

QEP CO INC
Form 10-K
May 27, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended February 29, 2004

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 0-21161

Q.E.P. CO., INC.

(Exact name of registrant as specified in its charter)

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DELAWARE
(State or other jurisdiction of
incorporation or organization)

13-2983807
(I.R.S. Employer
Identification No.)

1081 HOLLAND DRIVE, BOCA RATON, FLORIDA
(Address of principal executive offices)

33487
(Zip Code)

Registrant's telephone number, including area code: (561) 994-5550

Securities Registered Pursuant to Section 12(b) of the Act:

| <u>Title of each class</u> | <u>Name of exchange on which registered</u> |
|----------------------------|---|
| NONE | NONE |

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

Common Stock, \$0.001 par value
(Title of Class)

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 twelve 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 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.

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

The aggregate market value of voting common stock held by non-affiliates as of May 14, 2004 is 25,902,735, computed by reference to the closing price for such shares on the NASDAQ National Market System as of such date. The registrant does not have any authorized or issued non-voting common equity securities.

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The number of shares outstanding of each of the registrant's classes of common stock as of May 14, 2004 is: 3,431,550 shares of Common Stock, par value \$0.001 per share.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the definitive Proxy Statement which the Registrant will file with the Securities and Exchange Commission in connection with the Registrant's Annual Meeting of Stockholders to be held on July 9, 2004 are incorporated by reference in Part III of this Form 10-K.

PART I

Item 1. Business

General

Founded in 1979, Q.E.P. Co., Inc. (the Company or Q.E.P.) manufactures, markets and distributes a broad line of specialty tools and flooring related products for the home improvement market in the United States and 49 countries throughout the world. Under brand names including Q.E.P., O TOOLROBERTS, QSet and Fresh, the Company markets over 3,000 specialty tools and flooring related products used primarily for surface preparation and installation of ceramic tile, carpet, vinyl and wood flooring. Q.E.P.'s products include trowels, floats, tile cutters, wet saws, spacers, nippers, pliers, carpet trimmers and cutters, flooring adhesives, seaming tape, tack strip, knives, dryset powders and grouts. These products are sold to home improvement retailers, including national and regional chains such as Home Depot and Lowes, international chain stores such as Bunnings and Topps Tiles, specialty distributors to the hardware, construction, flooring and home improvement trades and chain or independent hardware, tile, and carpet retailers for use by the do-it-yourself consumers as well as the construction or remodeling professional.

The Company experienced an increase in net sales in fiscal 2004 which management attributes to (i) growth experienced by the Company's customers within the home improvement market, particularly among home center retailers in the United States of America such as Home Depot and Lowes and internationally at Bunnings and Topps Tiles, (ii) the Company's success in cross-marketing its products among its channels of distribution, (iii) the Company's expansion of its customer base and market share through sales to additional home improvement retailers and distributors, and (iv) growth of the home improvement market as a whole.

The Company's principal subsidiaries include Roberts Consolidated Industries, Inc., a worldwide leader in the carpet installation market; Roberts Holland B.V., a European distributor of flooring installation products, in Holland, France, the United Kingdom and Ireland; O Tool Company, a distributor to the trowel trade; Q.E.P. Chile, a distributor, manufacturer and installer of ceramic tile and ceramic tile accessories located in Santiago, Chile; Q.E.P. Australia Pty, Ltd., the largest distributor of tools and installation products for all types of flooring in the Australian marketplace; Boiardi Products Corp. of Little Falls, N.J., a manufacturer of a full line of thin-set mortars, grouts, self-leveling concrete toppings and crack-suppressing waterproof membranes used in the flooring industry; Zocalis, SRL, an Argentinean manufacturer of ceramic borders and trim; Q.E.P. Stone Holdings, which manufactures dry set powders and grouts in Georgia and Florida; Q.E.P. New Zealand, a distributor of accessory flooring supplies; and Q.E.P. Co. U.K., Ltd., a manufacturer and distributor of accessory flooring and safety products in the United Kingdom.

In fiscal 2004 the Company established a new product line called Fresh to sell painting tools in coordinated fashion colors. This product line is targeted to the female do-it-yourself consumer and is expected to be sold to mass merchants, supermarkets and drug store chains, as well as to Q.E.P.'s traditional customers.

Market Overview

The Company is a supplier of specialty flooring installation products and sells to the home improvement market. According to the latest industry information published by Floor Covering Weekly total floor covering sales for the entire United States of America industry rose 5.1% in 2002 to \$51.6 billion while home center sales, with lumberyards similar to Home Depot and Lowes, were \$7 billion. Additionally, it is expected that the United States retail floor covering sales will experience a growth rate of almost 5% in 2004. The Company believes that this growth is being driven by several factors,

including (i) a slowing but continued strong housing activity, (ii) aging of the United States housing stock which requires greater repair and maintenance expenditures, (iii) increased housing turnover of both new and existing homes, (iv) continued home improvement demand being facilitated by the current record level sales of new and existing homes, (v) appreciation of the United States housing market thus giving homeowners the ability to increase the investment in their homes through improvement projects, and (vi) changes in consumer preferences, which have caused an increase in the median size of new homes and which have contributed to demand for remodeling and expansion of older homes.

Home improvement market distribution channels continue to consolidate as a result of the success of the warehouse home center format. The continued dominance of national home improvement retailers results from their ability to offer broad product lines, project advice and orientation, competitive pricing, aggressive promotions and multiple location, large-format stores. The Company's two largest customers, Home Depot and Lowe's, accounted for over \$94 billion of home center sales in 2003. Based on data available to the Company, the Company believes that the primary beneficiaries of this consolidation among worldwide home improvement retailers have been the top two or three companies (ranked by annual sales volume). Thus, while the home improvement market's retail sales have expanded, the market is being increasingly dominated by the largest retailers.

The Company's two largest customers, Home Depot and Lowe's, experienced annual sales growth rates in 2003 of 11.3% and 19.0%, respectively, according to their published financial reports and both have announced plans to continue increasing the number of stores each operates. As consolidation continues among home improvement retailers, the Company expects that sales of the largest national and regional home improvement retailers will continue to increase at greater rates than the rate of sales growth in the overall market. The Company expects that the growth trends in the flooring segment of the home improvement market and among its customer base will directly affect the Company's ability to generate growth in its sales and net income, its expansion strategy and the nature of its sales and marketing initiatives.

Business Strategy

The Company's strategy is to continue to enhance its position as a worldwide leading manufacturer and distributor of specialty tools and related products by introducing new products and cross-selling products among its channels of distribution, expanding market share by obtaining new customers, and capitalizing on expected growth of its largest customers and of the home improvement market as a whole. Key elements of the Company's strategy include:

Pursue Strategic Acquisitions. Through its acquisitions, the Company has broadened its product lines, increased its customer base and increased its manufacturing, distribution and marketing capabilities. The Company intends to seek and evaluate acquisitions of both domestic and worldwide specialty tool and adhesive manufacturers, distributors and other companies whose products, distribution channels and brand names are complementary to those of the Company and which will offer further opportunities for product cross selling, expansion of manufacturing and marketing operations and the addition of new customers.

Increase Sales By Expanding Product Lines and Adding New Customers. The Company seeks to expand its product lines by introducing new and innovative products, which can be marketed to the Company's existing customer base. Through its acquisitions, the Company has expanded its customer base, the number of products available and its line of flooring installation products. In addition to expanding product offerings through acquisitions, the Company intends to internally develop and offer products in response to customer demands. The Company believes that broadening its product lines will make it a more attractive supplier to the major home improvement retailers and specialty distributors, thereby increasing the Company's sales and market penetration. Additionally, the Company is targeting mass merchandisers as prospective customers for a portion of its current product line.

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Capitalize on Cross-Selling Opportunities. The Company believes that there are significant opportunities for cross selling its products among its existing markets and channels of distribution. As part of its acquisition strategy, the Company seeks to identify acquisition candidates with complementary product lines and to cross sell acquired product lines to its existing customer base and its existing product lines to the customers of the acquired business.

Enhance Distribution and Manufacturing Capabilities. In order to effectively serve the customer base and keep certain costs to a minimum, the Company continually improves its distribution capabilities through the increased use of technology as well as reviewing its locations for correct size and geographic location. The Company currently has approximately 798,000 square feet of distribution and manufacturing capability located throughout the United States of America, Canada, Holland, Australia, New Zealand, the United Kingdom, Ireland and South America. The Company estimates that in fiscal 2004, it manufactured approximately 30% of its Q.E.P. and Roberts product lines.

Products

The Company manufactures, markets and distributes a broad line of over 3,000 specialty tools and flooring related products. The Company's products are offered under brand names including Q.E.P., O TOOLROBERTS, QSet and Fresh and are used primarily for surface preparation and installation of ceramic tile, carpet, vinyl and wood flooring.

The Company manufactures and distributes adhesives, grouts, mortars, dry set powders, carpet seaming tape and an assortment of carpet installation tools as well as floats, tile cutters, trowels, electric saws, nippers and other products to the flooring industry. These products are sold to both distributors and do-it-yourself customers. Although the Company manufactures and distributes over 3,000 products, a majority of the Company's sales are to customers who purchase between 20 and 200 individual stock-keeping units. As the Company seeks to broaden its product lines, the competition for limited shelf space available at home improvement retailers for specialty tools and related products may limit sales of existing or newly introduced products.

The Company maintains a research and development program through which it seeks to identify new product opportunities within its primary markets. Methods by which the Company seeks to identify product opportunities include soliciting product feedback from customers through its outside sales force and manufacturers' representatives, review of product brochures and catalogs issued by foreign and domestic competitors of specialty tools, review of product concepts with buyers employed by its customers, and attendance at industry trade shows and conventions at which new product concepts are introduced and discussed. The Company also considers participation in joint ventures and evaluation of product samples to be an important part of its effort to identify new product opportunities. The Company maintains a product quality control program primarily to verify the quality of its existing products and to develop ideas for additional products or enhancements to existing products.

In fiscal 2004 the Company began distributing its Fresh line of painting tools in coordinated fashion colors to mass merchandising stores and drug chains. The sales for this fiscal year were not material to the financial statements.

Relationship With Major Customers

In 1982, the Company began selling products to Home Depot, which is currently the largest home improvement retailer in the world, sixth largest retailer globally and the second largest retailer in the United States of America based on annual sales volume. In 1993, the Company added Lowe's as a customer, which is now the second largest home improvement retailer in the world and fourteenth largest retailer in the United States of America. Home Depot and Lowe's are the Company's two largest customers accounting for 46.4% and 13.2% of the Company's fiscal 2004 net sales, respectively.

Because of the importance of home improvement retailers to its business, the Company has, in consultation with these major customers, developed customer service programs to ensure that the specific needs of these customers are given a high priority with direct attention from senior officers of the Company. Features of the Company's customer service programs for its major customers include

providing a wide range of in-store services, such as, assistance with inventory, maintenance of product displays, introduction of new products, maintaining inventories of tools and related products in multiple locations to permit rapid shipping, delivering orders promptly, holding education classes for retail store personnel, packaging with multilingual labels, prepaying delivery for product shipments with minimum purchase requirements, participating in cooperative promotions and special sales events, providing product research for buyers, operating a customer service hotline, providing parts and repair service, extension of advertising allowances, accepting orders electronically and billing through electronic data interchange, bar coding for each individual stock-keeping unit, and incorporating anti-theft tags in packaging. The Company believes that its major customers place considerable value on service and promotional support and frequently evaluates its service and promotional activities in an effort to serve its customers more effectively.

The Company believes that the consolidation among home improvement retailers will continue and that the national and large regional home improvement retailers will continue to increase their market share in the near future. Home Depot and Lowe's have announced plans to increase significantly the number of stores each operates over the next several years. As a result, the Company expects the percentage of its sales to these customers to continue to be significant. However, the Company continues to expand its customer base in other areas, both domestically and internationally, through acquisitions.

The loss of Home Depot or Lowe's as a customer of the Company would have a material adverse effect on the financial position of the Company.

Manufacturing and Suppliers

The Company estimates that in fiscal 2004 it manufactured approximately 30% of its Q.E.P. and Roberts product lines. The Company manufactures adhesives, carpet seaming tape, carpet installation tools and ceramic tile spacers at its main manufacturing facility in Mexico, Missouri. Flooring adhesives are produced at the facility in Bramalea, Ontario, Canada. Grouts and related products are manufactured at the Company's New Jersey, Georgia and Ft. Pierce, Florida facilities. In Australia, the Company manufactures accessories used for the installation of ceramic tile. Ceramic trim is manufactured in Argentina. Tile cutters, safety products and ceramic tile spacers are manufactured in the United Kingdom.

The Company purchased finished products and components from approximately 250 different suppliers in fiscal 2004. Although the Company believes that multiple sources of supply exist for nearly all of the products and components purchased from outside suppliers and generally maintains at least two sources of supply for each item purchased, interruptions in supply or price changes in the items purchased by the Company could have a material adverse effect on the Company's operations. The Company receives product from its suppliers into its three main domestic warehouses located in Boca Raton, Florida; Mexico, Missouri and Henderson, Nevada. Disruption in supply to any of these warehouses may result in excessive inventory levels and added costs to the Company. Further, in fiscal 2004, the Company purchased in excess of \$11.5 million and \$7.0 million of finished product from two foreign suppliers representing 25.1% and 15.3%, respectively of domestic product purchases.

Distribution, Sales and Marketing

The Company's specialty tools and related products are currently sold through four distinct distribution channels: (i) the Company's sales staff; (ii) independent manufacturing representatives; (iii) an in-house telemarketing sales force; and (iv) outside salaried and commissioned sales representatives. Management estimates that sales through its primary distribution channels in fiscal 2004 were as follows: 60.9% to national and regional home improvement retailers and 39.1% to specialty distributors, other specialty retailers and original equipment manufacturers.

The Company maintains an in-house creative services department through which it produces and develops color product catalogs, signage, point of purchase materials and distinctive packaging to enhance sales per square foot at the retail level and to reinforce the Company's brand images. The Company maintains a website which allows customers to obtain product information, catalogues and order replacement parts. The Company also informs customers of product promotions through direct contact via e-mail or fax.

The Company's marketing and sales representatives, or its manufacturers' representatives, conduct regular visits to many customers' individual retail stores. In addition, the Company or its sales representatives provides product knowledge classes for retail store personnel. The Company also evaluates the product mix at its customers' locations from time to time with a view toward evolving the product mix to increase sales per square foot. When the Company secures a new customer, or introduces new product into existing customer stores, the Company generally resets all displays and assists store personnel in becoming familiar with the Company's product line.

Competition

The Company believes that competition in the home improvement flooring product market is based primarily on product quality, delivery capabilities, brand name recognition, availability of retail shelf space and price. The Company believes that its competitive strengths are its product quality, its wide range of products, delivery capabilities, brand recognition and strong customer relationships. The Company faces competition largely on a product-by-product basis from numerous manufacturing and distribution companies. The Company believes that the diversity of its product portfolio, among other things, will allow it to compete effectively with its competitors, although some of such competitors may sell larger quantities of a particular product than the Company.

The Company is aware of a number of competitors, many of which are foreign and may have greater financial, marketing and other resources than the Company. The Company's foreign sales, including Canada, accounted for approximately 26.9% of total sales during fiscal year 2004. Fiscal 2004 total sales generated by the Company's Canadian subsidiary were 8.7%, its European subsidiaries 7.9%, its Australian subsidiaries 8.7%, its South American subsidiaries 0.6% and 1.0% to foreign customers from its domestic subsidiaries. The Company is continuing to penetrate more foreign markets and, as a result, the Company may experience competition from foreign companies, which could adversely affect the Company's gross margins on its foreign sales.

Certain of the Company's larger customers have in the past contacted one or more of the Company's foreign suppliers to discuss purchasing home improvement products directly from these suppliers. Although the Company believes that its diversified product line, brand recognition and customer service will continue to offer benefits not otherwise available to the Company's customers from foreign manufacturers, the Company could experience competition from one or more foreign manufacturers which now serve as suppliers to the Company. If one or more of the Company's larger customers were to begin purchasing products previously supplied by the Company directly from foreign manufacturers, the Company's business would be adversely affected. Increased competition from these manufacturers or others could result in lower sales, price reductions or loss of market share, each of which would have an adverse effect on the Company's results of operations.

Environmental Matters

The Company is subject to federal, state and local laws, regulations and ordinances governing activities or operations that may have adverse environmental effects, such as discharges to air and water, handling and disposal practices for solid, special and hazardous wastes, and imposing liability for the cost of clean up, and for certain damages resulting from sites of past spills, disposal or other releases of hazardous substances (together, Environmental Laws). Sanctions which may be imposed for violation of Environmental Laws include the payment or reimbursement of investigative and clean up costs, administrative penalties and, in certain cases, prosecution under environmental criminal statutes. The

Company's manufacturing facilities are subject to environmental regulation by, among other agencies, the Environmental Protection Agency, the Occupational Safety and Health Administration, and various state authorities in the states where such facilities are located. The activities of the Company, including its manufacturing operations at its leased facilities, are subject to the requirements of Environmental Laws. The Company believes that the cost of compliance with Environmental Laws to date has not been material to the Company. The Company is not currently aware of any situations requiring remedial or other action which would involve a material expense to the Company, or expose the Company to material liability under Environmental Laws. As the operations of the Company involve the storage, handling, discharge and disposal of substances which are subject to regulation under Environmental Laws, there can be no assurance that the Company will not incur any material liability under Environmental Laws in the future or will not be required to expend funds in order to effect compliance with applicable Environmental Laws.

The Company completed testing at its facility in Bramalea, Ontario, Canada for leakage of hazardous materials and, as a result, in fiscal 1999 the Company prepared a plan to remediate the contamination over a period of years and this plan was subsequently approved by the Canadian Ministry of Environment. The Company recorded a reserve for potential environmental liability on the closing date of the Roberts acquisition of approximately \$325,000 and this amount was subsequently increased by \$275,000 to \$600,000 based on an estimate for the cost of remediation. Through fiscal 2004, the Company has spent approximately \$532,000 and anticipates spending additional amounts on ongoing monitoring of wells and other environmental activity at the approximate rate of between \$5,000 and \$25,000 per year for the next few years.

In March 2004, the Company settled a lawsuit initially filed against one of the Company's subsidiaries in January 1998, Cargill, Inc. Et Al. v. Abco Construction Et Al., for \$45,000. The provisions of this settlement allow for the plaintiffs to reopen this matter under certain conditions. Although there can be no certainty, the Company does not believe that it is likely that these conditions will ever materialize.

The Company has received notice from the United States Environmental Protection Agency (the "EPA") that an entity identified as Roberts Consolidated Industries, Inc. may be involved in the contamination of landfill sites in Clark County, Ohio and Santa Barbara County, California. In addition, in April 2003, the record owner of certain real property in Vancouver, Washington informed the Company that an entity known as Roberts Consolidated Industry, Inc. owned or operated the facility during which time hazardous substances were disposed of or released at the site and pursuant to Washington State law, it is also liable for remedial action costs at the site. At this time, the Company is not aware whether these entities are predecessors to any of its affiliates or whether they are unrelated entities.

Roberts Holdings International, Inc. ("Roberts Holding"), an inactive subsidiary of the Company who was also named in the Cargill matter, was named as a third party defendant in a case currently pending before the United States District Court for the Western District of Michigan. The case is Strebor Inc. v. International Paper Co., Case No. 1:02 CV0948, Western District of Michigan, Southern Division. The Company became aware of the lawsuit on June 30, 2003, when opposing counsel in the matter forwarded directly to the Company a copy of the Third Party Complaint of International Paper Co., naming Roberts Holding as a third party defendant. The third party plaintiff alleged that Roberts Holding is a successor to a company known as Roberts Consolidated Industries, Inc. and is required to indemnify previous owners for costs associated with the clean-up of a property in Kalamazoo, Michigan. The Company believes it has viable defenses to the claim both factually and contractually. The Company has filed suit against Strebor and International Paper in this matter. The Company believes that the ultimate outcome will not have a material adverse effect on the financial position of the Company. Although the Company does not believe that the ultimate outcome will have a material adverse effect on the Company, the amount of exposure to the Company and/or its subsidiaries is impossible to estimate at the present time based on the preliminary stage of the proceedings and because the Company's subsidiary apparently was only in possession of the site where the incident occurred almost 30 years ago and for a very short time.

Intellectual Property

The Company markets its specialty tools and related products under various trademarks owned by the Company or its subsidiaries, including Q.E.P., O TOOLROBERTS, QSet and Fresh. The Company has devoted substantial time, effort and expense to the development of brand name recognition and goodwill for products sold under its trademarks, has not received any notice that its use of such marks infringes upon the rights of others, and is not aware of any activities which would appear to constitute infringement of any of its marks. Roberts Consolidated Industries, Inc. has secured domestic and foreign patents relating to certain of its products. Although the patents are important to the operation of Roberts Consolidated Industries, Inc., the Company does not believe that the loss of any one or more of these patents would have a material adverse effect on the Company. These patents are scheduled to expire in the years 2008 and 2013. Roberts Consolidated Industries, Inc. also licenses its name to various foreign distributors and a domestic distributor of tackstrip.

Employees

As of May 14, 2004, the Company had 504 employees, including 118 administrative employees, 101 sales and marketing employees, 142 manufacturing employees and 143 employees responsible for shipping activities. There are 39 part-time employees and 241 of the employees are employed by the Company's international subsidiaries. The Company has not experienced any work stoppages and none of the Company's employees are represented by a union. The Company considers its relations with the employees to be good.

Item 2. Properties

The Company currently owns the facility in Bramalea, Ontario, Canada and leases all other facilities located in the United States of America, Canada, Europe, South America, New Zealand and Australia. All facilities aggregate approximately 798,000 square feet. The following table sets forth certain information concerning the facilities of the Company.

| LOCATION | USE | SQUARE FEET | ANNUALIZED | LEASE EXPIRATION | RENEWAL OPTION |
|---------------------------|---|----------------|------------|---------------------|-------------------|
| | | | COST | | |
| Boca Raton, Florida | Executive offices, warehouse; manufacturing | 77,000 | \$ 502,951 | 01/15/06 | |
| Lelystraat, Holland | Administrative and sales | 52,544 | 135,785 | 10/31/07 | |
| Marisstaat, Holland | Warehouse | 63,259 | 108,282 | 01/01/07 | |
| Plaisir, France | Administrative; warehouse | 1,700 | 13,049 | 09/30/05 | |
| Henderson, NV | Administrative; warehouse | 111,000 | 460,254 | 01/31/08 | Y |
| Mexico, Missouri | Administrative; warehouse; manufacturing | 155,000 | 373,514 | 06/15/06 | Y |
| Lancashire, England | Administrative; warehouse; manufacturing | 27,000 | 110,748 | 3/31/07 | |
| County Laois, Ireland | Administrative; warehouse; sales | 10,000 | 140,718 | Monthly | |
| Bramalea, Ontario | Administrative; warehouse; manufacturing | 92,000 | | Owned | |
| Mississagua, Ontario | Warehouse | 15,000 | 73,252 | Monthly | |
| Buenos Aires, Argentina | Administrative; warehouse; manufacturing | 4,293 | 12,901 | Monthly | |
| Auckland, New Zealand | Administrative; warehouse | 41,046 | 24,168 | 11/30/05 | Y |
| Dandenong, Australia | Manufacturing | 26,200 | 106,529 | 05/01/05 | Y |
| Hindsmarch, Australia | Administrative; warehouse | 7,234 | 19,814 | 03/01/05 | Y |
| Santiago, Chile | Administrative; warehouse; manufacturing | 1,674 | 14,400 | 05/01/05 | Y |
| Little Falls, NJ | Administrative; warehouse; manufacturing | 17,653 | 73,920 | 07/01/05 | Y |
| Calhoun, GA | Administrative; warehouse; manufacturing | 25,000 | 66,547 | 03/07/05 | |
| Ft. Pierce, FL | Administrative; warehouse; manufacturing | 18,000 | 77,668 | 06/30/05 | |
| Wetherill Park, Australia | Administrative; warehouse; sales office | 23,000 | 135,085 | 06/06/07 | |
| Newcastle, Australia | Sales office | 3,000 | 19,650 | 07/22/04 | |
| Coffs Harbour, Australia | Sales office | 1,076 | 3,787 | Monthly | |
| Brookvale, Australia | Sales office | 645 | 16,051 | 9/01/06 | |
| Tamworth, Australia | Sales office | 900 | 4,630 | 10/01/05 | |
| Wagga Wagga, Australia | Sales office | 1,259 | 3,903 | Monthly | |
| Gosford, Australia | Sales office | 1,647 | 9,907 | 09/30/05 | |
| Wollongong, Australia | Sales office | 1,022 | 12,418 | Monthly | |
| Mitcham, Australia | Administrative and warehouse | 4,112 | 18,217 | 04/01/06 | |
| Dandenong, Australia | Warehouse | 4,500 | 15,863 | 03/31/07 | |
| Victoria, Australia | Warehouse | 4,200 | 7,443 | 08/31/04 | |
| Melbourne, Australia | Warehouse | 4,000 | 11,708 | 03/31/05 | |
| Mitcham, Australia | Warehouse | 800 | 2,702 | 03/31/05 | |
| Mitcham, Australia | Warehouse | 2,000 | 8,433 | 06/30/04 | |

The Company believes that its existing facilities are adequate to meet its current needs and that additional facilities can be leased to meet future needs. Further, it is expected that all leases necessary for the continuing operations of the Company expiring in fiscal 2005, will be renewed.

Item 3. Legal Proceedings

The Company is involved in litigation from time to time in the course of its business. In the opinion of management, no material legal proceedings are pending to which the Company or any of its property is subject.

In March 2004, the Company settled a lawsuit initially filed against one of the Company's subsidiaries in January 1998, Cargill, Inc. Et Al. v. Abco Construction Et Al., for \$45,000. The provisions of this settlement allow for the plaintiffs to reopen this matter under certain conditions. Although there can be no certainty, the Company does not believe that it is likely that these conditions will ever materialize.

The Company received notice from the United States Environmental Protection Agency (the EPA) that an entity identified as Roberts Consolidated Industries, Inc. may be involved in the contamination of landfill sites in Clark County, Ohio and Santa Barbara County, California. In addition, in April 2003, the record owner of certain real property in Vancouver, Washington informed the Company that an entity known as Roberts Consolidated Industry, Inc. owned or operated a facility during which time hazardous substances were disposed of or released at the site and pursuant to Washington State law, it is also liable for remedial action costs at the site. At this time, the Company is not aware whether these entities are predecessors to any of its affiliates or whether they are unrelated entities.

Roberts Holdings International, Inc. (Roberts Holding), one of the Company's inactive subsidiaries was named as a third party defendant in a case currently pending before the United States District Court for the Western District of Michigan. The case is *Strebor Inc. v. International Paper Co.*, Case No. 1:02 CV0948, Western District of Michigan, Southern Division. The Company became aware of the lawsuit on June 30, 2003, when opposing counsel in the matter forwarded directly to the Company a copy of the Third Party Complaint of International Paper Co., naming Roberts Holding as a third party defendant. The third party plaintiff alleged that Roberts Holding is a successor to a company known as Roberts Consolidated Industries, Inc. and is required to indemnify previous owners for costs associated with the clean-up of property in Kalamazoo, Michigan. The Company believes it has viable defenses, to the claim both factually and contractually. The Company has filed suit against Strebor and International Paper in this matter. No significant discovery has yet taken place in the case and the matter is set for jury trial in April 2005. Mediation sessions took place during late 2003 and February 2004 and the parties are discussing the possible resolution of this matter. However, to date, no settlement has been reached. The Company believes that it has viable defenses both factually and contractually to the claims and if the case is not resolved, discovery will be pursued. Although the Company does not believe that the ultimate outcome will have a material adverse effect on the Company, the amount of exposure to the Company and/or its subsidiaries is impossible to estimate at the present time based on the preliminary stage of the proceedings and because the Company's subsidiary apparently was only in possession of the site where the incident occurred almost 30 years ago and for a very short time.

Item 4. Submission of Matters to Vote of Security Holders

No matters were submitted to a vote of security holders of the Company during the fourth quarter of the period covered by this report.

PART II
Item 5. Market for Registrant's Common Equity and Related Shareholder Matters**Market Price and Dividend Information**

The Company's Common Stock is traded on the Nasdaq National Market System. The following table sets forth the high and low sales price per share for the Common Stock for each quarter during fiscal year 2004 and 2003, as reported on the Nasdaq National Market System.

| | Fiscal Year Ended February 28 or 29, | | | |
|----------------|--------------------------------------|-----------|----------|----------|
| | 2004 | | 2003 | |
| | High | Low | High | Low |
| First Quarter | \$ 8.750 | \$ 5.100 | \$ 4.600 | \$ 4.110 |
| Second Quarter | \$ 10.930 | \$ 8.310 | \$ 4.520 | \$ 4.010 |
| Third Quarter | \$ 12.020 | \$ 9.470 | \$ 4.740 | \$ 4.050 |
| Fourth Quarter | \$ 15.970 | \$ 10.100 | \$ 6.500 | \$ 3.640 |

On May 14, 2004, the closing price of the Common Stock on the Nasdaq National Market System was \$15.00 per share. As of that date, there were 27 holders of record of the common stock and approximately 917 beneficial owners of the common stock.

The Company has not paid cash dividends on its common stock and does not intend for the foreseeable future to declare or pay any cash dividends on this stock; rather it intends to retain earnings, if any, for the future operation and expansion of the Company's business. Any determination to declare or pay dividends will be at the discretion of the Company's board of directors and will depend upon the Company's future earnings, results of operations, financial condition, capital requirements, considerations imposed by applicable law and other factors deemed relevant by the board of directors. The Company's credit facility also prohibits the payment of dividends on its common stock without the consent of the lenders.

Item 6. Selected Financial Data

The selected consolidated financial data set forth below as of and for the years ended February 28 or 29, 2000, 2001, 2002, 2003 and 2004 have been derived from the audited consolidated financial statements of the Company. The audited consolidated statements of income for the years ended February 28 or 29, 2000 and 2001, respectively and the audited consolidated balance sheets as of February 28 or 29, 2000 through 2002 are not included in this filing. The selected consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations (Item 7 of this report) and the audited consolidated financial statements and related notes thereto included elsewhere herein.

FISCAL YEAR ENDED FEBRUARY 28 OR 29,

| | 2004 | 2003 | 2002 | 2001 | 2000 |
|---|------------|------------|------------|------------|------------|
| (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) | | | | | |
| OPERATING DATA: | | | | | |
| Net Sales | \$ 143,273 | \$ 129,281 | \$ 109,675 | \$ 113,003 | \$ 113,571 |
| Cost of goods sold | 94,065 | 84,883 | 72,603 | 76,940 | 79,037 |
| Gross profit | 49,208 | 44,398 | 37,072 | 36,063 | 34,534 |
| Shipping | 13,369 | 11,950 | 9,589 | 9,801 | 8,987 |
| General and administrative | 12,300 | 10,980 | 9,740 | 9,650 | 9,380 |
| Selling and marketing | 14,598 | 13,762 | 11,895 | 11,616 | 9,494 |
| Restructuring charge | | | | 637 | |
| Other expense (income), net | 1,488 | 532 | (217) | (92) | |
| Operating income | 7,453 | 7,174 | 6,065 | 4,451 | 6,673 |
| Interest expense, net | 1,585 | 1,876 | 2,557 | 2,131 | 1,700 |
| Income before provision for income taxes, cumulative effect of change in accounting principle and extraordinary item | 5,868 | 5,298 | 3,508 | 2,320 | 4,973 |
| Provision for income taxes | 2,380 | 2,243 | 1,405 | 887 | 1,951 |
| Net income before cumulative effect of change in accounting principle and extraordinary item | 3,488 | 3,055 | 2,103 | 1,433 | 3,022 |
| Cumulative effect of change in accounting principle | | 3,048 | | | |
| Net income before extraordinary item | 3,488 | 7 | 2,103 | 1,433 | 3,022 |
| Extraordinary item, gain on early extinguishment of debt | | | | | 181 |
| Net income | \$ 3,488 | \$ 7 | \$ 2,103 | \$ 1,433 | \$ 3,203 |
| Basic net income per common share before cumulative effect of change in accounting principle and extraordinary item | \$ 1.02 | \$.90 | \$.62 | \$.42 | \$.90 |
| Cumulative effect of change in accounting principle | | (.89) | | | |
| Extraordinary item | | | | | .05 |
| Basic earnings per share | \$ 1.02 | \$.01 | \$.62 | \$.42 | \$.95 |
| Weighted average number of basic shares of common stock outstanding | 3,398 | 3,381 | 3,381 | 3,331 | 3,331 |
| Diluted net income per common share before cumulative effect of change in accounting principle and extraordinary item | \$ 0.99 | \$ 0.90 | \$ 0.62 | \$ 0.42 | \$ 0.90 |
| Cumulative effect of change in accounting principle | | (0.89) | | | |
| Extraordinary item | | | | | |
| Diluted earnings per share | \$ 0.99 | \$ 0.01 | \$ 0.62 | \$ 0.42 | \$ 0.95 |
| Weighted average number of diluted shares of common stock outstanding | 3,527 | 3,394 | 3,390 | 3,331 | 3,331 |
| | 2004 | 2003 | 2002 | 2001 | 2000 |

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BALANCE SHEET DATA:

| | | | | | |
|-----------------------|-----------|-----------|----------|----------|-----------|
| Working capital | \$ 13,753 | \$ 11,810 | \$ 9,710 | \$ 9,788 | \$ 13,511 |
| Total assets | 78,824 | 72,525 | 62,371 | 64,036 | 57,715 |
| Long term obligations | 9,606 | 9,520 | 9,143 | 11,241 | 11,588 |
| Total liabilities | 51,317 | 49,410 | 39,321 | 41,923 | 36,532 |
| Shareholders equity | 27,507 | 23,115 | 23,050 | 22,113 | 21,183 |

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Executive Overview

The Company is a worldwide leader in the manufacturing, marketing and distribution of a broad line of specialty tools and flooring related products for the home improvement market. The Company markets over 3,000 specialty tools and related products used primarily for surface preparation and installation of ceramic tile, carpet, vinyl and wood flooring. The Company's products are sold to home improvement retailers, specialty distributors to the hardware, construction, flooring and home improvement trades, chain or independent hardware, tile and carpet retailers for use by the do-it-yourself consumer as well as the construction or remodeling professional, and original equipment manufacturers. The Company has embarked on a growth strategy that encompasses acquisitions, the reduction of risk associated with certain large customer concentrations and the enhancement of cross selling of its product among the Company's channels of distribution. The Company believes that this strategy will improve overall performance and profitability of operations. For the fiscal year ended February 29, 2004, the Company achieved its highest level of sales and operating income at \$143.3 million and \$7.5 million, respectively, representing increases over the previous year of 10.8% and 3.9%, respectively. As to working capital, the Company maintains inventory levels based on anticipated demand from its customers taking into consideration the lead time necessary to receive product from the Company's suppliers. The Company pays such suppliers on open account based on negotiated terms with the supplier. The Company grants credit to its customers based on their credit worthiness and selling arrangement. The Company generally maintains its inventory at a level to insure prompt delivery to its customers and to provide safety stock levels necessitated by the longer lead times of its foreign suppliers.

The Company continues to grow both internally and through acquisitions. During fiscal 2004, the Company continued to broaden its international customer base by making strategic acquisitions in the United Kingdom and Ireland. The Company also began selling painting tools through different distribution channels. The Company was able to reduce its interest expense by refinancing its subordinated loan with a term loan from its existing bank group. During fiscal 2004 the strengthening of the euro and other foreign currencies had a favorable impact on sales but did not have a material impact on net income.

Accounting Policies and Estimates

Our significant accounting policies are contained in Note 1 to the Consolidated Financial Statements. The following are our most critical accounting policies which are those that require complex judgments and estimates about the effect of matters that are inherently uncertain and may change in subsequent periods.

Revenue Recognition

The Company recognizes sales when the merchandise is shipped and title has passed to the customer, the selling price is fixed and determinable, and collectibility of the sales price is reasonably assured. The Company provides for estimated costs of future anticipated product returns based on historical experience, when the related revenues are recognized. The Company records estimated reductions to revenue for customer programs including volume-based incentives.

Inventory Obsolescence

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The Company maintains reserves for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assessments about current and future demand and market conditions. If actual market conditions were to be less favorable than those projected by management, additional inventory reserves could be required.

Accounts Receivable

The Company's accounts receivable are principally due from home centers or flooring accessory distributors. Credit is extended based on an evaluation of a customer's financial condition, and collateral is not required. Accounts receivable are due at various times based on each customer's credit worthiness and selling arrangement. The outstanding balances are stated net of an allowance for doubtful accounts. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the customer's previous loss history, the customer's ability to pay its obligations and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts.

Income Taxes

The Company is required to estimate income tax in each jurisdiction in which it operates. This process involves estimating actual current tax exposure together with assessing temporary differences resulting from the different treatment of items for book and tax purposes. These differences result in deferred tax assets and liabilities which are included in the Company's Consolidated Balance Sheet. Deferred income taxes are recorded to reflect the tax consequences on future years of differences between the tax basis of assets and liabilities and their financial reporting amounts each year-end. The Company must then consider the likelihood that the deferred tax asset will be recoverable from future taxable income and to the extent that the Company believes that recoverability is not likely, the Company establishes a valuation allowance.

Impact of Inflation and Changing Prices

The Company has experienced inflation related to the purchase of raw materials and finished goods. The Company does not believe that the change in price of these raw materials and finished goods has had a material effect on net sales or results of operations. The Company cannot accurately determine the extent of inflation on changing prices or net sales.

Dollar figures set forth below are rounded to the nearest thousand.

Results of Operations

Fiscal 2004 as compared to Fiscal 2003

Net sales for the twelve months ended February 29, 2004 (fiscal 2004 , or the fiscal 2004 period) were \$143,273,000 compared to \$129,281,000 for the twelve months ended February 28, 2003 (fiscal 2003 , or the fiscal 2003 period), an increase of \$13,992,000 or 10.8%. Sales at the Company's North American subsidiaries increased by approximately \$7,013,000. Approximately \$1,600,000 of the total increase was the result of favorable exchange rates at the Company's Canadian subsidiary. The balance of the increase was the result of increased sales to the home center customer base principally due to new store expansion by home centers and the introduction of new product into existing stores. These increases were partially offset by a decline in the Company's distributor business. Sales at the Company's foreign subsidiaries increased by approximately \$6,979,000 of which approximately \$3,595,000 was the result of favorable exchange rates. Further, approximately \$3,300,000 of the foreign sales increase results from the full year effect of the acquisition of an Australian distributorship in July 2002 amounting to approximately \$2,100,000 and the acquisition of a manufacturer and distributor in England, in January 2004, amounting to approximately

\$1,200,000. Overall, selling prices remained relatively stable during the period.

Gross profit for fiscal 2004 was \$49,208,000 compared to \$44,399,000 for fiscal 2003, an increase of \$4,809,000 or 10.8%. As a percentage of net sales, gross profit remained constant at 34.3% for the fiscal 2004 and fiscal 2003 periods. The actual increase in gross profit was primarily the result of the increase in volume together with a favorable change in the foreign exchange rates of approximately \$1,622,000.

Shipping expenses for the fiscal 2004 period were \$13,369,000 compared to \$11,950,000 for the fiscal 2003 period, an increase of \$1,419,000 or 11.9%. As a percentage of net sales, these expenses increased slightly to 9.3% in the fiscal 2004 period from 9.2% in the fiscal 2003 period, primarily as a result of increased freight rates at the Company's North American and Australian subsidiaries and a decrease in the Company's average order size. The actual increase is primarily the result of increased sales volume. The Company's recent acquisitions accounted for an approximate increase of \$300,000 and exchange rate differences accounted for approximately \$277,000 of the increase in freight expense.

General and administrative expenses for the fiscal 2004 period were \$12,300,000 compared to \$10,980,000 for the fiscal 2003 period, an increase of \$1,320,000 or 12.0%. As a percentage of net sales, these expenses increased slightly to 8.6% in the fiscal 2004 period from 8.5% in the fiscal 2003 period, primarily as a result of an increase in human resources costs. These costs together with an increase in insurance, information technology and depreciation at the Company's North American subsidiaries, accounted for approximately \$832,000 of the increase. The Company's foreign subsidiaries accounted for an increase of approximately \$488,000 substantially all of which is exchange rate related.

Selling and marketing costs for the fiscal 2004 period increased to \$14,598,000 from \$13,762,000 in the fiscal 2003 period, an increase of \$836,000 or 6.1%. As a percentage of net sales, these expenses decreased to 10.2% in the fiscal 2004 period from 10.6% in the fiscal 2003 period, primarily as a result of certain fixed costs being spread over the higher sales volume. The actual increase is primarily the result of increased commissions and marketing allowances resulting from the higher sales volume together with an approximate \$728,000 increase resulting from exchange rate differences.

Other expense for the fiscal 2004 period includes, among other things, approximately \$767,000 resulting from a change to the value of the warrant put liability and approximately \$617,000 relating to the early repayment of the Company's subordinated debt. Other expense in the fiscal 2003 period was primarily the result of a change to the value of the warrant put liability.

Interest income for the fiscal 2004 and fiscal 2003 periods was approximately \$1,000. Interest expense for the fiscal 2004 period was approximately \$1,586,000 compared to approximately \$1,877,000 in the fiscal 2003 period. Interest expense decreased primarily as a result of the decrease in the borrowing rate applied to the Company's indebtedness and the repayment of the Company's high interest subordinated debt. These decreases were partially offset by the \$270,000 prepayment penalty in the fiscal 2004 period relating to the early repayment of the Company's subordinated debt.

Provision for income taxes was \$2,380,000 in fiscal 2004 compared to \$2,243,000 in the fiscal 2003 period, an increase of 137,000 or 6.1%. The increase is the result of the increase in the Company's taxable income. The effective tax rate was approximately 40.6% in the fiscal 2004 period compared to 42.3% in the fiscal 2003 period. The estimated tax rate is based upon the most recent effective tax rates available and is higher in the fiscal 2003 period primarily as a result of the Company not recognizing an income tax benefit related to its European subsidiary's loss. Further, the Company did not recognize a tax benefit in either the fiscal 2004 or fiscal 2003 period relating to the financial accounting requirement of the put liability.

In August 2002, the Company completed the valuation of its goodwill in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 142. The result of this valuation was an impairment loss to goodwill at the Company's European and Latin American subsidiaries. This impairment loss, amounting to approximately \$3,048,000, was recorded as a cumulative effect of a change in accounting principal and was effected as of March 1, 2002.

Net income for the fiscal 2004 period, excluding approximately \$566,000 of after tax expense relating to the early repayment of certain subordinated indebtedness previously described herein was approximately \$4,054,000 compared to approximately \$3,055,000, exclusive of the cumulative effect of a change in accounting principle for the fiscal 2003 period, an increase of approximately \$999,000 or 32.7%. After taking into consideration the foregoing analysis of changes in expenses, net income as a percentage of net sales increased to 2.8% in the fiscal 2004 period from 2.4% in the fiscal 2003 period. The Company's management believes that the financial results the Company would have achieved without the one-time charges related to the prepayment of its subordinated debt is meaningful to investors because it provides a consistent comparison with prior period results.

Exclusive of the above qualifications, net income for the fiscal 2004 period increased to \$3,488,000 from \$7,000 in the fiscal 2003 period, an increase of \$3,481,000 or 497.3%. Net income as a percentage of sales increased to 2.4% of sales for the fiscal 2004 period from 0% of sales in the fiscal 2003 period.

Results of Operations

Fiscal 2003 as compared to Fiscal 2002

Net sales for the twelve months ended February 28, 2003 (fiscal 2003 , or the fiscal 2003 period) were \$129,281,000 compared to \$109,675,000 for the twelve months ended February 28, 2002 (fiscal 2002 , or the fiscal 2002 period), an increase of \$19,606,000 or 17.9%. Selling prices remained relatively stable during the period. Sales increased primarily as a result of an increase in the Company's home center customer base volume resulting from new product introduction into existing stores and an increase in the number of stores operated by these customers. Additionally, the Australian distributor, acquired in fiscal 2003, accounted for approximately \$3.6 million of the increase.

Gross profit for fiscal 2003 was \$44,399,000 compared to \$37,072,000 for fiscal 2002, an increase of \$7,327,000 or 19.8%. As a percentage of net sales, gross profit increased to 34.3% in fiscal 2003 from 33.8% in fiscal 2002 primarily due to a change in product mix towards higher margin products, a reduction of certain raw material costs and an increase in gross margin at the Company's European subsidiary.

Shipping expenses for the fiscal 2003 period were \$11,950,000 compared to \$9,589,000 for the fiscal 2002 period, an increase of \$2,361,000 or 24.6%. As a percentage of net sales, these expenses increased to 9.2% in the fiscal 2003 period from 8.7% in the fiscal 2002 period primarily as a result of a decrease in the Company's average order size and an increase in freight rates charged by common carriers. The actual increase was substantially the result of the increased sales volume. Further, the newly acquired Australian distributor accounted for approximately \$343,000 of the increase.

General and administrative expenses for the fiscal 2003 period were \$10,980,000 compared to \$9,741,000 for the fiscal 2002 period, an increase of \$1,239,000 or 12.7%. As a percentage of net sales, these expenses decreased to 8.5% in the fiscal 2003 period from 8.9% in the fiscal 2002 period. This decrease was primarily due to the absorption of certain fixed costs over a higher sales volume and the elimination of approximately \$471,000 of goodwill expense in accordance with SFAS No. 142. The actual increase was primarily the result of an increase in personnel costs, costs associated with the Company's internet presence operations and approximately \$226,000 resulting from the recently acquired Australian distributor.

Selling and marketing costs for the fiscal 2003 period increased to \$13,762,000 from \$11,895,000 in the fiscal 2002 period, an increase of \$1,867,000 or 15.7%. As a percentage of net sales, these expenses decreased slightly to 10.6% in the fiscal 2003 period from 10.8% in the fiscal 2002 period principally as a result of certain fixed costs being absorbed over a higher sales volume. The actual increase is primarily the result of

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increased marketing allowances and commissions paid resulting from the increase in volume to the Company's home center customer base. Additionally, approximately \$299,000 is the result of the Australian distributorship acquisition.

Other expense for the fiscal 2003 period includes, among other things, approximately \$600,000 resulting from a change to the value of the warrant put liability. Other income in the fiscal 2002 period was primarily the result of a settlement agreement favorable to the Company.

Interest income for the fiscal 2003 period was approximately \$1,000 compared to \$10,000 in the fiscal 2002 period. Interest expense for the fiscal 2003 period was approximately \$1,877,000 compared to approximately \$2,567,000 in the fiscal 2002 period. Interest expense decreased primarily as a result of the decrease in the borrowing rate applied to the Company's indebtedness and the expiration of the unfavorable interest rate swap agreement in existence in the fiscal 2002 period.

Provision for income taxes was \$2,243,000 in fiscal 2003 compared to \$1,405,000 in the fiscal 2002 period, an increase of \$838,000 or 59.6%. The increase is the result of the increase in the Company's taxable income and an additional provision for certain foreign taxes. The effective tax rate was approximately 42.3% in the fiscal 2003 period compared to 40.0% in the fiscal 2002 period. The estimated tax rate is based upon the most recent effective tax rates available and is higher in the fiscal 2003 period primarily as a result of the Company not recognizing an income tax benefit related to its European subsidiary's loss and the aforementioned warrant put liability charge.

In August 2002, the Company completed the valuation of its goodwill in accordance with the provisions of SFAS No. 142. The result of this valuation was an impairment loss to goodwill at the Company's European and Latin American subsidiaries. This impairment loss, amounting to approximately \$3,048,000, was recorded as a cumulative effect of a change in accounting principal and was affected as of March 1, 2002.

Net income for the fiscal 2003 period, exclusive of the cumulative effect of a change in accounting principal, increased to \$3,055,000 compared to \$2,103,000 in the fiscal 2002 period, an increase of \$952,000 or 45.3%. Net income, exclusive of the cumulative effect of a change in accounting principal, as a percentage of sales increased to 2.4% in the fiscal 2003 period compared to 1.9% in the fiscal 2002 period reflecting a higher gross profit margin on a substantial increase in sales volume offset by related higher operating costs. The Company's net profit for fiscal 2003 was approximately \$7,000 after the cumulative effect of a change in accounting principle.

Exclusive of the above qualifications, net income for the fiscal 2003 period decreased to approximately \$7,000 from approximately \$2,103,000 in the fiscal 2002 period, a decrease of \$2,096,000 resulting from the factors described above and the approximate \$3,048,000 charge from the change in accounting principal. Net income as a percentage of net sales decreased from 1.9% in the fiscal 2002 period to 0% in the fiscal 2003 period.

Liquidity and Capital Resources

Working capital increased to approximately \$13,753,000 at February 29, 2004 from approximately \$11,810,000 at February 28, 2003, an increase of \$1,943,000 primarily as a result of an increase in the Company's income from operations, the refinancing of the Company's debt in November 2002, as further described elsewhere herein, and an approximate increase of \$208,000 resulting from the acquisition, in fiscal 2004, of a manufacturer and distributor in the United Kingdom. Any cash in excess of anticipated requirements is invested in commercial paper or overnight repurchase agreements with a financial institution. The Company states the value of such investments at market price and classifies them as cash equivalents in its balance sheet.

Net cash provided by operating activities during the fiscal 2004 period was approximately \$9,257,000 compared to cash used of approximately \$979,000 for the comparable fiscal 2003 period. The increase in cash from operating activities was primarily the result of an increase in income from operations as adjusted for non-cash charges for depreciation, amortization and the put liability charge in addition to significant decreases in accounts receivable and inventory as a result of the Company's ability to enhance collections of accounts receivable and dramatically reduce the inventory level from the previous year high which was adversely affected by the work stoppage at certain West Coast shipping ports in the United States of America. Net cash used in investing activities was approximately \$5,942,000 in the fiscal 2004 period compared to approximately \$1,753,000 for the comparable fiscal 2003 period. The fiscal 2004 amount was attributable to capital expenditures of approximately \$2,586,000, of which approximately \$1,395,000 relates to the expansion of the Company's plant in Bramalea, Ontario, Canada. Additionally, the Company expended approximately \$3,602,000 for the acquisition of a manufacturer and distributor in the United Kingdom. The fiscal 2003 amount was attributable to \$1,258,000 of capital expenditures and approximately \$495,000 of funds expended for an Australian distributor acquisition.

Net cash used in financing activities was approximately \$3,041,000 in the fiscal 2004 period as compared to cash provided by financing activities of approximately \$2,883,000 in the fiscal 2003 period. The fiscal 2004 amount is substantially the result of repayments of line of credit, term debt and acquisition debt amounting to approximately \$9,500,000 offset by new debt in the amount of approximately \$6,367,000. The new debt pertains to the refinancing of the Company's \$4,500,000 subordinated debt described elsewhere herein and a mortgage of approximately \$1,324,000 to finance the expansion of the Company's Canadian facility. The fiscal 2003 amount is substantially the result of an increase in short term financing to fund working capital needs.

In November 2002, the Company entered into an amended and restated loan agreement with its existing lender. Under the terms of the agreement the Company obtained a \$4,000,000 term loan, which was used to refinance its existing two term loans with this lender and provide additional working capital. Under the terms of the new loan, which will mature in 2007, the Company will pay \$400,000 per quarter during the first year of the loan and \$200,000 per quarter thereafter. The agreement, which now includes another financial institution as a participant, also increased the Company's borrowing capacity under a revolving loan facility to \$23,000,000 under the same formula for eligible accounts receivable and inventory that previously existed for the Company. The revolving loan facility expires in July 2005. The term loan and the revolver have an interest rate that ranges from LIBOR plus 1.50% to LIBOR plus 2.25% and are collateralized by substantially all of the Company's assets. The agreement also prohibits the Company from incurring certain additional indebtedness, limits certain investments, advances or loans, restricts substantial asset sales and capital expenditures and prohibits the payment of dividends, except for dividends due on the Company's Series A and C preferred stock. At February 29, 2004, the rate was LIBOR (1.2% at February 29, 2004) plus 1.75% and the Company had approximately \$3,416,000 available for future borrowings under its revolving loan facility net of approximately \$429,000 in outstanding letters of credit. During the twelve month period ended February 29, 2004, the Company borrowed approximately \$11,650,000 and repaid approximately \$15,599,000 under this revolving credit facility. This resulted in an average outstanding indebtedness during the period of approximately \$17,874,000.

In July 2003, the Company refinanced its mortgage loan in Canada and financed its expansion of the Canadian facility. The mortgage refinancing is for approximately \$1,867,000, and is amortized based on a 15-year period. The mortgage refinancing bears an interest rate of LIBOR plus 2.00% and will mature in October 2007. The mortgage loan requires principal payments of approximately \$10,500 per month.

In May 2003, the Company prepaid its subordinated loan facility with HillStreet Fund LP (HillStreet). Under the terms of the prepayment, the Company paid a prepayment penalty of 6% amounting to

\$270,000 together with the \$4,500,000 principal balance of the facility. The prepayment penalty was included in interest expense in the Consolidated Statement of Operations for the fiscal 2004 period. Funding for this prepayment came from a second term facility provided by the Company's two financial lenders. This term facility requires monthly payments of \$125,000 during the first five months and \$141,667 monthly thereafter. This loan bears interest at LIBOR plus 3.25%. The Company's Chairman and Chief Executive Officer has personally guaranteed up to a maximum of \$3,000,000 of this loan. The guarantor's potential liability under the guaranty decreases by an amount equal to each payment made by the Company. In connection with the guaranty, the Company's audit committee and board of directors approved, and the stockholders ratified, an agreement whereby the Company granted its Chairman 50,000 shares of restricted common stock. Based on an independent appraisal obtained by the Company, the value of the 50,000 shares was determined to be \$275,000 or \$5.50 per share. The Company further agreed to indemnify him to the extent of all payments made by the Chairman to the lenders pursuant to the guaranty.

In connection with the subordinated loan agreement between the Company and HillStreet, entered into on April 5, 2001 and which was paid in full on May 12, 2003, the Company issued 325,000 10-year warrants (the Put Warrants) at an exercise price of \$3.63 per share. The Put Warrants continue to remain outstanding, and can be put to the Company on and after April 5, 2006, based on criteria set forth in the warrant agreement. In addition, the Company may call these warrants on and after April 5, 2007, based on the same criteria. The Company recorded the initial liability for the Put Warrants based on an independent appraisal. The Company updates the value of the liability for the Put Warrants on a quarterly basis. The liability value of the Put Warrants is calculated based on the greatest of (1) the fair market value of the Company if a capital transaction or public offering occurs; or (2) a formula value based on a multiple of the last twelve month trailing EBITDA calculation; or (3) an appraised value as if the Company was sold as a going concern. Changes to the fair value of the Put Warrants are recognized in the earnings of the Company in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. In the fiscal 2004 period, the Company recorded an expense of approximately \$795,000 related to the increase in the Put Warrant Liability.

The Company's Australian subsidiary has a foreign payment facility which allows it to borrow against a certain percentage of inventory and accounts receivable. At February 29, 2004, the maximum permitted borrowing was approximately \$850,000, of which substantially all was utilized and there were no available borrowings as of such date.

In connection with an acquisition in July 2002, the Company's Australian subsidiary entered into a new loan facility with an Australian financial institution to provide financing of up to AUD\$ 2,500,000 (approximately US \$1,300,000). This facility includes a term facility and a short-term foreign and domestic facility that will be used to provide the capital necessary for acquisitions and general working capital purposes. The term facility expires in June 2005 and requires quarterly payments of AUD \$25,000 (approximately US \$19,000) and a final balloon payment. In July 2002, approximately AUD \$1,298,000 (approximately US \$715,000) of this facility was used to provide financing for the acquisition of an Australian distributor and, in addition, the Company issued a note to the related seller in the approximate amount of AUD \$1,445,000 (approximately US \$795,500). This note requires monthly payments in the amount of approximately \$21,000 through December 2006 with interest at 6.5%. Subsequent to February 28, 2004 the Company modified its existing facility in Australia to provide for borrowing up to a maximum of AUD \$4,427,000 (approximately US \$3,337,000). The additional financing will be utilized to finance a future acquisition and provide additional working capital. The facility consists of two term facilities, one of which expires in June of 2005 and the other in April 2007. Quarterly payments of AUD \$112,000 (US \$84,000) are required with balloon payments at the conclusion of each loan. The facility bears an interest rate of 2% above the Australian bank bill rate or cost of finance rate (5.45%) at February 29, 2004.

In connection with certain acquisitions during fiscal years 1999 through 2000, the Company issued three unsecured notes to the respective sellers. The first note, having an original principal balance of \$900,000 was originally payable in equal installments over a three year period with interest at the Company's prevailing borrowing rate. In October 2002, the Company paid \$50,000 and, in May 2003, amended the agreement to provide for full payment on October 10, 2004 of the remaining \$250,000. The agreement was further amended on February 2, 2004 to extend the final \$250,000 due as of February 29, 2004 to October 10, 2006. Interest on the extended payment is payable quarterly at 7%. The second note, in the principal amount of \$825,000, was payable in installments: \$312,500 plus interest of \$12,500 was paid in December, 2000, \$312,500 plus interest of \$12,500 was partially paid in December, 2001 and the balance was paid over a ten month period beginning January, 2002; the final installment of \$200,000 plus interest of \$25,000 was paid in December, 2003. The third note, in the original principal amount of \$1,600,000, is payable quarterly at \$80,000 plus interest at 8% from October 1, 2000 through October 1, 2005 and the amount outstanding as of February 29, 2004 was \$480,000.

In connection with the purchase of the assets of Vitrex Ltd., a manufacturer and distributor of accessory flooring and safety products in the United Kingdom as further described elsewhere in this report, the Company's United Kingdom subsidiary entered into two financing arrangements with a financial institution in the United Kingdom. The first financing arrangement allows for borrowing of up to approximately £900,000 (approximately U.S. \$1,600,000) based on the advancement of up to 80% of the value of accounts receivable. In addition, the subsidiary may borrow up to £400,000 (approximately U.S. \$728,000) against the value of the inventory. Both of these facilities are collateralized by substantially all of the assets of the subsidiary as well as a guaranty by the Company.

Impact of Inflation and Changing Prices

The Company has experienced inflation related to the purchase of raw materials and finished goods. The Company does not believe that the change in price of these raw materials and finished goods has had a material effect on net sales or results of operations. The Company cannot accurately determine the extent of inflation on changing prices or net sales. The Company does not believe inflation has had a material effect on net sales or results of operations.

Contractual and Other Obligations

The following table summarizes, as of February 29, 2004, the Company's minimum payments for long-term debt and other obligations for the next five years and thereafter.

Payments Due By Fiscal Year Ending February 28 or 29,

| | Total | 2005 | 2006 | 2007 | 2008 | 2009 | Thereafter |
|----------------------------|---------------|---------------|--------------|--------------|--------------|-----------|------------|
| Long-term debt | \$ 10,077,935 | 3,224,313 | 3,647,589 | 890,623 | 1,734,985 | 77,440 | 502,985 |
| Capital lease obligation | 200,228 | 95,952 | 85,155 | 19,121 | | | |
| Operating lease obligation | 5,480,826 | 2,151,932 | 1,560,507 | 1,266,306 | 502,081 | | |
| Purchase obligation | 13,397,727 | 13,397,727 | | | | | |
| Put warrant | 1,942,792 | | | 1,942,792(1) | | | |
| | \$ 31,099,508 | \$ 18,869,924 | \$ 5,293,251 | \$ 4,118,842 | \$ 2,237,066 | \$ 77,440 | \$ 502,985 |

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- (1) Represents the earliest period that the holder can put the warrants to the Company under the existing agreement (see Note I). Also, the Company has the right to call these warrants in the fiscal year ending February 29, 2008.

The Company believes its existing cash balances, internally generated funds from operations and its available bank lines of credit will provide the liquidity necessary to satisfy the Company's working capital needs, including the growth in inventory and accounts receivable balances, and will be adequate to finance anticipated capital expenditures and debt obligations for the next twelve months. There can be no assurance, however, that the assumptions upon which the Company bases its future working capital and capital expenditure requirements and the assumptions upon which it bases its belief that funds will be available to satisfy such requirements will prove to be correct. If these assumptions are not correct, the Company may be required to raise additional capital through loans or the issuance of debt securities that would require the consent of the Company's current lenders, or through the issuance of equity securities.

To the extent the Company raises additional capital by issuing equity securities or obtaining borrowings convertible into equity, ownership dilution to existing stockholders will result, and future investors may be granted rights superior to those of existing stockholders. Moreover, additional capital may be unavailable to the Company on acceptable terms, or may not be available at all.

Recently Issued Accounting Standards

Variable Interest Entities

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation 46 (FIN 46), *Consolidation of Variable Interest Entities*. FIN 46 clarifies the application of Accounting Research Bulletin 51, *Consolidated Financial Statements*, for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest (variable interest entities). Variable interest entities within the scope of FIN 46 will be required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity's expected losses, receives a majority of its expected returns, or both. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. At February 29, 2004 the Company currently is not a party to transactions contemplated under FIN 46.

Revenue Recognition

In November 2002, the Emerging Issues Task Force reached a consensus opinion on EITF 00-21, *Revenue Arrangements with Multiple Deliverables*. The consensus provides that revenue arrangements with multiple deliverables should be divided into separate units of accounting if certain criteria are met. The consideration for the arrangement should be allocated to the separate units of accounting based on their relative fair values, with different provisions if the fair value of all deliverables are not known or if the fair value is contingent on delivery of specified items or performance conditions. Applicable revenue recognition criteria should be considered separately for each separate unit of accounting. EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Entities may elect to report the change as a cumulative effect adjustment in accordance with APB Opinion 20, *Accounting Changes*. At February 29, 2004, the Company is not a party to transactions contemplated by EITF 00-21.

Derivative Instruments

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS No. 149 requires that contracts with comparable characteristics be accounted for similarly. In particular, SFAS No. 149 (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative discussed in paragraph 6(b) of SFAS No. 133, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying instrument to conform it to language used in FIN No. 45, and (4) amends certain other exiting pronouncements. The provisions of SFAS No. 149 are effective for contracts entered into or modified after June 30, 2003. The Company's adoption of SFAS No. 149 did not have a material impact on its results of operations or financial position.

Financial Instruments

On May 15, 2003, the FASB issued SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS 150 affects the issuer's accounting for three types of freestanding financial instruments.

Mandatorily redeemable shares, which the issuing company is obligated to buy back in exchange for cash or other assets.

Instruments that do or may require the issuer to buy back some of its shares in exchange for cash or other assets; includes put options and forward purchase contracts.

Obligations that can be settled with shares, the monetary value of which is fixed, tied solely or predominantly to a variable such as a market index, or varies inversely with the value of the issuer's shares.

SFAS 150 does not apply to features embedded in a financial instrument that is not a derivative in its entirety. Most of the guidance in SFAS 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003.

In March 2003, the Securities and Exchange Commission issued Regulation G *Condition for Use of Non-GAAP Financial Measures*. As defined in Regulation G, a non-GAAP financial measure is a numerical measure of a company's historical or future performance, financial position or cash flow that excludes or includes amounts or adjustments that are included or excluded in the most directly comparable measure calculated in accordance with generally accepted accounting principles. Companies that present non-GAAP financial measures must disclose a numerical reconciliation to the most directly comparable measurement using GAAP. This report contains use of non-GAAP financial measures and the required numerical reconciliation.

Forward-Looking Statements

This report contains certain forward-looking statements that are made pursuant to the safe harbor provisions of the Securities Litigation Reform Act of 1995. Forward-looking statements present the Company's expectations or forecasts of future events. These statements can be identified by the fact that they do not relate strictly to historical or current facts. They are frequently accompanied by words such as *believe*, *intend*, *expect*, *anticipate*, *plan*; or *estimate* and other words of similar meaning. In particular, such statements include statements relating to the adequacy of the Company's liquidity sources to meet the Company's working capital needs and anticipated expenditures; the Company's ability to increase the amount of sales of its products, and the ability of the Company to continue its strong performance and that of its products and to increase stockholder returns. Additionally, the report is subject to risks and uncertainties which could cause actual results to differ materially from those discussed in the forward-looking statements and from historical results of operations. Among the risks and uncertainties which could cause such a difference are the assumptions upon which the Company bases its assessments of its future working capital and capital expenditure requirements and those relating to the Company's ability to satisfy its working capital needs and to finance its anticipated capital expenditures which could prove to be different than expected, the Company's dependence upon a limited number of customers for a substantial portion of its sales, and the continued success of initiatives with the Home Depot and Lowe's, the success of the Company's marketing and sales efforts, improvements in productivity and cost reductions, including inventory reductions, the absence of increased pricing pressures from customers and competitors and the ability to defend market share in the face of price

competition, the Company's ability to maintain and improve its brands, the Company's reliance upon two major foreign suppliers, the Company's reliance upon suppliers and sales agents for the purchase of finished products which are then resold by it, the level of demand for the Company's products among existing and potential new customers, the Company's dependence upon the efforts of Lewis Gould, the Company's Chief Executive Officer and certain other key personnel, the Company's ability to successfully integrate new management personnel into the Company, the Company's ability to accurately predict the number and type of employees required to conduct its European and South American operations and the compensation required to be paid to such personnel, its ability to manage its growth, the risk of economic and market factors affecting the Company or its customers, the Company's belief that there will be no future adverse effect on the fair value of the Company's assets in accordance with the provisions of SFAS 142 and other risks and uncertainties described elsewhere herein. Subsequent written and oral forward-looking statements attributable to the Company or persons acting on its behalf are expressly qualified in their entirety by the cautionary statements set forth above and elsewhere in this report and in other reports filed by the Company with the Securities and Exchange Commission.

Risk Factors Affecting the Company's Performance

In addition to other information provided in this Annual Report on Form 10-K, the Company is subject to the following risk factors. While we believe our expectations are reasonable, they are not guarantees of future performance. Our results could differ substantially from our expectations if any of the events described in these risks occur.

The Company May Be Unable To Pass On To Its Customers Increases In The Costs Of Raw Materials

The prices of many of the Company's raw materials for the manufacture of adhesives and tile spacers vary with market conditions. In addition the price of many of the Company's finished goods are impacted by changes in currency, freight costs and raw materials at the point of production. The Company's ability to pass these increases on to its customers varies depending on the product line, rate and magnitude of any increase. There may be periods of time during which increases in these costs cannot be recovered.

The Company's Largest Customers Seek To Purchase Product Directly From Foreign Suppliers

Certain of the Company's larger customers have in the past contacted one or more of the Company's foreign suppliers to discuss purchasing home improvement products directly from these suppliers. Although the Company believes that its diversified product line, brand recognition and customer service will continue to offer benefits not otherwise available to the Company's customers from foreign manufacturers, the Company could experience competition from one or more foreign manufacturers which now serve as suppliers to the Company.

Failure To Identify Suitable Acquisition Candidates, To Complete Acquisitions And To Integrate Successfully The Acquired Operations

As part of its business strategy, the Company intends to pursue acquisitions that enhance its current product line and distribution channels both in the United States of America and around the world. Although the Company regularly evaluates acquisition opportunities, it may not be able to successfully identify suitable acquisition candidates; obtain sufficient financing on acceptable terms to fund acquisitions, or profitably manage the acquired businesses. In addition, the Company may not be able to successfully integrate the acquired operations and the acquired operations may not achieve the expected results.

The Company has been, and in the future may be subject to claims and liabilities under environmental, health and safety laws and regulations, which could be significant.

The Company is subject to federal, state and local laws, regulations and ordinances governing activities or operations that may have adverse environmental effects, such as discharges to air and water, handling and disposal practices for solid, special and hazardous wastes. The activities of the Company, including its manufacturing operations at its leased facilities, are subject to the requirements of Environmental Laws. The Company has received various notices from state and federal agencies that it may be responsible for certain environmental remediation activities and is, or has been, a defendant in environmental litigation. Although the Company is not currently aware of any situation requiring remedial or other action that would involve a material expense to the Company or expose the Company to material liability under Environmental Laws, the Company cannot assure you that it will not incur any material liability under Environmental Laws in the future or that it will not be required to expend funds in order to effect compliance with applicable Environmental Laws, either of which could have a material adverse effect on the Company.

The Company faces intense competition in its industry, which could decrease demand for its products and could have a material adverse effect on its profitability.

The Company's industry is highly competitive. The Company faces competition from a large number of manufacturers and independent distributors. Many of its competitors are larger and have greater resources and access to capital than the Company. In order to maintain the Company's competitive position, the Company will need to continue to develop new products and expand its customer base both domestically and internationally. Competitive pressures may also result in decreased demand for the Company's products. Any of these factors could have a material adverse effect on the Company.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

The Company's exposure to market risk results primarily from fluctuations in interest rates. In addition the Company has international subsidiaries which expose the financial condition and results of operations to fluctuation in the rates of various foreign currencies. For the year ended February 29, 2004, the foreign currency fluctuation was not material to the financial condition or results of operations of the Company.

In order to limit the effect of changes in interest the Company purchased, in February 2003 for \$125,000, a three year 4% LIBOR CAP on \$10 million of the Company's floating rate debt.

The Company averaged approximately \$24,040,000 of variable rate debt during fiscal 2004. If interest rates would have increased by 10%, the effect on the Company would have been an increase in interest expense of approximately \$96,000.

The Company issued 325,000 warrants associated with certain of its previously existing subordinated debt. These warrants contain put and call provisions as defined in the agreement. If the fair value of the warrant changes by \$0.10, the effect on the Company would be an adjustment to earnings of \$32,500.

Item 8. Financial Statements and Supplementary Financial Data

The response to this item is submitted on pages F1 F28 of this Report.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures.

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report pursuant to Exchange Act Rule 13a-14. Based upon the evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective in timely alerting them to material information relating to the Company and its consolidated subsidiaries required to be included in the Company's periodic filings. There were no significant changes in the Company's internal controls or in other factors that could significantly affect those controls subsequent to the date of the evaluation.

PART III

Item 10. Directors and Executive Officers of the Registrant

Information required by this item regarding directors and officers is incorporated by reference from the definitive Proxy Statement to be filed by the Company for the Annual Meeting of Stockholders to be held on July 9, 2004.

Item 11. Executive Compensation

Information required by this item regarding compensation of officers and directors is incorporated by reference from the definitive Proxy Statement to be filed by the Company for the Annual Meeting of Stockholders to be held on July 9, 2004.

Item 12. Security Ownership of Certain Beneficial Owners and Management

Information required by this item is incorporated by reference from the definitive Proxy Statement to be filed by the Company for the Annual Meeting of Stockholders to be held on July 9, 2004.

Item 13. Certain Relationships and Related Transactions

Information required by this item is incorporated by reference from the definitive Proxy Statement to be filed by the Company for the Annual Meeting of Stockholders to be held on July 9, 2004.

Item 14. Principal Accountant Fees and Services

Information required by this item is incorporated by reference from the definitive Proxy Statement to be filed by the Company for the Annual Meeting of Stockholders to be held on July 9, 2004.

PART IV
Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) The following documents are filed as part of the report:

1. and 2. The financial statements filed as part of this report are listed separately in the index to Financial Statements beginning on page F-1 of this report.

3. For Exhibits see Item 14 (c), below. Exhibit Nos. 10.1.1, 10.1.2, 10.1.3 and 10.3.11 consist of management contracts or compensatory plans or arrangements required to be filed as exhibits to this report.

(b) Reports on Form 8-K

A Form 8-K was filed on January 8, 2004 announcing the issuance of a press release setting forth the Company's earnings and condensed balance sheet for the fiscal third quarter and nine months ended November 30, 2003.

(c) List of Exhibits:

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|--|
| 2.1 | Form of Agreement and Plan of Merger regarding the change in incorporation of the Company from a New York Corporation to a Delaware Corporation ⁽¹⁾ |
| 2.1.1 | Stock Purchase Agreement dated October 21, 1997 between the Company and RCI Holdings, Inc. ⁽⁴⁾ |
| 3.1.1 | Certificate of Incorporation of the Company ⁽¹⁾ |
| 3.1.2 | Bylaws of the Company ⁽²⁾ |
| 3.3 | Form of Indemnification Agreement executed by Officers and Directors of the Company ⁽¹⁾ |
| 4.1 | Form of specimen certificate for Common Stock of the Company ⁽¹⁾ |
| 4.1.1 | Form of Warrant issued by the Company to the representative of the underwriters of the Company's initial public offering ⁽¹⁾ |
| 9 | Voting Trust Agreement, dated August 3, 1996, by and between Lewis Gould and Susan J. Gould ⁽¹⁾ |
| 10.1.1 | Employment Agreement, dated August 3, 1996, by and between Lewis Gould and the Company ⁽¹⁾ |
| 10.1.2 | Q.E.P. Co., Inc. Omnibus Stock Plan of 1996 ⁽²⁾ |
| 10.1.3 | Employment Agreement dated May 1, 2002 by and between Lewis Gould and the Company. ⁽⁹⁾ |
| 10.2.6 | Lease Agreement, dated September 17, 1996, by and among the Company and Lawrence Z. Crockett, as Trustee of the Lawrence Z. Crockett Trust dated March 31, 1994 and Marilyn M. Crockett, as Trustee of the Marilyn M. Crockett Trust dated March 31, 1994, including amendment thereto dated January 22, 1997 ⁽²⁾ |

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- 10.2.7.1.1 Industrial Lease, dated August 1, 1996, by and between JMB/Pennsylvania Advisors - IV, L.P., and the Company ⁽²⁾
 - 10.3.1.1.1 Revolving Loan and Security Agreement and Assignment of Leases, dated October 13, 1995, by and between Shawmut Bank Connecticut, N.A., a national banking association, and the Company, including Promissory Note dated October 13, 1995, Limited Guaranty of Lewis Gould dated October 13, 1995, and form of Guaranty executed by the Company's subsidiaries ⁽¹⁾
 - 10.3.2 First Amendatory Agreement to Revolving Loan and Security Agreement, dated as of July 25, 1997, by and among Q.E.P. Co., Inc. and its subsidiaries and Fleet National Bank (f/k/a Shawmut Bank Connecticut, N.A.), including Amended and Restated Revolving promissory Note dated July 25, 1997 and Release of Limited Guaranty of Lewis Gould, dated July 25, 1997. ⁽³⁾
 - 10.3.3 Amended and Restated Loan Agreement by and among Q.E.P. Co., Inc., Q.E.P.-O Tool, Inc., Marion Tool Corporation, Westpoint Foundry, Inc., Roberts Consolidated Industries, Inc., Roberts Holding International, Inc., and Roberts Company Canada Limited and Fleet National Bank dated as of October 21, 1997. ⁽⁵⁾
 - 10.3.3A First Amendatory Agreement to the Amended and Restated Loan Agreement by and among Q.E.P. Co., Inc., Q.E.P.-O Tool, Inc., Marion Tool Corporation, Westpoint Foundry, Inc., Roberts Consolidated Industries, Inc., Roberts Holding International, Inc., and Roberts Company Canada Limited and Fleet National Bank dated as of October 21, 1997. ⁽⁷⁾
 - 10.3.4 Stock Purchase Agreement effective January 1, 1998 between Q.E.P. Holding B.V. and Roberts Beheer B.V. ⁽⁶⁾
 - 10.3.5 Purchase and Sale Agreement effective as of December 31, 1997 between Roberts Beheer B.V., Q.E.P. Co., Inc. and Roberts Consolidated Industries, Inc. ⁽⁶⁾
 - 10.3.6 Subordinated Loan and Security Agreement, dated April 5, 2001, by and between The HillStreet Fund, L.P. and the Company, including Subordinated Term Promissory Note dated April 5, 2001, Warrant Agreement dated April 5, 2001, and Warrant dated April 5, 2001. ⁽⁸⁾
 - 10.3.7 Fourth Agreement of Amendment, dated April 5, 2001, by and between Fleet Capital Corporation and the Company, including 2001 Term Note dated April 5, 2001, Guaranty of Lewis Gould dated April 5, 2001, Amended Trademark Collateral Security Agreement. ⁽⁸⁾
 - 10.3.8 Second Amended and Restated Loan Agreement dated November 14, 2002, by and among the Company, its subsidiaries, Fleet Capital Corporation, HSBC Bank USA and Fleet Capital Corporation, as agent. ⁽¹⁰⁾
 - 10.3.9 Form of Term Note, Domestic Advances Note, Foreign Advances Note and B.V. Note executed in connect with Second Amended and Restated Loan Agreement dated November 14, 2002. ⁽¹¹⁾
 - 10.3.10 Guaranty Agreement among Lewis Gould, Fleet Capital Corporation, HSBC Bank USA and Fleet Capital Corporation, dated May 12, 2003. ⁽¹³⁾
 - 10.3.11 Agreement by the Company and Lewis Gould, dated May 12, 2003. ⁽¹³⁾
 - 14.1 Code of Ethics for Senior Financial Officers. ⁽¹⁴⁾
 - 21 Subsidiaries of the Company ⁽⁸⁾

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- 31.1 Certification of Principal Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. ⁽¹⁴⁾
- 31.2 Certification of Principal Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. ⁽¹⁴⁾
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ⁽¹⁴⁾
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ⁽¹⁴⁾
- 99.1 Form of Warrant issued to the following persons in the following amounts: RCI Holdings, Inc. (100,000) and Marlborough Capital Fund, Ltd. (100,000) ⁽⁴⁾
- 99.2 Form of 8% Convertible Subordinated Debenture issued to the following persons in the following amounts: RCI Holdings, Inc. (\$1,911,673.30), Marlborough Capital Fund, Ltd. (\$5,088,326.70), and IBJ Schroeder as Escrow Agent (\$500,000). ⁽⁴⁾
- 99.3 Escrow Agreement dated October 21, 1997 among the Company, RCI Holdings, Inc., and IBJ Schroeder. ⁽⁴⁾

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- (1) Incorporated by reference to Exhibit of the same number filed with the Company's Registration Statement on Form S-1 (Reg. No. 333-07477).
- (2) Incorporated by reference to Exhibit of the same number filed with the Company's Annual Report on Form 10-K filed on May 28, 1997.
- (3) Incorporated by reference to Exhibit of the same number filed with the Company's Quarterly Report on Form 10-Q filed on October 14, 1997.
- (4) Incorporated by reference to Exhibit of the same number filed with the Company's Report on Form 8-K filed on November 3, 1997 (except that Exhibit 2.1.1 above was numbered 2.1 in the Form 8-K).
- (5) Incorporated by reference to Exhibit of the same number filed with the Company's Quarterly Report on Form 10-Q filed on January 14, 1998.
- (6) Incorporated herein by reference to Exhibit of the same number filed with the Company's Annual Report on Form 10-K filed on May 28, 1998.
- (7) Incorporated herein by reference to Exhibit of the same number filed with the Company's Annual Report on Form 10-K filed on May 27, 2000.
- (8) Incorporated herein by reference to Exhibit of the same number filed with the Company's Annual Report on Form 10-K filed on May 28, 2001.
- (9) Incorporated herein by reference to Exhibit 10.1 filed with the Company's Quarterly Report on Form 10-Q filed January 13, 2003.
- (10) Incorporated herein by reference to Exhibit 10.2 filed with the Company's Quarterly Report on Form 10-Q filed January 13, 2003.

- (11) Incorporated herein by reference to Exhibit 10.3 filed with the Company's Quarterly Report on Form 10-Q filed January 13, 2003.
- (12) This exhibit shall be treated as accompanying this Annual Report on Form 10-K and shall not be deemed as filed as part of the Report.
- (13) Incorporated herein by reference to exhibit of the same number filed with the Company's Annual Report on Form 10-K filed on May 28, 2003.
- (14) Filed herewith.
- (d) The financial statement schedule filed as part of this report is listed separately in the Index to Financial Statements beginning on page F-1 of this report.

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, in the City of Boca Raton, State of Florida, on May 19, 2004.

Q.E.P. CO., INC.

By: /s/ Lewis Gould

 Lewis Gould
 Chairman and Chief Executive Officer

POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Lewis Gould and Marc P. Applebaum and each of them, his true and lawful attorney-in-fact and agents, with full power of substitution and resubstitution for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this Report on Form 10-K, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that each of said attorneys-in-fact or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| | | |
|---|--|--------------|
| /s/ Lewis Gould _____ Lewis Gould | Chairman, Chief Executive Officer and Director (Principal Executive Officer) | May 19, 2004 |
| /s/ Marc P. Applebaum _____ Marc P. Applebaum | Senior Vice President and Chief Financial Officer (Principal Financial Officer) | May 19, 2004 |
| /s/ Peter A. Ruggeri _____ Peter A. Ruggeri | Chief Accounting Officer | May 19, 2004 |
| /s/ Emil Vogel _____ Emil Vogel | Director | May 19, 2004 |
| /s/ Christian Nast _____ Christian Nast | Director | May 19, 2004 |

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/s/ Leonard Gould

Director

May 19, 2004

Leonard Gould

/s/ Geary Cotton

Director

May 19, 2004

Geary Cotton

C O N T E N T S

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REPORT OF INDEPENDENT REGISTERED

PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Q.E.P. Co., Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Q.E.P. Co., Inc. (a Delaware corporation) and Subsidiaries as of February 29, 2004 and February 28, 2003, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended February 29, 2004. 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit 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.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Q.E.P. Co., Inc. and Subsidiaries as of February 29, 2004 and February 28, 2003, and the results of their operations and their cash flows for each of the three years in the period ended February 29, 2004 in conformity with accounting principles generally accepted in the United States of America.

On March 1, 2002, and as discussed in Note H, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets.

We have also audited Schedule II of Q.E.P. Co., Inc. and Subsidiaries for each of the three years in the period ended February 29, 2004. In our opinion, this schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information required to be set forth therein.

/s/ Grant Thornton LLP

Grant Thornton LLP

Miami, Florida

April 15, 2004

Q.E.P. CO., INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

| | February 29, 2004 | February 28, 2003 |
|---|----------------------|----------------------|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 956,608 | \$ 304,453 |
| Accounts receivable, less allowance for doubtful accounts of approximately \$643,000 and \$354,000 as of February 29, 2004 and February 28, 2003, respectively. | 23,121,599 | 20,548,282 |
| Inventories | 28,854,980 | 28,386,525 |
| Prepaid expenses | 2,147,598 | 1,861,999 |
| Deferred income taxes | 382,167 | 598,876 |
| Total current assets | 55,462,952 | 51,700,135 |
| Property and equipment, net | 8,029,371 | 6,443,379 |
| Deferred income taxes | 1,112,381 | 1,216,913 |
| Goodwill | 11,400,335 | 10,096,318 |
| Other intangible assets, net | 2,247,711 | 2,254,593 |
| Other assets | 571,205 | 814,020 |
| Total assets | \$ 78,823,955 | \$ 72,525,358 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| CURRENT LIABILITIES | | |
| Lines of credit | \$ 19,233,115 | \$ 20,339,721 |
| Current maturities of long term debt | 2,751,683 | 2,818,148 |
| Acquisition notes payable | 568,582 | 839,326 |
| Accounts payable | 11,935,810 | 12,499,204 |
| Accrued liabilities | 7,221,143 | 3,393,251 |
| Total current liabilities | 41,710,333 | 39,889,650 |
| Notes payable | 6,152,134 | 6,582,680 |
| Acquisition notes payable | 805,765 | 1,171,795 |
| Deferred income taxes | 705,583 | 590,638 |
| Warrant put liability | 1,942,792 | 1,175,300 |
| Total Liabilities | 51,316,607 | 49,410,063 |
| Commitments and Contingencies | | |
| SHAREHOLDERS EQUITY | | |
| Preferred stock, 2,500,000 shares authorized, \$1.00 par value; 336,660 shares issued and outstanding at February 29, 2004 and February 28, 2003 | 336,660 | 336,660 |
| Common stock; 20,000,000 shares authorized, \$.001 par value; 3,414,050 shares and 3,381,190 shares issued and outstanding at February 29, 2004 and February 28, 2003, respectively | 3,414 | 3,381 |
| Additional paid-in capital | 9,274,739 | 9,068,703 |
| Retained earnings | 19,316,727 | 15,838,522 |
| Cost of stock held in treasury | (381,445) | (436,170) |
| Accumulated other comprehensive income | (1,042,747) | (1,695,801) |
| | 27,507,348 | 23,115,295 |

| | | |
|--|----------------------|----------------------|
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | \$ 78,823,955 | \$ 72,525,358 |
|--|----------------------|----------------------|

The accompanying notes are an integral part of these statements

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Q.E.P. CO., INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

| | Year ended | | |
|--|----------------|----------------|----------------|
| | February 29, | February 28, | February 28, |
| | 2004 | 2003 | 2002 |
| Net sales | \$ 143,272,547 | \$ 129,281,184 | \$ 109,674,723 |
| Cost of goods sold | 94,064,626 | 84,882,533 | 72,602,550 |
| Gross profit | 49,207,921 | 44,398,651 | 37,072,173 |
| Costs and expenses: | | | |
| Shipping | 13,369,139 | 11,950,419 | 9,588,832 |
| General and administrative | 12,299,927 | 10,980,175 | 9,740,543 |
| Selling and marketing | 14,598,222 | 13,761,824 | 11,894,600 |
| Other expense (income), net | 1,488,026 | 531,537 | (217,133) |
| | 41,755,314 | 37,223,955 | 31,006,842 |
| Operating income | 7,452,607 | 7,174,696 | 6,065,331 |
| Interest income | 789 | 770 | 9,897 |
| Interest expense | (1,586,006) | (1,876,773) | (2,567,455) |
| Income before provision for income taxes and cumulative effect of change in accounting principle | 5,867,390 | 5,298,693 | 3,507,773 |
| Provision for income taxes | 2,379,409 | 2,243,395 | 1,404,795 |
| Net income before cumulative effect of change in accounting principle | 3,487,981 | 3,055,298 | 2,102,978 |
| Cumulative effect of change in accounting principle | | (3,047,788) | |
| Net income | \$ 3,487,981 | \$ 7,510 | \$ 2,102,978 |
| Basic earnings per common share: | | | |
| Income before cumulative effect of change in accounting principle | \$ 1.02 | \$ 0.90 | \$ 0.62 |
| Cumulative effect of change in accounting principle | | (0.89) | |
| Net income | \$ 1.02 | \$ 0.01 | \$ 0.62 |
| Diluted earnings per common share: | | | |
| Income before cumulative effect of change in accounting principle | \$ 0.99 | \$ 0.90 | \$ 0.62 |
| Cumulative effect of change in accounting principle | | (0.89) | |
| Net income | \$ 0.99 | \$ 0.01 | \$ 0.62 |

The accompanying notes are an integral part of these statements

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Q.E.P. CO. INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

| | Preferred Stock | | Common Stock | | Paid-in capital | Retained earnings | Accumulated Other Comprehensive Income | Treasury stock | Other Comprehensive Income |
|---|-----------------|------------|--------------|----------|--------------------|----------------------|---|-------------------|----------------------------------|
| | Shares | Amount | Shares | Amount | | | | | |
| Balance at February 28, 2001 | 336,660 | \$ 336,660 | 3,381,190 | \$ 3,381 | \$ 9,082,087 | \$ 13,758,547 | \$ (716,933) | \$ (350,993) | \$ 1,098,647 |
| Net income | | | | | | 2,102,978 | | | 2,102,978 |
| Other comprehensive income: | | | | | | | | | |
| Foreign currency translation adjustment | | | | | | | (1,094,378) | | (1,094,378) |
| Purchase of treasury stock | | | | | | | | (39,649) | |
| Purchase of warrants | | | | | (13,384) | | | | |
| Dividends | | | | | | (18,742) | | | |
| Balance at February 28, 2002 | 336,660 | \$ 336,660 | 3,381,190 | \$ 3,381 | \$ 9,068,703 | \$ 15,842,783 | \$ (1,811,311) | \$ (390,642) | \$ 1,008,600 |
| Net income | | | | | | 7,510 | | | 7,510 |
| Other comprehensive income: | | | | | | | | | |
| Foreign currency translation adjustment | | | | | | | 115,510 | | 115,510 |
| Purchase of treasury stock | | | | | | | | (45,528) | |
| Dividends | | | | | | (11,771) | | | |
| Balance at February 28, 2003 | 336,660 | \$ 336,660 | 3,381,190 | \$ 3,381 | \$ 9,068,703 | \$ 15,838,522 | \$ (1,695,801) | \$ (436,170) | \$ 123,020 |
| Net income | | | | | | 3,487,981 | | | 3,487,981 |
| Other comprehensive income: | | | | | | | | | |
| Foreign currency translation adjustment | | | | | | | 653,054 | | 653,054 |

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| | | | | | | | | | |
|--|----------------|-------------------|------------------|-----------------|---------------------|----------------------|-----------------------|---------------------|---------------------|
| Purchase of treasury stock | | | | | | | | (206,760) | |
| Issuance of stock in connection with a guarantee agreement | | | | 13,514 | | | | 261,485 | |
| Issuance of stock in connection with the exercise of stock options | | 32,860 | 33 | 192,522 | | | | | |
| Dividends | | | | | | | (9,776) | | |
| Balance at February 29, 2004 | 336,660 | \$ 336,660 | 3,414,050 | \$ 3,414 | \$ 9,274,739 | \$ 19,316,727 | \$ (1,042,747) | \$ (381,445) | \$ 4,141,035 |

The accompanying notes are an integral part of these statements

Q.E.P. CO., INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Year Ended | | |
|--|----------------------|----------------------|----------------------|
| | February 29, 2004 | February 28, 2003 | February 28, 2002 |
| Cash flows from operating activities: | | | |
| Net income | \$ 3,487,981 | \$ 7,510 | \$ 2,102,978 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | |
| Cumulative effect of change in accounting principle | | 3,047,788 | |
| Depreciation and amortization | 2,861,229 | 1,838,712 | 1,429,296 |
| Change in fair value of warrant put liability | 767,492 | 600,300 | |
| Amortization of costs in excess of assets acquired | | | 471,126 |
| Amortization of discount on long term debt | | 108,336 | 112,874 |
| Bad debt expense | 431,652 | 363,705 | 94,909 |
| Gain on sale of property and equipment | (132,604) | | |
| Deferred income taxes | 436,186 | (12,090) | 210,520 |
| Changes in assets and liabilities, net of acquisitions: | | | |
| Accounts receivable | (1,773,003) | (2,519,141) | (167,607) |
| Inventories | 1,257,164 | (7,508,682) | (292,666) |
| Prepaid expenses | (149,603) | (44,629) | (224,234) |
| Other assets | (165,704) | (964,659) | (218,487) |
| Accounts payable and accrued liabilities | 2,235,787 | 4,103,546 | (899,185) |
| Net cash provided by (used in) operating activities | 9,256,577 | (979,304) | 2,619,524 |
| Cash flows from investing activities | | | |
| Capital expenditures | (2,585,762) | (1,257,785) | (576,907) |
| Acquisitions, net of cash acquired | (3,601,561) | (495,630) | |
| Proceeds from sale of property & equipment | 245,362 | | |
| Net cash used in investing activities | (5,941,961) | (1,753,415) | (576,907) |
| Cash flows from financing activities: | | | |
| Net (payments) borrowings under lines of credit | (1,106,606) | 3,576,507 | 1,278,592 |
| Borrowings of long term debt | 6,366,531 | 4,715,643 | 6,000,000 |
| Repayments of long term debt | (7,605,960) | (4,721,360) | (7,999,681) |
| Repayments of acquisition debt | (787,966) | (630,859) | (785,000) |
| Purchase of treasury stock | (90,000) | (45,528) | (39,649) |
| Proceeds from exercise of stock options | 192,554 | | |
| Purchase of common stock warrants | | | (13,384) |
| Dividends | (9,776) | (11,770) | (18,742) |
| Net cash (used in) provided by financing activities | (3,041,223) | 2,882,633 | (1,577,864) |
| Cumulative currency translation adjustment | 378,762 | (280,781) | (427,250) |
| Net increase (decrease) in cash | 652,155 | (130,867) | 37,503 |
| Cash and cash equivalents at beginning of year | 304,453 | 435,320 | 397,817 |

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| | | | |
|--|------------|------------|------------|
| Cash and cash equivalents at end of year | \$ 956,608 | \$ 304,453 | \$ 435,320 |
|--|------------|------------|------------|

The accompanying notes are an integral part of these statements.

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Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE A - DESCRIPTION OF BUSINESS

Q.E.P. Co., Inc. is a leading manufacturer, marketer and distributor of a broad line of specialty tools and flooring related products for the home improvement market. Under brand names including Q.E.P., O TOOLROBERTS, QSet and Fresh the Company markets specialty tools and flooring related products used primarily for the surface preparation and installation of ceramic tile, carpet, vinyl and wood flooring. Total products marketed by Q.E.P. and subsidiaries approximate 3,000. The Company sells its products to large home improvement retail centers, as well as traditional distribution outlets in 50 states and more than 49 countries worldwide.

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Principles of Consolidation

The consolidated financial statements include the accounts of Q.E.P. Co., Inc. and its wholly owned subsidiaries, after eliminating all significant inter-company accounts and transactions.

2. Warrants

In connection with the refinancing of certain subordinated debt (see Note I), the Company issued 325,000 warrants at \$3.63, which will expire on April 4, 2011. These warrants can be put to the Company after the fifth year based on certain criteria. Further, the Company may call these warrants, based on certain criteria, after the sixth year.

3. Cash Equivalents

The Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

4. Accounts Receivable

The Company's accounts receivable are principally due from home centers or flooring accessory distributors. Credit is extended based on an evaluation of a customer's financial condition and collateral is not required. Accounts receivable are due at various times based on each customer's credit worthiness and selling arrangement. The outstanding balances are stated net of an allowance for doubtful accounts. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the customer's previous loss history, the customer's ability to pay its obligations and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts.

5. *Inventories*

Inventories are stated at the lower of standard cost, which approximates first-in, first-out, or market.

6. *Property and Equipment*

Property and equipment are stated at cost. Depreciation is provided by straight-line methods in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives. Leasehold improvements are amortized over their expected useful life or the life of the respective lease, whichever is shorter.

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Q.E.P. CO., INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following are the estimated lives of the Company's property and equipment:

| | |
|-----------------------------------|----------------|
| Machinery and warehouse equipment | 5 to 10 years |
| Furniture and computer equipment | 3 to 10 years |
| Capital leases | 3 to 5 years |
| Building | 30 to 33 years |
| Leasehold improvements | 5 to 15 years |

Maintenance and repairs are charged to expense, and significant renewals and betterments are capitalized. When property is sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any resulting gain or loss is reflected in operations for the period.

7. *Intangible Assets*

As of March 1, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangibles. Accordingly, goodwill is no longer amortized but is tested for impairment using a fair value approach at the reporting unit level. Impairment charges are recognized for amounts where the reporting unit's goodwill exceeds its fair value. The Company amortizes the cost of other intangibles over their estimated useful lives. Amortizable intangible assets are tested for impairment based on undiscounted cash flows and, if impaired, written down to fair value.

Prior to March 1, 2002 goodwill was amortized over periods ranging from five to thirty-five years on a straight line basis.

8. *Impairment of Long-Lived Assets and Long-Lived Assets To Be Disposed Of*

The Company evaluates its long-lived assets and certain intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets or intangibles may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such an asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

9. *Income Taxes*

The Company is required to estimate income tax in each jurisdiction in which it operates. This process involves estimating actual current tax exposure together with accessing temporary differences resulting from the different treatment of items for book and tax purposes. These differences result in deferred tax assets and liabilities which are included in the Company's Consolidated Balance Sheet. Deferred income taxes are recorded to reflect the tax consequences on future years of differences between the tax basis of assets and liabilities and their financial reporting amounts each year-end. The Company must then consider the likelihood that the deferred tax asset will be recoverable from future taxable income and, to the extent that the Company believes that recoverability is not likely, the Company establishes a valuation allowance.

Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. Leases

Leases which meet certain criteria are classified as capital leases. For such leases, assets and obligations are recorded initially at the fair market values of the leased assets. The capitalized leases are amortized using the straight-line method over the assets' estimated economic lives. Interest expense relating to the lease liabilities is recorded to affect a constant rate of interest over the terms of the obligations. Leases not meeting capitalization criteria are classified as operating leases and related rentals are charged to expense as incurred.

11. Stock-Based Compensation

The Company grants stock options for a fixed number of shares to employees and directors with an exercise price equal to at least 85% of the fair market value of the shares at the date of grant. The Company has adopted the disclosure-only provision of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation, Transition and Disclosure*, which permits the Company to account for stock option grants in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Under APB 25, compensation expense is recorded when the exercise price of the Company's employee stock option is less than the market price of the underlying stock at the date of grant.

The Company continues to account for options issued under the intrinsic value method of APB 25. Had compensation cost been determined based on the fair value at the grant date for stock option awards consistent with the provisions of SFAS No. 123, the Company's net income (loss) and diluted earnings (loss) per share for the years ended February 28 or 29, 2004, 2003, and 2002, respectively would have been as follows:

| | (in thousands, except per share data) | | |
|-----------------------------|---------------------------------------|-----------|----------|
| | 2004 | 2003 | 2002 |
| Net income (loss) | | | |
| As reported | \$ 3,488 | \$ 7 | \$ 2,103 |
| Pro forma | \$ 3,398 | \$ (87) | \$ 1,996 |
| Net income (loss) per share | | | |
| As reported | \$ 0.99 | \$ 0.01 | \$ 0.62 |
| Pro forma | \$ 0.96 | \$ (0.03) | \$ 0.56 |

The weighted average fair value at date of grant for options granted during 2004, 2003 and 2002 was \$5.40, \$2.57 and \$1.18 per option, respectively. The fair value of each option at date of grant was estimated using the Black-Scholes option pricing model with the following weighted average assumptions for grants.

| | 2004 | 2003 | 2002 |
|---------------------------------|--------|--------|-------|
| Expected stock price volatility | 38.84% | 37.37% | 36.7% |

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Expected lives of options:

| | | | |
|-------------------------|---------|---------|---------|
| Directors and officers | 3 years | 3 years | 3 years |
| Employees | 3 years | 3 years | 3 years |
| Risk-free interest rate | 4.08% | 3.78% | 4.4% |
| Expected dividend yield | 0.0% | 0.0% | 0.0% |

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Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

12. Earnings Per Share

Basic earnings per share is computed based on weighted average shares outstanding during the period. Diluted earnings per share is computed using the weighted average number of common and dilutive common stock equivalent shares outstanding during the period. Dilutive common stock equivalent shares consist of stock options and warrant common stock equivalent shares which are not utilized when the effect is antidilutive.

13. Comprehensive Income

The Company records comprehensive income in accordance with SFAS No. 130, Reporting Comprehensive Income. SFAS No. 130 requires foreign currency translation adjustments to be included in other comprehensive income.

The components of comprehensive income and the effect on earnings for the year ended February 29, 2004 are detailed in the Company's accompanying Consolidated Statements of Shareholders' Equity.

14. Post Employment Benefits

The Company has a policy which provides post employment service benefits to its salaried employees. The Company records a liability for post employment benefits in accordance with SFAS No. 112, Employers Accounting for Post Employment Benefits. Since the Company cannot reasonably estimate post employment service benefits, including severance benefits, on an ongoing basis, these costs are recorded only when the probability of payment and the amount of such payment can be reasonably determined.

15. Derivative Instruments and Hedging Activities

The Company records its derivative instruments and hedging activities in accordance with the Financial Accounting Standards Board (FASB) issued SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended. SFAS No. 133 establishes accounting and reporting standards requiring that every derivative instrument (including certain derivative instruments embedded in other contracts) be recorded in the balance sheet as either an asset or liability at its fair value. The statement requires that changes in the derivative's fair value be recognized currently in earnings unless specific hedge accounting criteria are met.

16. Interest Rate Risk Management

The Company uses both interest rate cap and swap agreements to reduce the impact of interest rate changes on its floating rate debt. The interest rate swap agreement (the Swap) involves the exchange of fixed and floating interest rate payment obligations over various terms without the exchange of the underlying notional principal amount. The differential to be paid or received is recognized as an adjustment to interest expense in the period incurred. As of February 28, 2003 and February 29, 2004, the Company is not party to any swap agreements. In return for an upfront payment, a cap rate agreement entitles the purchaser to receive the amounts, if any, by which an agreed upon floating rate index exceeds

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the CAP interest rate. In February 2003, the Company purchased, for \$125,000, a three-year 4% LIBOR CAP on \$10 million of the Company's floating rate debt, the effect of which in fiscal 2004 is immaterial to the consolidated financial statements of the Company.

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Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

17. Fair Value of Financial Instruments

The following methods and assumptions were used in estimating the indicated fair values of financial instruments:

Cash and cash equivalents: The carrying amount approximates fair value due to the short maturity of these instruments.

Short term debt: The carrying amount approximates fair value due to the short maturity of these instruments.

Long term debt: The fair value of the Company's borrowings approximates the carrying value based on current rates offered to the Company for similar debt.

Interest rate cap: The fair value approximates the carrying value of this instrument at the balance sheet date.

Warrant put liability: The carrying amount approximates fair value based on the market value of the Company's stock or contract value as defined.

18. Foreign Currencies

The financial statements of subsidiaries outside the United States of America are generally measured using the local currency as the functional currency. Assets and liabilities recorded in foreign currencies on the books of foreign subsidiaries are translated at the exchange rate on the balance sheet date. Translation adjustments resulting from this process are charged or credited to equity. Revenues, costs and expenses are translated at average rates of exchange prevailing during the year. Gains and losses on foreign currency transactions are included in operating expenses.

19. Revenue Recognition

Sales are recognized when merchandise is shipped and title has passed to the customer, the selling price is fixed and determinable and collectibility of the sales price is reasonably assured. Such revenue is recorded net of estimated sales returns, discounts and allowances. The Company establishes reserves for returns and allowances based on current and historical information and trends. Sales and accounts receivable have been reduced by such amounts.

20. Shipping and Handling Costs

Shipping and handling costs are classified as a separate operational expense on the accompanying Consolidated Statements of Income.

21. Advertising Cost

Advertising expense for the years ended February 28 or 29, 2004, 2003 and 2002 was \$2,304,000, \$2,021,000 and \$1,758,000 respectively. The majority of these costs were paid to the Company's two largest customers. In return, the Company receives and tracks the advertising in various forms of media of its products on a local, regional and national level. These retailers also display the Company's products on in store signage and sends advertising of the Company's products directly to its professional contractor customers. The Company believes, based on its review of information available, that the value received approximates the cost. These costs are included in selling and marketing on the consolidated statements of income. In the event costs exceed the fair market value, the excess cost will be included as a reduction of sales.

Q.E.P. CO., INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS22. *Use of Estimates*

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make certain estimates 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 revenues and expenses during the reporting period.

Actual results could differ from those estimates.

23. Certain amounts in the fiscal year 2003 presentation have been reclassified to conform with the fiscal year 2004 presentation.

NOTE C ACQUISITIONS

Acquisitions are accounted for as purchases and, accordingly, have been included in the Company's consolidated results of operations since the acquisition date. The purchase price is allocated based on the estimated fair values of assets acquired and liabilities assumed. Purchase price allocations are subject to refinement until all pertinent information regarding the acquisitions is obtained.

In January 2004, the Company acquired Vitrex, a manufacturer and distributor of ceramic tools and safety equipment in the United Kingdom in accordance with its business strategy to pursue strategic acquisitions and expand its product line offerings. The results of Vitrex's operations have been included in the consolidated financial statements, included herein, since that date.

In connection with the acquisition, the Company paid a total of approximately \$3,602,000 through a cash payment. The acquisition was accounted for as a purchase in accordance with SFAS No. 141 and accordingly the purchase price was allocated based on the estimated fair market values of the identifiable assets and liabilities obtained, resulting in original goodwill of approximately \$971,000. Goodwill will not be amortized in the future but will be tested for impairment in accordance with the provisions of SFAS No. 142.

| | |
|---|--------------|
| Cash consideration paid | \$ 3,601,561 |
| Less: fair value of identifiable assets acquired: | |
| Accounts receivable, net | 1,231,967 |
| Inventory | 1,786,907 |
| Other assets | 36,996 |
| Property and equipment | 486,497 |
| | <hr/> |
| | 59,194 |
| Plus: fair value of liabilities assumed: | |
| Accounts payable and accrued expenses | 911,952 |
| | <hr/> |

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Excess of cost over fair value of net assets acquired:

| | |
|----------|------------|
| Goodwill | \$ 971,146 |
|----------|------------|

During fiscal 2003, the Company acquired certain assets and liabilities of an Australian distributor to increase market penetration in Australia. In connection with this acquisition, the Company paid a total of approximately \$2,060,000 through a cash payment of approximately \$496,000, issuance of a note to the sellers in the approximate amount of \$795,000 and assumption of certain liabilities amounting to approximately \$769,000. The acquisition was accounted for as a purchase in accordance with SFAS No. 141 and accordingly the purchase price was allocated based on the estimated fair market values of the identifiable assets and liabilities obtained, resulting in original goodwill of approximately \$413,000. Goodwill will not be amortized in the future but will be tested for impairment in accordance with the provisions of SFAS No. 142.

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Q.E.P. CO., INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of acquisition:

| | |
|--|------------|
| Cash consideration paid | \$ 495,630 |
| Note payable issued | 795,470 |
| | <hr/> |
| Total consideration | 1,291,100 |
| Less: fair value of identifiable assets acquired: | |
| Accounts receivable, net | 790,410 |
| Inventory | 695,489 |
| Other assets | 8,570 |
| Property and equipment | 152,701 |
| | <hr/> |
| | (356,070) |
| Plus: fair value of liabilities assumed: | |
| Accounts payable and accrued expenses | 769,096 |
| | <hr/> |
| Excess of cost over fair value of net assets acquired: | |
| Goodwill | \$ 413,026 |
| | <hr/> |

The goodwill of \$971,146 and \$413,026, resulting from these acquisitions, is not deductible for tax purposes.

The unaudited pro forma consolidation of the acquisitions occurring in fiscal 2004 and fiscal 2003 showing the results of operations assuming the above purchases occurred on March 1, 2003 or March 1, 2002 are not material and are not included herein.

NOTE D EARNINGS PER SHARE

Basic earnings per share is computed by dividing net income, after deducting preferred stock dividends accumulated during the period, by the weighted average number of shares of common stock outstanding during each period. Diluted earnings per share is computed by dividing net income, after deducting preferred stock dividends accumulated during the period, by the weighted average number of shares of common and dilutive common stock equivalent shares outstanding during each period. Diluted common stock equivalent shares consist of stock options and warrant common stock equivalent shares which are not used when the effect is antidilutive. For the three years ended February 29, 2004, 325,000 common stock equivalent shares with an exercise price of \$3.63 per share were not used due to their antidilutive effect. For the three years ended February 29, 2004, the weighted average number of basic shares of common stock outstanding amounted to 3,397,930 in 2004, 3,381,190 in 2003 and 3,381,190 in 2002. For the three years ended February 29, 2004 the weighted average number of diluted shares of common stock outstanding amounted to 3,526,732 in 2004, 3,394,236 in 2003 and 3,390,028 in 2002.

NOTE E GEOGRAPHIC INFORMATION

The Company operates in one business segment, flooring-related products, because of the similarity of economic conditions, products, production processes, customers and expected long-term performance. The Company manufactures and distributes flooring-related products to the residential new construction, do-it-yourself and professional remodeling and renovation markets and home centers.

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Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Information attributable to the Company's geographic areas is as follows:

| | United States of America | Canada/ Latin America | New Zealand/ Australia | United Kingdom/ Europe | Inter-company Eliminations | Consolidated Total |
|-------------------------|--------------------------------|-----------------------------|------------------------------|------------------------------|-------------------------------|-----------------------|
| 2004 | | | | | | |
| Sales | \$ 106,504,039 | \$ 12,947,883 | \$ 12,459,431 | \$ 11,361,194 | \$ | \$ 143,272,547 |
| Transfers between areas | 2,941,643 | 5,134,750 | 436,803 | | (8,513,196) | |
| Total Sales | \$ 109,445,682 | \$ 18,082,633 | \$ 12,896,234 | \$ 11,361,194 | \$ (8,513,196) | \$ 143,272,547 |
| Long-lived Assets | \$ 39,594,443 | \$ 3,975,495 | \$ 2,131,810 | \$ 2,122,319 | \$ (24,463,064) | \$ 23,361,003 |
| 2003 | | | | | | |
| Sales | \$ 100,456,456 | \$ 11,851,346 | \$ 8,598,994 | \$ 8,374,388 | \$ | \$ 129,281,184 |
| Transfers between areas | 859,768 | 4,768,553 | | | (5,628,321) | |
| Total Sales | \$ 101,316,224 | \$ 16,619,899 | \$ 8,598,994 | \$ 8,374,388 | \$ (5,628,321) | \$ 129,281,184 |
| Long-lived Assets | \$ 39,822,140 | \$ 2,855,213 | \$ 1,529,390 | \$ 450,967 | \$ (23,832,487) | \$ 20,825,223 |
| 2002 | | | | | | |
| Sales | \$ 87,197,283 | \$ 10,866,127 | \$ 3,761,605 | \$ 7,849,708 | \$ | \$ 109,674,723 |
| Transfers between areas | 2,534,283 | 3,001,319 | | | (5,535,602) | |
| Total Sales | \$ 89,731,566 | \$ 13,867,446 | \$ 3,761,605 | \$ 7,849,708 | \$ (5,535,602) | \$ 109,674,723 |
| Long-lived Assets | \$ 41,431,650 | \$ 2,325,823 | \$ 584,501 | \$ 823,820 | \$ (23,943,579) | \$ 21,222,215 |

NOTE F INVENTORIES

Inventories consisted of the following:

| | February 29, 2004 | February 28, 2003 |
|-----------------------------------|----------------------|----------------------|
| Raw materials and work-in-process | \$ 3,291,674 | \$ 3,881,804 |

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| | | |
|----------------|----------------------|----------------------|
| Finished goods | 25,563,306 | 24,504,721 |
| | <u>25,563,306</u> | <u>24,504,721</u> |
| | <u>\$ 28,854,980</u> | <u>\$ 28,386,525</u> |

NOTE G - PROPERTY AND EQUIPMENT

| | February 29, 2004 | February 28, 2003 |
|--|------------------------------|------------------------------|
| | <u> </u> | <u> </u> |
| Property and equipment consisted of the following: | | |
| Machinery and warehouse equipment | \$ 6,127,161 | \$ 4,966,649 |
| Office furniture, equipment and computer equipment | 5,209,039 | 4,371,708 |
| Building and leasehold improvements | 3,849,964 | 2,214,167 |
| | <u>15,186,164</u> | <u>11,552,524</u> |
| Less accumulated depreciation and amortization | (7,156,793) | (5,109,145) |
| | <u>\$ 8,029,371</u> | <u>\$ 6,443,379</u> |

In fiscal 2004 and fiscal 2003, the Company acquired approximately \$89,000 and \$159,000, respectively, of machinery and equipment under capitalized leases. Such assets are recorded net of accumulated amortization of approximately \$13,000 and \$20,000 at February 29, 2004 and February 28, 2003, respectively.

Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE H INTANGIBLE ASSETS

SFAS No. 142, "Goodwill and Other Intangible Assets" was adopted by the Company as of March 1, 2002. SFAS No. 142 provides that intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives not be amortized, but is tested at least annually for impairment. Any loss recognized upon adoption shall be recorded as a cumulative effect of a change in accounting principle. Any impairment loss incurred subsequent to the initial adoption of SFAS No. 142 is to be recorded in current earnings.

Under the transitional provisions of SFAS No. 142, the Company's goodwill was tested for impairment. Each of the Company's reporting units was tested for impairment by comparing the fair value of each reporting unit with its carrying value. Fair value was determined based on a valuation study performed by an independent third party appraiser which primarily considered the discounted cash flow and similar company's trading multiples. As a result of the Company's impairment test, the Company recorded, as a cumulative effect of a change in accounting principle, in fiscal 2003, an impairment loss of approximately \$1,173,000 and \$1,875,000 at its European and Latin American subsidiaries, respectively. In August 2003, the Company tested its remaining goodwill for impairment. The result of this test, performed by an independent third party appraiser, was that there was no impairment of goodwill in the fiscal 2004 period.

| | February 29, 2004 | February 28, 2003 |
|-------------------|----------------------|----------------------|
| Goodwill | \$ 11,400,335 | \$ 10,096,318 |
| Trademarks | 1,893,965 | 1,949,618 |
| Other intangibles | 353,746 | 304,975 |
| | <u>\$ 13,648,046</u> | <u>\$ 12,350,911</u> |

Intangible assets are net of accumulated amortization of approximately \$776,000 and \$1,831,000 in fiscal 2004 and fiscal 2003, respectively.

Other than goodwill, all intangible assets are subject to amortization and are as follows:

| | Average Life (Years) | February 29, 2004 | | February 28, 2003 | |
|-------------------|-------------------------|--------------------------|-----------------------------|--------------------------|-----------------------------|
| | | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Trademarks | 20 | \$ 2,430,862 | \$ (536,897) | \$ 2,368,190 | \$ (418,572) |
| Other intangibles | 5 | 595,832 | (242,086) | 492,873 | \$ (187,898) |
| | | <u>\$ 3,026,694</u> | <u>\$ (778,983)</u> | <u>\$ 2,861,063</u> | <u>\$ (606,470)</u> |

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The following table provides information regarding estimated amortization expense for each of the following years ended February 28 or 29:

| | |
|------|------------|
| 2005 | \$ 164,632 |
| 2006 | 134,667 |
| 2007 | 131,478 |
| 2008 | 131,478 |
| 2009 | 131,478 |

Consolidated amortization expense related to intangible assets, excluding goodwill, for the fiscal 2004 and fiscal 2003 periods was approximately \$166,756 and \$316,000, respectively. Future amortization expense for intangible assets will depend on acquisition activities, if any, and other business transactions. The amount of goodwill amortization included in the net earnings of the Company for the year ended February 28, 2002 was approximately \$471,000.

Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Prior to the adoption of SFAS No. 142 in fiscal 2003, the effect on earnings and earnings per share of excluding such goodwill amortization for fiscal 2002 is as follows:

| | <u>2002</u> |
|---|--------------|
| Net earnings, as reported | \$ 2,102,978 |
| Net earnings, excluding goodwill amortization | \$ 2,574,104 |
| Earnings per share, as reported | \$ 0.62 |
| Earnings per share, excluding goodwill amortization | \$ 0.75 |

NOTE I DEBT

Total debt consists of the following:

| | <u>February 28,</u> <u>2004</u> | <u>February 28,</u> <u>2003</u> |
|--|------------------------------------|------------------------------------|
| Payable to banks under revolving credit facilities | \$ 19,233,115 | \$ 20,339,721 |
| Subordinated debt | | 4,053,128 |
| Payable to banks under term loan credit facilities | 6,398,517 | 4,341,322 |
| Payable to a bank under a mortgage agreement | 1,855,545 | 529,880 |
| Acquisition notes payable | 1,374,347 | 2,011,121 |
| Other debt, including capital leases | 649,755 | 476,498 |
| | <u>29,511,279</u> | <u>31,751,670</u> |
| Less current installments | 22,553,380 | 23,997,195 |
| Long Term | <u>\$ 6,957,899</u> | <u>\$ 7,754,475</u> |

Payable to banks under revolving credit facilities

In November 2002, the Company entered into an amended and restated loan agreement with its existing lender, which provided a revolving credit facility and two separate term loans (discussed below). The agreement, which now includes another financial institution as a participant, increased the Company's borrowing capacity under the revolving loan facility to \$23,000,000 under the same formula for eligible accounts receivable and inventory that previously existed for the Company. The revolving loan facility expires in July 2005. The revolver bears an interest rate that ranges from LIBOR plus 1.50% to LIBOR plus 2.25% and is collateralized by substantially all of the Company's assets. The agreement also prohibits the Company from incurring certain additional indebtedness, limits certain investments, advances or loans, restricts substantial asset sales and capital expenditures and prohibits the payment of dividends, except for dividends due on the Company's Series A and

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C preferred stock. At February 29, 2004, the rate was LIBOR (1.2% at February 29, 2004) plus 1.75% and the Company had approximately \$3,416,000 available for future borrowings under its revolving loan facility net of approximately \$429,000 in outstanding letters of credit. During the twelve month period ended February 29, 2004, the Company borrowed approximately \$11,650,000 and repaid approximately \$15,599,000 under this revolving credit facility. This resulted in an average outstanding indebtedness during the period of approximately \$17,874,000.

The Company's Australian subsidiary has a foreign payment facility which allows it to borrow against a certain percentage of inventory and accounts receivable. At February 29, 2004, the maximum permitted borrowing was approximately \$850,000, of which substantially all was utilized and there were no available borrowings as of such date.

Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In connection with the purchase of the assets of Vitrex Ltd., as further described elsewhere in this report, the Company's United Kingdom subsidiary entered into two financing arrangements with HSBC Bank in the United Kingdom. The first financing arrangement allows for borrowing up to approximately £900,000 (approximately U.S. \$1,600,000) based on the advancement of up to 80% of the value of accounts receivable. In addition, the subsidiary may borrow up to £400,000 (approximately U.S. \$728,000) against the value of the inventory. Both of these facilities are collateralized by substantially all of the assets of the subsidiary as well as a guaranty by the Company.

Subordinated Debt

In connection with the subordinated loan agreement between the Company and HillStreet, entered into on April 5, 2001 and which was paid in full on May 12, 2003, the Company issued 325,000 10-year warrants (the Put Warrants) at an exercise price of \$3.63 per share. The Put Warrants continue to remain outstanding and can be put to the Company on and after April 5, 2006, based on criteria set forth in the warrant agreement. In addition, the Company may call these warrants on and after April 5, 2007, based on the same criteria. The Company recorded the initial liability for the Put Warrants based on an independent appraisal. The Company updates the value of the liability for the Put Warrants on a quarterly basis. The liability value of the Put Warrants is calculated based on the greatest of (1) the fair market value of the liability for the Company if a capital transaction or public offering occurs; or (2) a formula value based on a multiple of the last twelve month trailing EBITDA calculation; or (3) an appraised value as if the Company was sold as a going concern. Changes to the fair value of the Put Warrants are recognized in the earnings of the Company in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. In the fiscal 2004 period, the Company recorded an expense of approximately \$795,000 related to the increase in the Warrant Put Liability.

Payable to Banks Under Term Loan Facilities

As discussed previously, the Company's loan agreement provides for two separate term loan facilities. The first term loan facility with an original amount of \$4,000,000 refinanced by Company's then existing term loan and provided additional working capital. Amortization during the current year was \$400,000 per quarter. Currently this loan requires payments of \$200,000 per quarter.

In May 2003, the Company prepaid its subordinated loan facility with HillStreet Fund LP (HillStreet) utilizing the second term loan facility. Under the terms of the prepayment, the Company paid a prepayment penalty of 6% amounting to \$270,000 together with the \$4,500,000 principal balance of the facility. The prepayment penalty was included in interest expense in the Condensed Consolidated Statement of Operations for the fiscal 2004 period. This term facility requires monthly payments of \$125,000 during the first five months and \$141,667 monthly thereafter. This loan bears interest at LIBOR plus 3.25%. The Company's Chairman and Chief Executive Officer has personally guaranteed up to a maximum of \$3,000,000 of this loan. The guarantor's potential liability under the guaranty decreases by an amount equal to each payment made by the Company. In connection with the guaranty, the Company's audit committee and board of directors approved and the stockholders ratified an agreement whereby the Company granted its Chairman 50,000 shares of restricted common stock. Based on an independent appraisal obtained by the Company, the value of the 50,000 shares was determined to be \$275,000 or \$5.50 per share. The Company further agreed to indemnify him to the extent of all payments made by the Chairman to the lenders pursuant to the guaranty.

In connection with an acquisition in July 2002, the Company's Australian subsidiary entered into a loan facility with an Australian financial institution to provide financing of up to AUD \$2,500,000 (approximately US \$1,300,000). This facility includes a term facility and a short-term foreign and domestic facility that will be used to provide the capital necessary for acquisitions and general working capital purposes. The term facility expires in June 2005 and requires quarterly payments of AUD \$25,000 (approximately US \$19,000) and a final balloon payment.

Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Payable to a Bank Under a Mortgage Agreement

In July 2003, the Company refinanced its mortgage loan in Canada and financed its expansion of the Canadian facility. The mortgage refinancing is for approximately \$1,867,000, and is amortized based on a 15-year period. The mortgage refinancing bears an interest rate of LIBOR plus 2.00% and will mature in October 2007. The mortgage loan requires principal payments of approximately \$10,500 per month.

Acquisition Notes Payable

In July 2002, the Company's Australian subsidiary entered into a new loan agreement of approximately AUD \$1,298,000 (approximately US \$715,000) for the purpose of providing financing for the acquisition of an Australian distributor and, in addition, the Company issued a note to the related seller in the approximate amount of AUD \$1,445,000 (approximately US \$795,500). This note requires monthly payments in the amount of approximately \$21,000 through December 2006 with interest at 6.5%.

In connection with certain acquisitions during fiscal years 1999 through 2000, the Company issued three unsecured notes to the respective sellers. The first note, having an original principal balance of \$900,000 was originally payable in equal installments over a three year period with interest at the Company's prevailing borrowing rate. In October 2002, the Company paid \$50,000 and, in May 2003, amended the agreement to provide for full payment on October 10, 2004 of the remaining \$250,000. The agreement was further amended on February 2, 2004 to extend the final \$250,000 due as of February 29, 2004 to October 10, 2006. Interest on the extended payment is payable quarterly at 7%. The second note, in the principal amount of \$825,000, is payable in installments: \$312,500 plus interest of \$12,500 was paid in December, 2000, \$312,500 plus interest of \$12,500 was partially paid in December, 2001 and the balance was paid over a ten month period beginning January, 2002; the final installment of \$200,000 plus interest of \$25,000 was paid in December, 2003. The third note, in the original principal amount of \$1,600,000, is payable quarterly at \$80,000 plus interest at 8% from October 1, 2000 through October 1, 2005 and the amount outstanding as of February 28, 2004 was \$480,000.

Subsequent to February 29, 2004, the Company's Australian subsidiary entered into a new loan agreement with its existing lender. The new facility increased the maximum limit of borrowings to approximately AUD \$4,427,000 (approximately US \$3,337,000). The additional availability is to be utilized to fund a future acquisition and provide additional working capital. The additional term note of this facility of approximately AUD \$1,050,000 (US \$813,000) will mature in 2007 and requires quarterly payments of AUD \$87,500 (US \$67,800). Interest on the facility will be 2% above the lending institutions bill rate or cost of funding.

Interest paid for all debt was approximately \$1,534,893, \$1,859,351 and 2,189,600 in fiscal 2004, 2003 and 2002 respectively.

The aggregate maturities of all debt, excluding the warrant put liability, maturing during each of the next five years as of February 29, 2004 is as follows:

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| | |
|------------------|----------------------|
| 2005 | \$ 22,553,381 |
| 2006 | 3,732,744 |
| 2007 | 909,744 |
| 2008 | 1,734,985 |
| 2009 | 77,440 |
| Thereafter | 502,985 |
| Total | \$ 29,511,279 |
| Current | \$ 22,553,380 |
| Long Term | 6,957,899 |
| | \$ 29,511,279 |

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Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE J - ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

| | February 29, 2004 | February 28, 2003 |
|---|-----------------------------|-----------------------------|
| Accrued payroll and employee benefits | \$ 2,760,252 | \$ 1,466,619 |
| Accrued volume rebates and advertising allowances | 2,413,850 | 950,772 |
| Accrued income taxes | 1,074,000 | 446,747 |
| Accrued environmental expense | 192,623 | 79,993 |
| Accrued interest | 110,776 | 304,467 |
| Accrued liabilities - other | 669,642 | 144,653 |
| | <u>\$ 7,221,143</u> | <u>\$ 3,393,251</u> |

NOTE K - COMMITMENTS AND CONTINGENCIES

The Company provides accruals for all direct costs associated with the estimated resolution of contingencies at the earliest date at which it is deemed probable that a liability has been incurred and the amount of such liability can be reasonably estimated.

The Company is involved in litigation from time to time in the course of its business. In the opinion of management, no material legal proceedings are pending to which the Company or any of its property is subject.

1. Future Minimum Obligations

The Company conducts its operations from various leased facilities. Future minimum payments under non-cancelable operating leases consist of the following in fiscal years ending after February 29, 2004:

| | |
|------|--------------|
| 2005 | \$ 2,151,932 |
| 2006 | 1,560,507 |
| 2007 | 1,266,306 |
| 2008 | 502,081 |

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| | |
|-------|---------------------|
| 2009 | |
| Total | <u>\$ 5,480,826</u> |

Total rent expense under non-cancelable operating leases approximated \$2,473,000, \$2,310,000, and \$2,201,000 in fiscal 2004, 2003, and 2002, respectively.

Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. Roberts Consolidated Industries, Inc.

The Company is subject to federal, state and local laws, regulations and ordinances governing activities or operations that may have adverse environmental effects, such as discharges to air and water, handling and disposal practices for solid, special and hazardous wastes, and imposing liability for the cost of cleaning up, and certain damages resulting from sites of past spills, disposal or other releases of hazardous substances (together, Environmental Laws). Sanctions which may be imposed for violation of Environmental Laws include the payment or reimbursement of investigative and clean up costs, administrative penalties and, in certain cases, prosecution under environmental criminal statutes. The Company's manufacturing facilities are subject to environmental regulation by, among other agencies, the Environmental Protection Agency, the Occupational Safety and Health Administration, and various state authorities in the states where such facilities are located. The activities of the Company, including its manufacturing operations at its leased facilities, are subject to the requirements of Environmental Laws. The Company believes that the cost of compliance with Environmental Laws to date has not been material to the Company. The Company is not currently aware of any situations requiring remedial or other action, which would involve a material expense to the Company, or expose the Company to material liability under Environmental Laws. As the operations of the Company involve the storage, handling, discharge and disposal of substances which are subject to regulation under Environmental Laws, there can be no assurance that the Company will not incur any material liability under Environmental Laws in the future or will not be required to expend funds in order to effect compliance with applicable Environmental Laws.

The Company completed testing at its facility in Bramalea, Ontario, Canada for leakage of hazardous materials and, as a result, in fiscal 1999 the Company prepared a plan to remediate the contamination over a period of years and this plan was subsequently approved by the Canadian Ministry of Environment. The Company recorded a reserve for potential environmental liability on the closing date of the Roberts acquisition of approximately \$325,000 and this amount was subsequently increased by \$275,000 to \$600,000 based on an estimate for the cost of remediation. Through fiscal 2004, the Company has spent approximately \$532,000 and anticipates spending additional amounts on ongoing monitoring of wells and other environmental activity at the approximate rate of between \$5,000 and \$25,000 per year for the next few years.

NOTE L - PENSION AND RETIREMENT PLANS

Profit Sharing and 401(k) Plan

The Company and its subsidiaries offers a 401(k) benefit plan which provides for voluntary contributions by employees subject to a maximum annual contribution. The Company may, at the discretion of the board of directors, make contributions to the plan. For the three years ended February 29, 2004, the Company contributed approximately \$57,000, \$48,000, and \$62,000, respectively.

Subsequent to the acquisition of Roberts Consolidated Industries, Inc. (Roberts), the Company terminated the Roberts Salaried Employees Defined Benefit Pension Plan. As of May 31, 1998, the projected benefit obligation was estimated to be \$2,452,000 and the plan assets were approximately \$2,947,000. The Company initially recorded an asset in excess of projected benefit of approximately \$700,000. During fiscal 1999, the Company had an actuarial valuation prepared which adjusted this amount and goodwill by approximately \$226,000. During fiscal 2001, the Plan distributed its remaining assets to its participants under a new defined contribution plan and, with the approval of regulatory authorities, the remainder reverted to the Company.

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In May 2003, this new defined contribution plan distributed all remaining assets to the participants. Accordingly, no pension expense was recorded in each of the three years ended February 29, 2004.

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Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company also participates in a pension plan at one foreign subsidiary. The Company remits premiums to insurance companies who manage the plans. The Company records pension expense related to the normal premiums and amortizes the prior service costs over a ten-year period. The Company has recorded \$131,825, \$114,300, and \$64,400 as pension expense for the years ended February 28 or 29, 2004, 2003 and 2002 respectively. As of February 29, 2004, approximately \$170,000 of prior service cost is to be amortized and is recorded in Other Assets in the accompanying Consolidated Balance Sheet as of February 29, 2004.

NOTE M - INCOME TAXES

Income (loss) before provision for income taxes and cumulative effect of a change in accounting principal consisted of the following:

| | Year Ended February 28 or 29, | | |
|---------------|-------------------------------|---------------------|---------------------|
| | 2004 | 2003 | 2002 |
| United States | \$ 4,415,311 | \$ 4,998,036 | \$ 4,192,810 |
| Foreign | 1,452,079 | 300,657 | (685,037) |
| Total | \$ 5,867,390 | \$ 5,298,693 | \$ 3,507,773 |

The components of the provision for income taxes are as follows:

| | Year Ended February 28 or 29, | | |
|------------------|-------------------------------|------------------|------------------|
| | 2004 | 2003 | 2002 |
| Current: | | | |
| Federal | \$ 1,396,968 | \$ 1,806,194 | \$ 1,089,993 |
| State | 117,124 | 148,586 | 51,848 |
| Foreign | 433,288 | 300,705 | 52,436 |
| | 1,947,380 | 2,255,485 | 1,194,277 |
| Deferred: | | | |
| Federal | 346,503 | (30,404) | 447,443 |
| State | 24,459 | (2,402) | 35,357 |
| Foreign | 61,067 | 20,716 | (272,282) |
| | 432,029 | (12,090) | 210,518 |

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| | | | |
|----------------------------|--------------|--------------|--------------|
| Total income tax provision | \$ 2,379,409 | \$ 2,243,395 | \$ 1,404,795 |
|----------------------------|--------------|--------------|--------------|

The tax effects of temporary differences which give rise to deferred tax assets are as follows:

| | February 29, 2004 | February 28, 2003 |
|--|---------------------|---------------------|
| Provision for doubtful accounts | \$ 110,539 | \$ 104,548 |
| Accrued expenses | 179,612 | 181,469 |
| Fixed assets | (669,887) | (548,332) |
| Inventory | 92,016 | 312,859 |
| Net operating loss U.S. | 243,007 | 269,637 |
| Foreign credit carryforwards and net operating loss | 1,072,929 | 1,087,432 |
| Other | (23,641) | (13,416) |
| | <u>\$ 1,004,575</u> | <u>\$ 1,394,197</u> |
| Less: valuation allowance on foreign net operating loss carryforward | (215,610) | (169,046) |
| Net deferred tax asset | <u>\$ 788,965</u> | <u>\$ 1,225,151</u> |

Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company has approximately \$668,000 in net operating loss carry forwards which expire in the years 2011 through 2018, all of which relate to the Company's acquisitions in fiscal 2000. The net operating loss carry forward is subject to separate IRC Section 382 Limitation. The Section 382 limitation limits the Company's utilization of its net operating losses to an annual amount after an ownership change.

The Company has net operating losses in various foreign countries of approximately \$2,550,000. Approximately \$200,000 of these losses expire in 2006 and the remainder have no limit on their expiration. The Company has recorded a deferred tax asset based on its estimate of the recoverability prior to their expiration. Further, the Company has determined that certain foreign net operating losses may not be realized; therefore, a valuation allowance of approximately \$216,000 has been established.

The following is a reconciliation of the statutory federal income tax rate to the effective rate reported in the financial statements:

| | Year Ended February 28 or 29, | | | | | |
|--|-------------------------------|-------------|---------------------|-------------|---------------------|-------------|
| | 2004 | | 2003 | | 2002 | |
| | Amount | % | Amount | % | Amount | % |
| Provision for federal income taxes at the statutory rate | \$ 1,994,912 | 34.0 | \$ 1,801,556 | 34.0 | \$ 1,192,643 | 34.0 |
| State and local income taxes net of federal income tax benefit | 105,967 | 1.8 | 140,049 | 2.6 | 101,725 | 2.9 |
| Warrant put liability | 311,218 | 5.3 | 254,107 | 4.8 | 230,000 | 6.6 |
| Other | (32,688) | (0.6) | 47,683 | 0.9 | (119,573) | (3.5) |
| Actual provision | \$ 2,379,409 | 40.5 | \$ 2,243,395 | 42.3 | \$ 1,404,795 | 40.0 |

Cash paid for income taxes was approximately \$1,546,000, \$1,619,000, and \$984,000 in fiscal 2004, 2003 and 2002, respectively.

NOTE N - SIGNIFICANT CUSTOMER AND VENDOR INFORMATION

1. Significant Customer Information

The Company sells products to a large number of customers which are primarily in the United States of America. The Company performs ongoing credit evaluations of its customers' financial condition and requires no collateral from its customers. The Company's customer base includes a high concentration of home center chains with two such customers accounting for a total of 56%, 60%, and 59% of sales in fiscal 2004, 2003, and 2002, respectively. One customer represented 46%, 49%, and 46% and the other customer represented 13%, 11%, and 13% of sales in fiscal 2004, 2003, and 2002, respectively. These same two customers represented 38% and 7% of accounts receivable at February 29, 2004 and 41% and 6.3% of accounts receivable at February 28, 2003. Although the Company is directly affected by the well-being of the home center industry, management does not believe significant credit risk exists at February 29, 2004.

2. *Significant Vendor Information*

Although the Company believes that multiple sources of supply exist for nearly all of the products and components purchased from outside suppliers, the Company purchased approximately 25.1% and 15.3%, 30% and 13%, and 28% and 12% of domestic product purchases for the fiscal years ended 2004, 2003, and 2002, respectively, through two vendors.

NOTE O - SHAREHOLDERS EQUITY

The Company is authorized to issue a maximum of 2,500,000 shares of \$1 preferred stock.

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Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Series A

500,000 of the Company's 2,500,000 authorized shares of preferred stock, \$1 par value per share, are designated as Series A Preferred Stock. The holders of each share of Series A Preferred Stock shall be entitled to receive, before any dividends shall be declared, or paid on, or set aside for the Company's common stock, out of funds legally available for that purpose, cumulative dividends in cash at the rate of \$.035 per share per annum through September 30, 2000, payable in semiannual installments, accruing from the date of issuance of the shares. Commencing October 1, 2000, the rate of dividends is equal to the prime interest rate on the first day of the month in which the dividends are payable, less 1¹/₄%.

The Company may redeem any or all of the shares of Series A Preferred Stock outstanding at a price per share of \$1.07 plus an amount equal to any accrued but unpaid dividends thereon during the first year following the issuance of such shares and such price shall be reduced by one percent (1%) each year thereafter until \$1.00 per share is reached. The Series A Preferred Stock has no voting rights. During fiscal 1995, the Company issued 425,547 shares of Series A preferred stock in connection with a business acquisition. In fiscal 1997, 106,387 of these shares were converted to 3,129 shares of common stock. At February 29, 2004 and February 28, 2003, there were 319,160 shares of Series A Preferred Stock issued and outstanding. There were \$9,776 and \$11,171 of dividends declared and paid during each of the fiscal years 2004 and 2003, respectively.

Series B

1,000,000 of the Company's 2,500,000 authorized shares of preferred stock, \$1 par value per share, are designated as Series B Preferred Stock. The holder of each share of Series B Preferred Stock shall be entitled to receive, out of the surplus of the Company, a non-cumulative dividend at the rate of \$.05 per share per annum, payable annually before any dividend shall be set apart for, or paid on, the common shares for such years. The Series B Preferred Stock has no voting rights. The Company may redeem any or all of the shares of Series B Preferred Stock then outstanding at a price per share of \$1.00. At February 29, 2004 and 2003, there were no outstanding shares of Series B preferred stock.

Series C

1,000,000 of the Company's 2,500,000 authorized shares of preferred stock, \$1 par value per share, are designated as Series C Preferred Stock. The holder of each share of Series C Preferred Stock shall be entitled to receive, before any dividends shall be declared, or paid on, or set aside for the Company's common stock, out of funds legally available for that purpose, cumulative dividends at the rate of \$.035 per share per annum, payable in annual installments accruing from the date of issuance of the shares. The Series C Preferred Stock has no voting rights. The Company may redeem any or all of the shares of Series C Preferred Stock then outstanding at a price per share of \$1.00. During fiscal year 1995, 17,500 shares of Series C Preferred Stock were issued in connection with a business acquisition. In fiscal year 2004, the fiscal 2003 dividends of approximately \$600 were paid. In fiscal year 2004, dividends of approximately \$600 were declared and were unpaid at February 29, 2004.

Treasury Stock

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Total common shares purchased in fiscal year 1996 and held in treasury were 15,152 shares for an aggregate cost \$57,900. In fiscal 2001, pursuant to a resolution passed by the board of directors, the Company repurchased 42,000 shares of common stock at an aggregate cost of \$293,093. Further, pursuant to the same resolution, the Company repurchased 12,000 shares of common stock at an aggregate cost of \$39,649 in fiscal 2002, 12,000 shares of common stock at an aggregate cost of \$45,528 in fiscal 2003 and 24,000 shares of common stock at an aggregate cost of \$206,760 in fiscal 2004. Further, pursuant to the guarantee of certain of the Company's debt by the Company's Chairman and

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Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Chief Executive Officer, 50,000 shares of treasury stock were issued to him at an aggregate cost of \$261,485. As of February 29, 2004 the amount of shares held in treasury were 58,940 at an aggregate cost of \$381,445.

NOTE P - STOCK OPTION PLAN

The Company has adopted a stock option plan (the Plan) for employees, consultants and directors of the Company. Stock options granted pursuant to the Plan shall be authorized by the board of directors. The aggregate number of shares which may be issued under the Plan shall not exceed 500,000 shares of common stock. Stock options are granted at prices not less than 85% of the fair market value on the date of the grant. Option terms, vesting and exercise periods vary, except that the term of an option may not exceed ten years. For the years ended February 28 or 29, 2004, 2003, and 2002, all options were granted at fair market value on the date of the grant.

The weighted average fair value at date of grant for options granted during 2004, 2003, and 2002 was \$5.40, \$2.57, and \$1.18 per option, respectively. The fair value of each option at date of grant was estimated using the Black-Scholes option pricing model with the following weighted average assumptions for grants.

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---------------------------------|-------------|-------------|-------------|
| Expected stock price volatility | 38.84% | 37.37% | 36.7% |
| Expected lives of options: | | | |
| Directors and officers | 3 years | 3 years | 3 years |
| Employees | 3 years | 3 years | 3 years |
| Risk-free interest rate | 4.08% | 3.78% | 4.4% |
| Expected dividend yield | 0.0% | 0.0% | 0.0% |

| | <u>Shares</u> | <u>Weighted average exercise price</u> |
|--|---------------|--|
| Options outstanding at February 28, 2001 | 392,063 | |
| Exercised | | |
| Granted | 123,750 | \$ 3.91 |
| Expired | (157,813) | \$ 5.94 |
| Cancelled or forfeited | (1,000) | \$ 5.78 |
| Options outstanding at February 28, 2002 | 357,000 | |
| Exercised | | |
| Granted | 52,500 | \$ 4.72 |
| Expired | (63,487) | \$ 6.08 |
| Cancelled or forfeited | | |
| Options outstanding at February 28, 2003 | 346,013 | |

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| | | | |
|--|----------------|----|------|
| Exercised | (25,164) | \$ | 5.71 |
| Granted | 40,000 | \$ | 9.99 |
| Cancelled or forfeited | (55,586) | \$ | 5.71 |
| | <u>305,263</u> | | |
| Options outstanding at February 29, 2004 | | | |
| | <u>218,013</u> | \$ | 5.69 |
| Options currently exercisable | | | |

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Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes information about stock options outstanding as of February 29, 2004:

| <u>Range of exercise prices</u> | <u>Number outstanding</u> | <u>Weighted average remaining contractual life</u> | <u>Weighted average exercise price</u> | <u>Number exercisable</u> | <u>Weighted average exercise price</u> |
|---------------------------------|---------------------------|--|--|---------------------------|--|
| \$ 3.65 - \$ 5.55 | 133,750 | 7.25 | \$ 4.24 | 82,500 | \$ 4.23 |
| \$ 5.60 - \$ 7.25 | 135,513 | 5.02 | \$ 6.58 | 135,513 | \$ 6.58 |
| \$ 7.26 - \$10.08 | 36,000 | 9.23 | \$ 9.99 | | \$ |
| Total | 305,263 | | | 218,013 | |

During fiscal 2002, the Company issued 50,000 non-qualified stock options to an officer of the Company. These options have an exercise price of \$4.00 and expire in ten years.

NOTE Q SUPPLEMENTAL INVESTING AND FINANCING ACTIVITIES

During fiscal 2004, the Company acquired a manufacturer and distributor in the United Kingdom. In connection with this acquisition, liabilities were assumed as follows:

| | |
|---|--------------|
| Cash paid | \$ 3,601,561 |
| Liabilities assumed | 911,952 |
| | <hr/> |
| Purchase price | \$ 4,513,513 |
| Fair value of net assets acquired | 3,542,367 |
| | <hr/> |
| Excess of purchase price over fair value of net assets acquired | \$ 971,146 |

Also, during fiscal 2004, the Company made certain capital expenditures as follows:

| | |
|---|--------------|
| Total capital expenditures | \$ 2,674,366 |
| Amounts representing capitalized leases | 88,604 |
| | <hr/> |
| Capital expenditures paid in cash | \$ 2,585,762 |

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In fiscal 2004, the Company entered into the following non cash financing transactions, (i) in May 2003, the Company granted 50,000 shares of its common stock to the Company's Chairman and Chief Executive Officer. The value of the shares, as determined by an unrelated third party was \$275,000; (ii) the Company repurchased from one of its shareholder's 24,000 shares of its common stock for approximately \$207,000 for which \$90,000 was paid in cash and the remaining balance is included in accounts payable in the accompanying consolidated balance sheet as of February 29, 2004 (See Note O).

During fiscal 2003, the Company made an acquisition of an Australian distributor. In connection with this acquisition, liabilities were assumed as follows:

| | |
|---|---|
| Cash paid | \$ 495,630 |
| Liabilities assumed | 769,096 |
| Issuance of notes to related sellers | 795,470 |
| | <hr/> |
| Purchase price | \$ 2,060,196 |
| Fair value of net assets acquired | 1,647,170 |
| | <hr/> |
| Excess of purchase price over fair value of net assets acquired | \$ 413,026 |
| | <hr style="border-top: 3px double black;"/> |

Also, during fiscal 2003, the Company made certain capital expenditures as follows:

| | |
|---|---|
| Total capital expenditures | \$ 1,417,041 |
| Amounts representing capitalized leases | 159,256 |
| | <hr/> |
| Capital expenditures paid in cash | \$ 1,257,785 |
| | <hr style="border-top: 3px double black;"/> |

Q.E.P. CO., INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

During fiscal 2002, the Company made certain capital expenditures as follows:

| | |
|-------------------------------------|------------|
| Total capital expenditures | \$ 576,907 |
| Amounts representing capital leases | 36,250 |
| | <hr/> |
| Capital expenditures paid in cash | \$ 540,657 |
| | <hr/> |

NOTE R NEW ACCOUNTING PRONOUNCEMENTS*Variable Interest Entities*

In January 2003, the FASB issued FASB Interpretation 46 (FIN 46), *Consolidation of Variable Interest Entities*. FIN 46 clarifies the application of Accounting Research Bulletin 51, *Consolidated Financial Statements*, for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest (variable interest entities). Variable interest entities within the scope of FIN 46 will be required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity's expected losses, receives a majority of its expected returns, or both. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. It applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. At February 29, 2004 the Company is not a party to transactions contemplated under FIN 46.

Revenue Recognition

In November 2002, the Emerging Issues Task Force reached a consensus opinion on EITF 00-21, *Revenue Arrangements with Multiple Deliverables*. The consensus provides that revenue arrangements with multiple deliverables should be divided into separate units of accounting if certain criteria are met. The consideration for the arrangement should be allocated to the separate units of accounting based on their relative fair values, with different provisions if the fair value of all deliverables are not known or if the fair value is contingent on delivery of specified items or performance conditions. Applicable revenue recognition criteria should be considered separately for each separate unit of accounting. EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Entities may elect to report the change as a cumulative effect adjustment in accordance with APB Opinion 20, *Accounting Changes*. At February 29, 2004, the Company is not a party to transactions contemplated by EITF 00-21.

Derivative Instruments

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In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS No. 149 requires that contracts with comparable characteristics be accounted for similarly. In particular, SFAS No. 149 (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative discussed in paragraph 6(b) of SFAS No. 133, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying to conform it to language used in FIN No. 45, and (4) amends certain other existing pronouncements. The provisions of SFAS No. 149 are effective for contracts entered into or modified after June 30, 2003. The Company's adoption of SFAS No. 149 did not have a material impact on its results of operations or financial position.

Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Financial Instruments

On May 15, 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). SFAS No. 150 affects the issuer's accounting for three types of freestanding financial instruments.

Mandatorily redeemable shares, which the issuing company is obligated to buy back in exchange for cash or other assets.

Instruments that do or may require the issuer to buy back some of its shares in exchange for cash or other assets; includes put options and forward purchase contracts.

Obligations that can be settled with shares, the monetary value of which is fixed, tied solely or predominantly to a variable such as a market index, or varies inversely with the value of the issuer's shares.

SFAS No. 150 does not apply to features embedded in a financial instrument that is not a derivative in its entirety. Most of the guidance in SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003.

In March 2003, the Securities and Exchange Commission issued Regulation G *Condition for Use of Non-GAAP Financial Measures*. As defined in Regulation G, a non-GAAP financial measure is a numerical measure of a company's historical or future performance, financial position or cash flow that excludes or includes amounts or adjustments that are included or excluded in the most directly comparable measure calculated in accordance with generally accepted accounting principles. Companies that present non-GAAP financial measures must disclose a numerical reconciliation to the most directly comparable measurement using GAAP. This report contains use of non-GAAP financial measures and the required numerical reconciliation.

Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE S: SUPPLEMENTAL FINANCIAL DATA ANNUAL FINANCIAL DATA (UNAUDITED)

The annual results for the two years ended February 29, 2004 are set forth in the following table:

| | <u>Sales</u> | <u>Gross Profit</u> | <u>Net Earnings (Loss)</u> | <u>Earnings (Loss) per share</u> |
|---|-----------------------|----------------------|--------------------------------|--------------------------------------|
| <u>2004</u> | | | | |
| First quarter | \$ 34,710,448 | \$ 11,950,523 | \$ 411,428 | \$ 0.12 |
| Second quarter | 34,489,070 | 11,970,626 | 979,266 | 0.28 |
| Third quarter | 36,564,856 | 12,535,133 | 1,052,290 | 0.30 |
| Fourth quarter | 37,508,173 | 12,751,639 | 1,044,997 | 0.29 |
| Total | \$ 143,272,547 | \$ 49,207,921 | \$ 3,487,981 | \$ 0.99 |
| <u>2003</u> | | | | |
| First quarter | \$ 31,190,454 | \$ 10,398,101 | \$ 713,768 | \$ 0.21 |
| Second quarter | 33,408,699 | 11,714,478 | 796,305 | 0.23 |
| Third quarter | 32,351,502 | 11,158,462 | 663,956 | 0.20 |
| Fourth quarter | 32,330,529 | 11,127,610 | 881,269 | 0.26 |
| Cumulative effect of change in accounting principle | | | (3,047,788) | (0.89) |
| Total | \$ 129,281,184 | \$ 44,398,651 | \$ 7,510 | \$ 0.01 |

Q.E.P. CO., INC. AND SUBSIDIARIES

SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS

| <u>Column A</u> | <u>Column B</u> | <u>Column C</u> | | <u>Column D</u> | <u>Column E</u> |
|--|---------------------------------------|--------------------------------------|----------------------------------|-------------------|---------------------------------|
| <u>Description</u> | <u>Balance at beginning of period</u> | <u>Additions</u> | | <u>Deductions</u> | <u>Balance at end of period</u> |
| | | <u>Charged to costs and expenses</u> | <u>Charged to other accounts</u> | <u>(a)</u> | |
| Year ended February 28, 2002 | | | | | |
| Deducted from asset accounts Allowance for doubtful accounts | \$ 661,826 | \$ 94,909 | | \$ 335,129 | \$ 421,606 |
| Year ended February 28, 2003 | | | | | |
| Deducted from asset accounts Allowance for doubtful accounts | \$ 421,606 | \$ 363,705 | | \$ 431,366 | \$ 353,945 |
| Foreign net operating loss valuation allowance | | \$ 169,000 | | | \$ 169,000 |
| Year ended February 29, 2004 | | | | | |
| Deducted from asset accounts Allowance for doubtful accounts | \$ 353,945 | \$ 431,652 | | \$ 142,701 | \$ 642,896 |
| Foreign net operating loss valuation allowance | \$ 169,000 | \$ 46,609 | | | \$ 215,609 |

(a) Accounts written off as uncollectable, net of recoveries.

EXHIBIT INDEX

Exhibit

| Number | Exhibit Description |
|---------------|---|
| 14.1 | Code of Ethics for Senior Financial Officers |
| 31.1 | Certification of Principal Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Principal Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |