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TOPAZ GROUP INC
Form 10-Q
May 15, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended March 31, 2002

OR

/ TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the transition period from _____ to _____

Commission file number 0-27415

The Topaz Group, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Nevada

91-1762285

(State or Other Jurisdiction of
Incorporation or Organization)

(I.R.S. Employer Identification No.)

126/1 Krungthonburi Road
Banglampoo Lang, Klongsarn
Bangkok 10600 Thailand

(Address of Principal Executive Offices)

(Zip Code)

Registrant's Telephone Number, including area code _____

- N/A -

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report

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 /

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The Topaz Group, Inc. and Subsidiaries

CONSOLIDATED BALANCE SHEETS

| | December 31, 2001 | March 31, 2002 |
|---|----------------------|-------------------|
| | ----- | ----- |
| | | (unaudited) |
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 351,565 | \$ 31,565 |
| Accounts receivable, net of allowance of \$788,369 and \$795,831 | 5,891,767 | 6,711,767 |
| Inventories | 19,004,800 | 22,851,800 |
| Prepaid expenses and deposits | 372,285 | 62,285 |
| | ----- | ----- |
| Total current assets | 25,620,417 | 30,507,417 |

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| | | |
|---|---------------|----------|
| PROPERTY AND EQUIPMENT - NET | 2,308,017 | 2,28 |
| OTHER ASSETS | 36,928 | 4 |
| | ----- | ----- |
| Total assets | \$ 27,965,362 | \$ 32,84 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES | | |
| Lines of credit | \$ 2,054,698 | \$ 2,93 |
| Accounts payable | 2,559,005 | 5,63 |
| Accrued liabilities | 1,171,030 | 94 |
| Payables to related party | 546,061 | 1,09 |
| | ----- | ----- |
| Total current liabilities | 6,330,794 | 10,60 |
| REDEEMABLE ORDINARY SHARES | 4,736,115 | 4,80 |
| COMMITMENTS | - | |
| STOCKHOLDERS' EQUITY | | |
| Class A preferred stock, liquidation preference of \$8,130,570 and \$8,384,545 | 3,555,511 | 3,55 |
| Class B preferred stock, liquidation preference of \$2,811,193 and \$2,899,007 | 1,007 | |
| Common stock | 2,135 | |
| Additional paid in capital | 1,673,330 | 1,67 |
| Retained earnings | 11,666,470 | 12,19 |
| | ----- | ----- |
| | 16,898,453 | 17,42 |
| | ----- | ----- |
| Total liabilities and stockholders' equity | \$ 27,965,362 | \$ 32,84 |
| | ===== | ===== |

The accompanying notes are an integral part of these statements.

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The Topaz Group, Inc. and Subsidiaries
CONSOLIDATED STATEMENTS OF EARNINGS (unaudited)

| | Three months ended March 31 | |
|--|-----------------------------|----------|
| | 2001 | 2002 |
| | ----- | ----- |
| Sales | \$ 4,586,282 | \$ 5,625 |
| Cost of goods sold | 3,280,297 | 4,156 |
| | ----- | ----- |
| Gross profit | 1,305,985 | 1,468 |
| Selling, general and administrative expenses | 838,782 | 921 |

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| | | |
|------------------------------|--------------|--------|
| | ----- | ----- |
| Earnings from operations | 467,203 | 547 |
| Other income (expense) | | |
| Exchange rate gain | 93,357 | 8 |
| Interest expense | (14,603) | (17) |
| Gain (loss) on remeasurement | 681,665 | (68) |
| Other, net | 14,670 | 57 |
| | ----- | ----- |
| | 775,089 | (19) |
| | ----- | ----- |
| NET EARNINGS | \$ 1,242,292 | \$ 528 |
| | ===== | ===== |
| NET EARNINGS PER SHARE: | | |
| Basic | \$ 1.06 | \$ |
| | ===== | ===== |
| Diluted | \$ 0.21 | \$ |
| | ===== | ===== |

The accompanying notes are an integral part of these statements.

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The Topaz Group, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

| | | |
|--|----------------------------|---------|
| | Three months ended March 3 | |
| | ----- | ----- |
| Increase (Decrease) in Cash and Cash Equivalents | 2001 | 2002 |
| | ----- | ----- |
| Cash flows from operating activities | | |
| Net earnings | \$ 1,242,292 | \$ 528 |
| Adjustments to reconcile net earnings to net cash provided by (used in) operating activities | | |
| Depreciation and amortization | 32,634 | 37 |
| Remeasurement of redeemable ordinary shares | (177,735) | 71 |
| Changes in assets and liabilities: | | |
| Receivables | 362,870 | (818) |
| Inventories | (387,236) | (3,848) |
| Prepaid expenses, deposits and other assets | (256,354) | (261) |
| Accounts and related payables | (1,425,847) | 2,525 |
| Accrued liabilities | 789,178 | 866 |
| | ----- | ----- |
| Net cash provided by (used in) operating activities | 179,802 | (901) |
| Cash flows from investing activities | | |
| Purchases of property and equipment | (56,330) | (17) |
| | ----- | ----- |
| Net cash used in investing activities | (56,330) | (17) |
| Cash flows from financing activities | | |

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| | | |
|--|------------|--------|
| Borrowings (payments) on line of credit, net | (281,737) | 885 |
| | | |
| Net cash provided by (used in) financing activities | (281,737) | 885 |
| | | |
| Net decrease in cash and cash equivalents | (158,265) | (34) |
| Cash and cash equivalents at the beginning of period | 321,734 | 351 |
| | | |
| Cash and cash equivalents at the end of period | \$ 163,469 | \$ 317 |
| | | |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the period Interest | \$ 14,500 | \$ 17 |
| | | |

The accompanying notes are an integral part of these statements.

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The Topaz Group, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

NOTE A - FINANCIAL STATEMENTS

The unaudited consolidated financial statements of the Company and its subsidiaries have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles of the United States of America ("GAAP") have been condensed or omitted pursuant to such rules and regulations. The results of operations for interim periods are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2002. This form 10-Q should be read in conjunction with the form 10-K that includes audited consolidated financial statements for the years ended December 31, 2000 and 2001, and the related consolidated statements of earnings, stockholders' equity and cash flows for the three years in the period ended December 31, 2001.

NOTE B - BASIS OF PRESENTATION

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned Thailand subsidiaries, Creative Gems & Jewelry Limited ("Creative"), Advance Gems & Jewelry Limited ("Advance") and Advance Gems Manufacturing Co., Ltd ("Advance Manufacturing") (collectively, the "Subsidiaries"). All significant intercompany accounts and transactions have been eliminated. Except as otherwise disclosed, all amounts are in U.S. dollars.

NOTE C - INVENTORIES

Inventories consist of the following:

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

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| | | |
|------------------|---------------|---------------|
| Raw materials | \$ 981,139 | \$ 1,461,396 |
| Finished stones | 17,200,314 | 20,597,389 |
| Finished jewelry | 823,347 | 794,573 |
| | ----- | ----- |
| | \$ 19,004,800 | \$ 22,853,358 |
| | ===== | ===== |

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The Topaz Group, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

NOTE D - EARNINGS PER COMMON SHARE

The components of basic and diluted earnings per share were as follows:

| | Three months ended March 31, | |
|--|------------------------------|------------|
| | 2001 | 2002 |
| | ----- | ----- |
| BASIC | | |
| Net earnings | \$ 1,242,292 | \$ 528,047 |
| | ===== | ===== |
| Weighted average outstanding shares of common stock | 1,174,886 | 2,134,886 |
| Net earnings per share | \$ 1.06 | \$ 0.24 |
| | ===== | ===== |
| DILUTED | | |
| Net earnings available to common shareholders | \$ 1,242,292 | \$ 528,047 |
| | ===== | ===== |
| Weighted average outstanding shares of common stock | 1,174,886 | 2,134,886 |
| Dilutive effect of preferred shares (1) | 4,877,563 | 3,917,563 |
| | ----- | ----- |
| Common stock and potentially issuable common stock | 6,052,449 | 6,052,449 |
| Net earnings per share | \$ 0.21 | \$ 0.08 |
| | ===== | ===== |

(1) The dilutive effect of warrants outstanding during each of the presented periods was immaterial to these computations.

NOTE E - NEW AUTHORITATIVE ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board issued Statement of

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Financial Accounting Standards No. 141 (SFAS 141), Business Combinations. SFAS 141 applies to all business combinations initiated after June 30, 2001. The Statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. The adoption of SFAS 141 did not have an impact on the Company's consolidated financial statements.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 142 (SFAS 142), Goodwill and Other Intangible Assets. The provisions of SFAS 142 are required to be applied starting with fiscal years beginning after December 15, 2001 with earlier application permitted for entities with fiscal years beginning after March 15, 2001 provided that the first interim financial statements have not previously been issued. The statement is required to be applied at the beginning of the entity's fiscal year and to be applied to all goodwill and other intangible assets recognized in its financial statements to that date. The initial application of SFAS 142 did not have an impact on the Company's consolidated financial statements.

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The Topaz Group, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

NOTE E - NEW AUTHORATIVE ACCOUNTING PRONOUNCEMENTS - Continued

In October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard (SFAS 144), ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS. SFAS 144 supersedes SFAS 121, ACCOUNTING FOR THE IMPAIRMENT OF LONG-LIVED ASSETS AND LONG-LIVED ASSETS TO BE DISPOSED OF, and the accounting and reporting provisions of Accounting Principles Board Opinion 30, REPORTING THE RESULTS OF OPERATIONS - REPORTING THE EFFECTS OF DISPOSAL OF A SEGMENT OF A BUSINESS, AND EXTRAORDINARY, UNUSUAL AND INFREQUENTLY OCCURRING EVENTS AND TRANSACTIONS, for segments of a business to be disposed of. SFAS 144 is effective for fiscal years beginning after December 15, 2001. The initial application of SFAS 144 did not have an impact on the Company's consolidated financial statements.

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

The following discussion of the financial condition and results of operations should be read in conjunction with the consolidated financial statements and related notes thereto. The following discussion contains certain forward-looking statements that involve risk and uncertainties. Our actual results could differ materially from those discussed herein. Factors that could cause or contribute to such differences include, but are not limited to, risks and uncertainties related to the need for additional funds, the rapid growth of the operations and our ability to operate profitably after the initial growth period is completed. We undertake no obligation to publicly release the results of any revisions to those forward-looking statements that may be made to reflect any future events or circumstances.

QUARTER ENDED MARCH 31, 2002 AND MARCH 31, 2001

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SALES. Total sales for the quarter ended March 31, 2002 were \$5,625,270 compared to \$4,586,282 for the quarter ended March 31, 2001, an increase of 22.6%. The increase in sales is primarily attributed to the replenishment of inventories by wholesalers and retailers from fourth quarter economic uncertainties. The retail market in the US represented approximately 70% of the Company's annual revenues for fiscal 2001.

COST OF GOODS SOLD. Cost of goods sold for the quarter ended March 31, 2002 was \$4,156,397, representing 73.8% of sales, compared to \$3,280,297 for the quarter ended March 31, 2001, which represented 71.5% of sales for that quarter. The increase in cost of goods sold is due in part to increased radiation costs per unit for the topaz products colored at the University of Missouri. The Company is charged a base fixed fee and per unit costs to use this reactor. The production or coloration of topaz at the University of Missouri at less than full capacity results in the base fixed fee increasing the cost per unit to color the topaz.

OPERATING COSTS. Operating costs were \$921,077 for the quarter ended March 31, 2002, or 16.3% of revenues, compared to \$838,782 in the quarter ended March 31, 2001, or 18.2% of revenues. This was an increase of \$82,295 or 9.8%. The increase is due in part to increased professional fees relating to the company's listing on the American Stock Exchange.

OPERATING PROFIT. Operating profit for the quarter ended March 31, 2002 was \$547,796 compared to operating profit of \$467,203 for the quarter ended March 31, 2001, which is an increase of 17.2%. The increase is due to increased sales of 22.6% which was partially offset by a decrease in the gross profit percentage of 2.3% and an increase in selling, general and administrative expenses of 9.8%.

OTHER INCOME. Other income and (expense) was (\$19,749) in the quarter ended March 31, 2002 compared to \$775,089 in the quarter ended March 31, 2001, or a decrease of 102.5%. The change is almost entirely due to gains (losses) resulting from currency fluctuations. Our Thai subsidiaries maintain their books and records in Thai Baht. However, their functional currency is the U.S. dollar. Monetary assets and liabilities and related income and expense items are remeasured using the current rates. Certain non-monetary assets (notably property and equipment) are remeasured at historical rates. Other nonmonetary balance sheet items and related revenues, expenses, gains and losses are remeasured using average exchange rates. The remeasurement gain (loss) was \$(68,796) in the quarter ended March 31, 2002, compared to

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\$681,665 for the comparable quarter in 2001. This was principally caused by reduced Baht currency fluctuations relative to the US dollar in the quarter ended March 31, 2002 compared to the same quarter for 2001. The Company implemented a software package in June, 2001 to record the Baht transactions in US dollars as they occur. Recording the transactions as they occur in US dollars is intended to reduce our exposure to currency remeasurement gains and losses.

NET EARNINGS. Net earnings was \$528,047 for the first quarter ended 2002 compared to \$1,242,292 for 2001, a decrease of 57.4%. The difference is largely attributed to a decrease in currency gains (losses) resulting from foreign currency fluctuations.

LIQUIDITY AND CAPITAL RESOURCES

Our principal source of working capital is income from operations, borrowings under our revolving credit facilities and short-term loans from a

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company affiliate. At March 31, 2002, we had a cash and cash equivalent balance of \$317,552 and working capital of \$19,900,067.

Our operating activities provided (used) cash of (\$901,396) for the quarter ended March 31, 2002 compared to \$179,802 for the quarter ended March 31, 2001. The decrease in cash provided by operating activities resulted primarily from a net decrease in cash flow from net earnings of \$714,245, an increase in inventories of \$3,848,558 offset by an increase in accounts payable of \$3,071,514. The earnings decrease is caused by a reduction in currency remeasurement gains and the increase in accounts payable caused by the increase in inventories primarily for topaz products. The inventory increase from year end to the first quarter end is caused by the recovery from the economic slowdown in the fourth quarter of 2001. Inventory buildup was significant in late February and continued through March 2002 to support growth in revenues caused by the replenishment of inventories for wholesalers and retailers.

The net cash provided by (used in) financing activities for the quarter ended March 31, 2002 was \$(281,787) compared to \$885,135 for the quarter ended March 31, 2001. This net increase is due primarily to increases in borrowings under existing lines of credit.

We have line-of-credit arrangements with two Thai financial institutions and a line of credit arrangement with a U.S. financial institution entered into in October 1999, April 2000 and October 2001, respectively. The Thai lines are renewable automatically on a yearly basis and the U.S. line expires in September 2002; the lines are also subject to the banks' periodic reviews resulting in adjustment of our credit limit. The Thai lines bear interest at a rate equal to LIBOR plus two percent (9% at March 31, 2002); the U.S. line bears interest at prime plus 1.25% (6% at March 31, 2002). The 1999 line is personally guaranteed by two of our directors and collateralized by various real estate properties belonging to us and one of our directors. The 2000 line is also guaranteed by two of our directors and secured by a deed on a real estate property owned by a related party. The U.S. line is secured personally by one of our directors, our U.S. receivables and inventory and by a lien on various Thai real estate properties and fixed assets of a related party. As of March 31, 2002, approximately \$1,081,249 was available for commercial draft borrowing under both the 1999 and 2000 lines. As of March 31, 2001, approximately \$72,530 was available for borrowing under the U.S. line. As of March 31, 2002 and March 31, 2001, the outstanding balance under the Thai lines of credit was \$1,012,500 and \$728,389, respectively. As of March 31, 2002 the outstanding balance under the U.S. line was approximately \$1,927,500.

The effects on liquidity of carrying large values of inventory can be referenced by days of sales in inventory. On average, for the twelve months ended March 31, 2002 and 2001, inventory would remain on the books for 403 days and 316 days, respectively, until sold. The inventory is classified as a current asset on the balance sheet but restricts the use of working capital until the inventory is sold. The increase in inventory days was caused by the build up of inventories to support the replenishment of inventories with wholesalers and retailers.

Inventory is valued by applying a moving average method for valuation. Under this method of valuation, generally, the finished stone inventory does not progressively devalue with age and the prices per carat remain relatively stable. The average cost includes the raw cost of the product plus any additional costs to bring it to its current condition including processing, transportation, insurance and holding costs. Variances in valuation under the

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moving average cost method occur when stone prices, overhead cost and other related costs, which make up the value of the inventory, vary significantly up or down within the fiscal period. As such, material variances in the inventory costs are identified and valued separately to reflect true value.

Our business can be classified into two major groups including sale of finished jewelry and finished stones, to a lesser degree. Most of our finished jewelry is made to order and is shipped when completed. Inventory valuations include the lesser of manufactured cost or market valuation per unit times the quantities on hand. Lower of cost or market is referenced by recent sale prices of the finished stones compared to the cost to produce or acquire such stones. If recent sales of an existing stone are not available, current market price samples in the selling market will dictate the lower of cost or market for valuation purposes.

Management believes we have the ability to meet our current and anticipated financing needs for the next twelve months with the facilities in place and funds from operations, however, given our growth prospects, we may need to seek increases in our credit facilities during the upcoming year to sustain further revenue growth.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

CURRENCY FLUCTUATIONS

1. FORWARD-LOOKING STATEMENTS

From time to time, we may make certain statements that contain "forward-looking" information. Words such as "anticipate", "estimate", "project", "believe" and similar expressions are intended to identify such forward-looking statements. Forward-looking statements may be made by management orally or in writing, including, but not limited to, in press releases, as part of the Financial Information or Management's Discussion and Analysis or Plan of Operations and as part of other sections of this registration statement.

Such forward-looking statements are subject to certain risks, uncertainties and assumptions, including without limiting those identified below. Should one or more of these risks or uncertainties materialize, or should any of the underlying assumptions prove incorrect, actual results of current and future operations may vary materially from those anticipated, estimated or projected. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of their respective dates.

2. EXCHANGE RATE INFORMATION

Our Consolidated Financial Statements are prepared in U.S. dollars. The financial statements of our foreign subsidiaries are remeasured into U.S. dollars in accordance with Statement of Financial Accounting Standards No. 52. Fluctuations in the value of foreign currencies cause U.S. dollar amounts to change in comparison with previous periods and, accordingly, we cannot quantify in any meaningful way, the effect of such fluctuations upon

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future income. This is due to the constantly changing exposure in the Thai Baht for our Thai subsidiaries.

As of March 31, 2002, the average daily interbank exchange rate for the Baht was trading at 43.52 Baht to one US dollar. The exchange rate in Thailand has shown signs of stability in early 2002 and we anticipate this to continue through the latter part of 2002. Weakening in the Baht may come from the gap

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between the U.S. and Thai interest rates giving a further boost to exports. Regions of Thailand continue to promote exports to strengthen their economies. We are unable to predict whether the trends noted above would have a material effect on our future financial condition or the results of operations and, if so, whether such an effect will be positive or negative.

3. EXCHANGE RATE FLUCTUATION

| | THAI BAHT | | | |
|---------|--------------------|------------|-----------|---------------------|
| | ----- FIRST QTR | SECOND QTR | THIRD QTR | FOURTH QTR ----- |
| 2002 | | | | |
| High | 44.57 | | | |
| Average | 43.80 | | | |
| Low | 43.00 | | | |
| 2001 | | | | |
| High | 45.00 | 45.85 | 45.87 | 45.07 |
| Average | 43.29 | 45.45 | 44.98 | 44.40 |
| Low | 42.19 | 44.68 | 43.92 | 43.37 |
| 2000 | | | | |
| High | 38.30 | 39.45 | 42.77 | 44.49 |
| Average | 37.96 | 38.67 | 40.97 | 43.44 |
| Low | 36.71 | 37.72 | 39.10 | 41.88 |

Future volatility in the Baht may come from the continued strength in the Thai exports. Other Asian countries are showing overall weakness in exports and large technology industries, with the exception of Japan. Japan's problems are primarily domestic. Asian countries overall will weaken with some support domestically by China and India. We do not anticipate Thailand to be effected by Japan's economic downturn and that of surrounding Asian regions, however, there can be no assurance of this.

We anticipate the cost of raw materials, which includes precious and non-precious metals, to show moderate cost increases in the short-term.

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4. FOREIGN CURRENCY RISK

As of March 31, 2001, we had no open forward-contracts. Our Thai subsidiaries keep their books in the Thai Baht currency. As such, the Thai balances are exposed to currency gains and losses depending upon the currency rate fluctuations when compared to the US dollar for the respective periods. The currency and remeasurement gains and losses for periods ended March 31, 2002 and 2001 are (\$60,137) and \$775,022, respectively.

5. INTEREST RATE FLUCTUATIONS

Our interest expenses and income are sensitive to changes in interest rates. We had interest-bearing obligations of \$2,939,832 for the period ended March 31, 2002 bearing various interest rates, and any fluctuation in the interest rate will have a direct impact on our interest expenses, cash flow and results of operations.

PART II

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OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

None.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

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

None.

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

None.

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SIGNATURES

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

Date: May 15, 2002

THE TOPAZ GROUP, INC.

By: /s/ Terrance C. Cuff

Name: Terrance C. Cuff
Title: Chief Financial Officer

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