464,943 |
| Accrued liabilities | (1,158,181 |) (431,038 |
| Other liabilities | (291,010 |) (14,000 |
| Net change | \$4,336,319 | \$(1,206,136 |
| Net cash paid (refunded) during the period for: | | |
| Income taxes | \$2,029,000 | \$(40,301 |
| Interest | \$— | \$38,691 |

14. STOCKHOLDERS' EQUITY

The following table summarizes the changes in stockholders' equity for the nine months ended March 31, 2014 and 2013:

| | Nine Months Ended | |
|--------------------|-------------------|--------------|
| | March 31 | |
| | 2014 | 2013 |
| Net income (loss) | \$(3,398,560 |) \$820,282 |
| Dividends declared | (1,328,887 |) (1,328,887 |

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| | | | |
|--|--------------|-------------|---|
| Stock-based compensation expense | 516,829 | 440,533 | |
| Income tax benefit from stock-based compensation expense | 12,432 | — | |
| Decrease in stockholders' equity | \$(4,198,186 |) \$(68,072 |) |

10

Index

15. LEGAL MATTERS

As of March 31, 2014, the Company is party to the matters related to the unauthorized transactions and the termination of a vendor contract described below:

On February 18, 2010, the Company filed an action against American Express Company, American Express Travel Related Services Company, Inc., AMEX Card Services Company, Decision Science, and Pamela S. Hopkins in Superior Court of Maricopa County, Arizona, case no. CV2010-006631. The claims alleged include aiding and abetting breach of fiduciary duty, aiding and abetting fraud, and conversion relating to the unauthorized transactions. The case is proceeding in the Superior Court with respect to those claims.

On December 17, 2010, the Company filed an action against Park Bank in Circuit Court of Milwaukee County, Wisconsin alleging claims of negligence and breach of fiduciary duty relating to the unauthorized transactions. The Company voluntarily dismissed the negligence claim and the case is proceeding in the Circuit Court.

On March 6, 2014, the Company filed a replevin action against Red Fusion Studios, Inc. ("Red Fusion") in Circuit Court of Milwaukee County, Wisconsin, Case No. 14CV001885, seeking the return of the Company's property and information following the termination of the agreement that the Company had with Red Fusion for the development of the Company's Striva Technology. Red Fusion filed counterclaims relating to fees that Red Fusion alleges it is owed as a result of the termination. The Company has filed a Motion to Dismiss the counterclaims. A hearing has been scheduled for June 26, 2014 on the Company's Motion to Dismiss.

The ultimate resolution of these matters is not determinable unless otherwise noted.

Index

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

Overview

The Company markets a complete line of high-fidelity headphones, speaker-phones, computer headsets, telecommunications headsets, active noise canceling headphones, wireless headphones and compact disc recordings of American Symphony Orchestras on the Koss Classics label. The Company operates as one business segment.

In December 2009, the Company learned of significant unauthorized transactions, details of which have been disclosed in depth in the Company's previous periodic reports filed with the SEC. References to unauthorized transactions below should be read in conjunction with those reports.

Results of Operations Summary

Net sales in the quarter ended March 31, 2014 decreased 48.2%, compared to the same quarter last year, to \$4,300,373 with decreased sales primarily in export markets but also in certain mass and web retailer sales. Gross profit as a percent of sales decreased 14.4% to 25.4% for the quarter ended March 31, 2014, compared to 39.8% for the same quarter last year. This decrease is primarily due to lower sales on fixed manufacturing overhead costs as well as a large anticipated return from a customer. Fixed manufacturing overhead costs increased due to manufacturing overhead costs related to Mexico operations, which began in the fourth quarter of fiscal year 2013. Removing those costs for comparison purposes, gross profit as a percent of sales would have been 33.1% this quarter. Selling, general and administrative spending was lower primarily due to reduced software development expenditures, reduced expense for deferred compensation, reduced sales commissions on lower sales, and reduced charitable donations. These lower expenses were partially offset by an increase in fees paid for celebrity product endorsements.

Financial Results

The following table presents selected financial data for the three and nine months ended March 31, 2014 and 2013. Comparative figures are presented compared to the same period one year prior:

| Financial Performance Summary | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-------------|-------------------|---------------|
| | March 31 | | March 31 | |
| | 2014 | 2013 | 2014 | 2013 |
| Net sales | \$4,300,373 | \$8,302,113 | \$17,648,927 | \$25,859,006 |
| Net sales increase (decrease) % | (48.2) |)% 0.8 | % (31.7) |)% (4.1) |
| Impairment of capitalized software, inventory and related items | \$— | \$— | \$4,535,747 | \$— |
| Gross profit | \$1,093,635 | \$3,303,992 | \$792,069 | \$9,312,770 |
| Gross profit as % of net sales | 25.4 | % 39.8 | % 4.5 | % 36.0 |
| Gross profit as % of net sales before impairment | 25.4 | % 39.8 | % 30.2 | % 36.0 |
| Selling, general and administrative expenses | \$2,354,337 | \$3,111,919 | \$7,925,186 | \$9,134,158 |
| Selling, general and administrative expenses as % of net sales | 54.7 | % 37.5 | % 44.9 | % 35.3 |
| Unauthorized transaction related costs | \$86,391 | \$180,295 | \$306,375 | \$332,608 |
| Unauthorized transaction related recoveries | \$(317,553) | \$(28,294) | \$(1,134,082) | \$(1,375,678) |
| Unauthorized transaction related costs and recoveries, net | \$(231,162) | \$152,001 | \$(827,707) | \$(1,043,070) |
| Income (loss) from operations | \$(1,029,540) | \$40,072 | \$(6,305,410) | \$1,221,682 |
| Income (loss) from operations as % of net sales | (23.9) |)% 0.5 | % (35.7) |)% 4.7 |

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| | | | | |
|---|--------------|-------------|----------------|-------------|
| Other income (expense) | \$65,536 | \$16,786 | \$49,737 | \$(39,719) |
| Income tax (benefit) provision | \$(938,883) | \$(58,583) | \$(2,857,113) | \$361,681 |
| Income tax (benefit) provision as % of income before income tax (benefit) provision | 97.4 | % (103.0) | % 45.7 | % 30.6 % |

12

Index

2014 Results Compared with 2013

(comments refer to both the three and nine month periods unless otherwise stated)

Net sales decreased in both the three and nine months ended March 31, 2014, as sales to most export markets were much lower than last year. Net sales in our domestic markets decreased in the both the three and nine months ended March 31, 2014 with initial shipments to new customers and increases in certain markets partially offsetting declining sales at certain mass retailers.

Export sales declined in the three and nine months ended March 31, 2014 compared to the same periods the prior year by approximately 61% and 50%, respectively. Certain key customers in Europe and Asia accounted for the majority of the decline in export sales. Management believes its customers in Europe are dealing with the impact of weak economies, which affect sell-through and their ability to properly balance inventories. Further, sales to two of our key export customers, one in Ukraine and another in Russia, have declined due to the political unrest in that region. The sales decline in Asia is the result of a specialty product which has experienced a decline in volume compared to the three and nine months ended March 31, 2013.

Loss of space at a couple of retailers has negatively affected sales in the U.S. This appears to be changing with the introduction of the Fit Series product line which has gained placement at the retail level, and several new customers have been added due to this line. These sales were offset by a large anticipated return from a customer and reduced sales to a couple of new retail customers who last year had significant load-in sales. Overall the U.S. sales for the three and nine months ended March 31, 2014 were approximately 30% and 11%, respectively, less than in the same period the previous year.

The Company took an impairment charge for capitalized software, inventory and related items in the three months ended December 31, 2013. It was determined during the three months ended December 31, 2013, that the capitalized software was being replaced by a new architecture currently under development. This review also indicated that certain inventory items were either obsolete or were in excess of what is forecast to be sold in the next two to three years. The Company still plans to develop the revised software platform and expects to launch new products using this technology. Software development expenditures incurred in the three months ended March 31, 2014 were expensed as incurred and future software development expenditures will be expensed as incurred as well.

Gross profit prior to the impairment as a percent of sales was lower than last year. The lower gross profit margin was primarily the result of start up costs for manufacturing operations in Mexico. This new manufacturing facility started shipping headphones during the three months ended December 31, 2013. The gross profit margin was also negatively impacted by the fixed manufacturing costs on a lower sales base.

Partially offsetting the negative impacts to gross profit margin is the impact of a reduction in our short and long term warranty reserve. Based on a review of both foreign and domestic sales compared to their respective warranty expense, the Company has adjusted the reserve commensurately.

Selling, general and administrative expenses were lower than the same period last year. Deferred compensation expense has decreased to a credit as the result of changes to assumed retirement dates and an increase in the discount rate. Profit-based compensation decreased on the lower earnings in the nine months ended March 31, 2014. Legal fees have continued to decline in both the three and nine months ended March 31, 2014. During the three months ended December 31, 2013, the derivative liability was reversed since the associated shares subject to repurchase are insignificant. During the three months ended September 30, 2013, the Company received approximately \$93,000 of proceeds from a customer account that had previously been written off.

Additionally, the Company has reduced its spending on new product development directed at the STRIVA WiFi-based headphones and other WiFi-based products in the quarter ended March 31, 2014, due to a change in vendor and the related cost savings. The company has not reduced spending on new product offerings in the traditional wired headphone space. Several new headphone products have been introduced in the current fiscal year and more were unveiled at the annual Consumer Electronics Show (CES) in Las Vegas in January 2014.

Unauthorized transaction related recoveries were primarily from asset forfeitures and sale of items at auction. The Company believes that most of the proceeds from asset forfeitures have been received as of March 31, 2014.

The income (loss) from operations for the quarter ended March 31, 2014 decreased primarily due to the decline in net sales, the large return expected from a customer and the impact of start up costs for manufacturing in Mexico. These impacts were partially offset by lower selling, general and administrative expenses and increased recoveries from asset forfeitures.

Index

The effective income tax rate for the nine months ended March 31, 2014 was 45.1% which is comprised of the U.S. federal statutory rate of 34%, the effect of state income taxes and the decrease in unrecognized tax benefits during the quarter. It is anticipated that the effective income tax rate will be between 40 - 50% in the year ended June 30, 2014 due the decrease of unrecognized tax benefits.

Liquidity and Capital Resources

Cash Flows

The following table summarizes our cash flows from operating, investing and financing activities for the nine months ended March 31, 2014 and 2013:

| | | | |
|---|--------------|--------------|---|
| Total cash provided by (used in): | 2014 | 2013 | |
| Operating activities | \$3,942,251 | \$2,543,954 | |
| Investing activities | (723,796 |) (759,126 |) |
| Financing activities | (1,328,887 |) (1,328,887 |) |
| Net increase in cash and cash equivalents | \$ 1,889,568 | \$455,941 | |

Operating Activities

During the nine months ended March 31, 2014, cash provided by operations increased primarily due to receiving the proceeds of the settlement of the lawsuit against the Company's former auditors. Pursuant to the settlement, in July 2013, the Company received gross proceeds of \$8,500,000, or \$6,380,000 net of associated legal fees. During the quarter ended September 30, 2013, the Company paid approximately \$2,000,000 for federal taxes.

Inventories were reduced by approximately \$833,000 in the nine months ended March 31, 2014. This reduction was a result of the \$1.8 million inventory impairment as part of the impairment of capitalized software, inventory and other items as detailed in Note 3, partially offset by a large return from a customer.

Investing Activities

Cash used in investing activities was slightly higher for the nine months ended March 31, 2014 as the Company had higher capital expenditures for tooling related to new products. In addition, the Company had to purchase tooling for the Mexico operations. The capitalized software development expenditures decreased as a result of expensing on-going costs for the related products since the technology was launched during the year ended June 30, 2012. The Company anticipates it will incur expenditures of approximately \$800,000 for tooling, leasehold capital expenditures for improvements and Mexico manufacturing equipment during the fiscal year ending June 30, 2014. The Company expects to generate sufficient cash flow through operations to fund these expenditures.

Financing Activities

The payment of quarterly dividends resulted in a net use of cash in the nine months ended March 31, 2014 and 2013. The Company intends to pay its quarterly dividend of \$0.06 per share for the quarter ended March 31, 2014. At the Board of Directors meeting in May 2014, the Company determined that based on the financial results, the Company will not declare a quarterly dividend for the quarter ending June 30, 2014. The Company will determine whether to declare and the amount of any future dividends based upon its assessment of the Company's financial condition and liquidity, improvement in sales as a whole and in particular in the export markets, an increased generation of cash from operations, and the Company's earnings. As of March 31, 2014, the Company had no outstanding borrowings on

its bank line of credit facility.

There were no purchases of common stock in 2014 or 2013 under the stock repurchase program. No stock options were exercised in 2014 or 2013.

14

Index

Liquidity

In addition to capital expenditures for tooling and Mexico manufacturing as well as continued investment in software and new product development, the Company has interest payments on its borrowings when it uses its line of credit facility, and has paid quarterly dividends for the past several years, but will not declare a dividend for the quarter ended June 30, 2014. The Company believes that cash generated from operations, together with cash reserves and borrowings available under its credit facility, provide it with adequate liquidity to meet operating requirements, debt service requirements, and planned capital expenditures for the next twelve months and thereafter for the foreseeable future. Whether there is adequate liquidity to resume paying quarterly dividends, and if so, the amount per share of such dividends, will be dependent on certain factors, including the Company's financial condition and liquidity, an improvement in sales as a whole and in particular in the export markets, an increased generation of cash from operations, and the Company's overall earnings. Management believes an improvement in sales and reducing the amount of capital expenditures are important factors for improving the Company's liquidity. The Company regularly evaluates new product offerings, inventory levels and capital expenditures to ensure that it is effectively allocating resources in line with current market conditions.

Credit Facility

On May 12, 2010, the Company entered into a secured credit facility with JPMorgan Chase Bank, N.A. ("Lender"). The Credit Agreement dated May 12, 2010 between the Company and the Lender ("Credit Agreement") provides for an \$8,000,000 revolving secured credit facility and for letters of credit for the benefit of the Company of up to a sublimit of \$2,000,000. On July 24, 2013, the Credit Agreement was amended to extend the expiration to July 31, 2015. The Company and the Lender also entered into a Pledge and Security Agreement dated May 12, 2010 under which the Company granted the Lender a security interest in substantially all of the Company's assets in connection with the Company's obligations under the Credit Agreement. There were no borrowings outstanding on the facility as of March 31, 2014 and June 30, 2013, respectively.

Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements other than the lease for the facility in Milwaukee, Wisconsin, which it leases from its Chairman. On May 15, 2012, the lease was renewed for a period of five years, ending June 30, 2018, and is being accounted for as an operating lease. The lease extension maintained the rent at a fixed rate of \$380,000 per year. The Company is responsible for all property maintenance, insurance, taxes and other normal expenses related to ownership. The facility is in good repair and, in the opinion of management, is suitable and adequate for the Company's business purposes.

Index

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e)) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") are designed to ensure that: (1) information required to be disclosed in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms; and (2) such information is accumulated and communicated to management, including the principal executive officer and principal financial officer, to allow timely decisions regarding required disclosures. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

The Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures as of March 31, 2014. The Company's management has concluded that the Company's disclosure controls and procedures as of March 31, 2014 were effective.

Changes in Internal Control Over Financial Reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

IndexPART II
OTHER INFORMATION

Item 1. Legal Proceedings

As of March 31, 2014, the Company is currently involved in legal matters against third parties related to the unauthorized transactions and related to termination of a vendor contract. A description of these legal matters is included at Note 15 to the condensed consolidated financial statements, which description is incorporated herein by reference.

Item 1A. Risk Factors

Not applicable.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table presents information with respect to purchases of common stock of the Company made during the three months ended March 31, 2014, by the Company.

COMPANY REPURCHASES OF EQUITY SECURITIES

| Period (2014) | Total # of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan (1) | Approximate Dollar Value of Shares Available under Repurchase Plan |
|----------------------|-----------------------------------|------------------------------------|--|--|
| January 1 - March 31 | — | \$— | — | \$ 2,139,753 |

(1) In April of 1995, the Board of Directors approved a stock repurchase program authorizing the Company to purchase from time to time up to \$2,000,000 of its common stock for its own account. Subsequently, the Board of Directors periodically has approved increases in the stock repurchase program. The most recent increase was for an additional \$2,000,000 in October 2006, for a maximum of \$45,500,000 of which \$43,360,247 had been expended through March 31, 2014.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

See Exhibit Index attached hereto.

Index

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Form 10-Q contains forward-looking statements within the meaning of that term in the Private Securities Litigation Reform Act of 1995 (the “Act”) (Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934). Additional written or oral forward-looking statements may be made by the Company from time to time in filings with the Securities Exchange Commission, press releases, or otherwise. Statements contained in this Form 10-Q that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Act. Forward-looking statements may include, but are not limited to, projections of revenue, income or loss and capital expenditures, statements regarding future operations, anticipated financing needs, compliance with financial covenants in loan agreements, plans for acquisitions or sales of assets or businesses, plans relating to products or services of the Company, assessments of materiality, predictions of future events, the effects of pending and possible litigation and assumptions relating to the foregoing. In addition, when used in this Form 10-Q, the words “anticipates,” “believes,” “estimates,” “expects,” “intends,” “plans” and variations thereof and similar expressions are intended to identify forward-looking statements.

Forward-looking statements are inherently subject to risks and uncertainties, some of which cannot be predicted or quantified based on current expectations. Consequently, future events and actual results could differ materially from those set forth in, contemplated by, or underlying the forward-looking statements contained in this Form 10-Q, or in other Company filings, press releases, or otherwise. In addition to the factors discussed in this Form 10-Q, other factors that could contribute to or cause such differences include, but are not limited to, developments in any one or more of the following areas: future fluctuations in economic conditions, the receptivity of consumers to new consumer electronics technologies, the rate and consumer acceptance of new product introductions, competition, pricing, the number and nature of customers and their product orders, production by third party vendors, foreign manufacturing, sourcing, and sales (including foreign government regulation, trade and importation concerns), borrowing costs, changes in tax rates, pending or threatened litigation and investigations, and other risk factors which may be detailed from time to time in the Company’s Securities and Exchange Commission filings.

Readers are cautioned not to place undue reliance on any forward-looking statements contained herein, which speak only as of the date hereof. The Company undertakes no obligation to publicly release the result of any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unexpected events.

Index

SIGNATURES

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

KOSS CORPORATION

/s/ Michael J. Koss

May 15, 2014

Michael J. Koss

Vice Chairman

President

Chief Executive Officer

Chief Operating Officer

/s/ David D. Smith

May 15, 2014

David D. Smith

Executive Vice President

Chief Financial Officer

(Principal Financial and Principal Accounting Officer)

Secretary

Index

EXHIBIT INDEX

Exhibit No. Exhibit Description

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer *

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer *

32.1 Section 1350 Certification of Chief Executive Officer **

32.2 Section 1350 Certification of Chief Financial Officer **

101 The following financial information from Koss Corporation's Quarterly Report on Form 10-Q for the quarter ended March 31, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Statements of Operations (Unaudited) for the nine months ended March 31, 2014 and 2013, (ii) Condensed Consolidated Balance Sheets as of March 31, 2014 (Unaudited) and June 30, 2013 (iii) Condensed Consolidated Statements of Cash Flows (Unaudited) for the nine months ended March 31, 2014 and 2013 and (iv) the Notes to Condensed Consolidated Financial Statements (Unaudited). *

* Filed herewith

** Furnished herewith