

Edgar Filing: SINGING MACHINE CO INC - Form 10-Q/A

SINGING MACHINE CO INC  
Form 10-Q/A  
January 03, 2005

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q/A

AMENDMENT TO

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

For the quarterly period ended JUNE 30, 2003

0 - 24968

Commission File Number

THE SINGING MACHINE COMPANY, INC.

(Exact Name of Small Business Issuer as Specified in its Charter)

DELAWARE  
(State  
of Incorporation)

95-3795478  
(I.R.S. Employer  
I.D. No.)

6601 LYONS ROAD, BUILDING A-7, COCONUT CREEK, FL 33073  
(Address of principal executive offices)

(954) 596-1000  
(Issuer's telephone number, including area code)

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS

Check whether the registrant filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court. Yes  No

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

CLASS	NUMBER OF SHARES OUTSTANDING ON JULY 30, 2003
----- Common Stock, \$0.01 par value	----- 8,300,178

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THE SINGING MACHINE COMPANY, INC. AND SUBSIDIARY

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

THE SINGING MACHINE COMPANY, INC. AND SUBSIDIARY  
PART I - FINANCIAL INFORMATION

ITEM I. FINANCIAL STATEMENTS

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## THE SINGING MACHINE COMPANY, INC. AND SUBSIDIARY CONSOLIDATED BALANCE SHEETS

	JUNE 30, 2003	MARCH 31, 2003
	-----	-----
	(unaudited)	
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 86,413	\$ 268,26
Restricted Cash	862,122	838,41
Accounts Receivable, less allowances of \$171,411 and \$405,759, respectively	4,236,488	5,762,94
Due from manufacturer	60,272	1,091,87
Inventories	25,959,760	25,194,34
Prepaid expense and other current assets	1,943,844	1,483,60
Deferred tax asset	1,925,612	1,925,61
	-----	-----
TOTAL CURRENT ASSETS	35,074,511	36,565,05
PROPERTY AND EQUIPMENT, at cost less accumulated depreciation of \$1,648,369 and \$1,472,850, respectively	2,149,919	2,026,25
OTHER NON-CURRENT ASSETS	341,530	343,99
	-----	-----
TOTAL PROPERTY, EQUIPMENT AND OTHER ASSETS	2,491,449	2,370,24
	-----	-----
TOTAL ASSETS	\$37,565,960	\$38,935,29
	=====	=====
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Bank overdraft	46,652	316,64
Accounts payable	\$ 9,785,339	\$ 8,486,00
Accrued expenses	1,231,491	1,443,40
Due to related party	200,000	400,00
Notes payable	2,000,000	
Revolving credit facility	4,903,371	6,782,82
Income taxes payable	3,823,360	3,821,04
	-----	-----
TOTAL CURRENT LIABILITIES	21,990,213	21,249,93
	-----	-----
<b>SHAREHOLDERS' EQUITY</b>		
Preferred stock, \$1.00 par value; 1,000,000 shares authorized, no shares issued and outstanding	--	--
Common stock, Class A, \$.01 par value; 100,000 shares authorized; no shares issued and outstanding	--	--
Common stock, \$0.01 par value; 18,900,000 shares authorized; 8,300,178 and 8,171,678 shares issued and outstanding	83,002	81,71
Additional paid-in capital	5,049,880	4,843,43
Retained earnings	10,442,865	12,760,21
	-----	-----
TOTAL SHAREHOLDERS' EQUITY	15,575,747	17,685,36

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TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY

\$37,565,960

\$38,935,29

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

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THE SINGING MACHINE COMPANY, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(unaudited)

	THREE MONTHS ENDED	
	JUNE 30, 2003  (as restated)	JUNE 30, 2002
NET SALES	\$ 7,627,975	\$ 4,296,841
COST OF SALES	5,901,866	2,990,881
GROSS PROFIT	1,726,109	1,305,960
OPERATING EXPENSES		
Advertising	270,770	165,765
Compensation	1,111,579	770,898
Freight & handling	225,866	245,490
Royalty expense	83,964	67,830
Selling, general & administrative expenses	2,168,168	1,389,020
TOTAL OPERATING EXPENSES	3,860,347	2,639,003
LOSS FROM OPERATIONS	(2,134,238)	(1,333,043)
OTHER INCOME (EXPENSES)		
Other income	7,669	13,901
Interest expense	(188,468)	(1,549)
Interest income	--	11,604
NET OTHER EXPENSES	(180,799)	23,956
NET LOSS BEFORE INCOME TAX	(2,315,037)	(1,309,087)
INCOME TAX EXPENSE	2,315	118,334
NET LOSS	\$ (2,317,352)	\$ (1,427,421)
LOSS PER SHARE:		
Basic & Diluted	\$ (0.28)	\$ (0.18)

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WEIGHTED AVERAGE COMMON AND COMMON

EQUIVALENT SHARES OUTSTANDING:

Basic & Diluted

8,278,469

8,061,277

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

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### THE SINGING MACHINE COMPANY, INC. AND SUBSIDIARY CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

	FOR THE QUARTER ENDED JUNE 30	
	2003	2002
		(as restated)
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Loss	\$ (2,317,352)	\$ (1,309,087)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	175,519	121,047
Changes in assets and liabilities:		
(Increase) decrease in:		
Accounts Receivable	1,526,456	924,688
Due from manufacturer	0	(251,909)
Inventories	266,185	(3,666,981)
Prepaid Expenses and other assets	(457,782)	87,483
Increase (decrease) in:		
Accounts payable	1,299,330	2,413,542
Accrued expenses	(211,914)	(784,259)
Income taxes payable	2,315	(58,542)
	282,757	(2,524,018)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Restricted cash	(23,711)	0
Purchase of property and equipment	(299,186)	(612,141)
Deposit for credit line	0	(650)
	(322,897)	(612,791)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Bank overdraft	(269,994)	0
Net revolving credit facility	(1,879,453)	0
Payments on related party loan	(200,000)	0
Proceeds from note payable	2,000,000	
Proceeds from exercise of stock options and warrants	207,735	81,785

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Net cash provided by Financing Activities	(141,712)	81,785
	-----	-----
DECREASE IN CASH AND CASH EQUIVALENTS	(181,852)	(3,055,024)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	268,265	5,520,147
	-----	-----
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 86,413	\$ 2,465,123
	=====	=====
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the year for interest	\$ 188,469	\$ 1,549
	=====	=====
Cash paid during the year for income taxes	\$ 0	\$ 58,542
	=====	=====

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

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### THE SINGING MACHINE COMPANY, INC AND SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

#### NOTE 1 - SUMMARY OF ACCOUNTING POLICIES

##### BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements include the accounts of The Singing Machine Company, Inc. and its subsidiary (the "Company", "The Singing Machine"). All significant intercompany transactions and balances have been eliminated. The unaudited consolidated financial statements have been prepared in conformity with Rule 10-01 of Regulation S-X of the Securities and Exchange Commission and therefore do not include information or footnotes necessary for a complete presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. However, all adjustments (consisting of normal recurring accruals), which, in the opinion of management, are necessary for a fair presentation of the financial statements, have been included. Operating results for the period ended June 30, 2003 are not necessarily indicative of the results that may be expected for the remaining quarters or the year ending March 31, 2004 due to seasonal fluctuations in The Singing Machine's business, changes in economic conditions and other factors. For further information, please refer to the Consolidated Financial Statements and Notes thereto contained in The Singing Machine's Annual Report on Form 10-K for the year ended March 31, 2003.

##### INVENTORIES

Inventories are comprised of electronic karaoke audio equipment, accessories, and compact discs and are stated at the lower of cost or market, as determined using the first in, first out method. The following table represents the major components of inventory at the dates specified.

JUNE 30, 2003	MARCH 31, 2003
-----	-----

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Finished goods	\$ 27,991,580	\$ 27,807,763
Inventory in transit	1,568,870	1,101,940
Less Inventory reserve	(3,600,690)	(3,715,357)
	-----	-----
Total Inventory	\$ 25,959,760	\$ 25,194,346
	=====	=====

RECLASSIFICATIONS

Certain prior year amounts have been reclassified to conform to the current year presentation.

STOCK BASED COMPENSATION

The Company accounts for stock options issued to employees using the intrinsic value method in accordance with the provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. As such, compensation cost is measured on the date of grant as the excess of the current market price of the underlying stock over the exercise price. Such compensation amounts are amortized over the respective vesting periods of the option grant. The Company applied the disclosure provisions of Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure an amendment of FASB Statement No. 148", which permits entities to provide pro forma net earnings (loss) and pro forma earnings (loss) per share disclosures for employee stock option grants as if the fair-valued based method defined in SFAS No. 123 had been applied to options granted.

Had compensation cost for the Company's stock-based compensation plan been determined using the fair value method for awards under that plan, consistent with Statement of Financial Accounting Standards (SFAS) No 123, "Accounting for Stock Based Compensation" (Statement No. 123), the Company's net earnings would have been changed to the pro-forma amounts indicated below.

		JUNE 30, 2003	JUNE 30, 2002
		-----	-----
Net loss	As reported	\$ (2,317,352)	\$ (1,427,421)
	Pro forma	\$ (2,518,804)	\$ (1,456,293)
Net loss per share - basic & diluted	As reported	\$ (0.28)	\$ (0.18)
	Pro forma	\$ (0.30)	\$ (0.18)

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The effect of applying Statement No. 123 is not likely to be representative of the effects on reported net earnings for future years due to, among other things, the effects of vesting.

For stock options and warrants issued to consultants, the Company applies the fair value method of accounting as prescribed by SFAS 123. There were no consulting expenses relating to grants for the quarters ended June 30, 2003 and 2002.

For financial statement disclosure purposes and for purposes of valuing stock options and warrants issued to consultants, the fair market value of each stock

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option granted was estimated on the date of grant using the Black-Scholes Option-Pricing Model in accordance with SFAS 123 using the following weighted-average assumptions:

First Quarter 2004: expected dividend yield 0%,  
risk-free interest rate of 4%,  
volatility 79.9% and expected term of five years.

First Quarter 2003: expected dividend yield 0%,  
risk-free interest rate of 6.8%,  
volatility 42% and expected term of two years.

### RECENT ACCOUNTING PRONOUNCEMENTS

SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS 133. SFAS 149 is generally effective for contracts entered into or modified after June 30, 2003 (with a few exceptions) and for hedging relationships designated after June 30, 2003. The Company does not expect the provisions of SFAS 149 to have a material impact on its financial position or results of operations.

SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"). SFAS 150 improves the accounting for certain financial instruments that, under previous guidance, issuers could account for as equity. The new Statement requires that those instruments be classified as liabilities in statements of financial position. This statement is effective at the beginning of the second quarter of fiscal 2004. The Company does not expect the provisions of SFAS 150 to have a material impact on its financial position or results of operations.

### NOTE 2 - GOING CONCERN

The accompanying unaudited consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern.

On March 14, 2003, the Company was notified of its violation of the net worth covenant of its Loan and Security Agreement (the "Agreement") with its commercial lender and the Company was declared in default under the Agreement. The lender amended the Agreement on July 31, 2003, extending the loan until August 20, 2003, but did not waive the condition of default. This condition of default raises substantial doubt about the Company's ability to continue as a going concern.

The Company is attempting to restructure and extend its revolving credit facility. Based upon cash flow projections, the Company believes the anticipated cash flow from operations will be sufficient to finance the Company's operating needs until inventory is sold and the receivables subsequently collected, provided that the bank does not call the loan. There can be no assurances that forecasted results will be achieved or that additional financing will be obtained. The financial statements do not include any adjustments relating to the recoverability and classification of asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

Although the Company had a larger than normal amount of currently saleable inventory at June 30, 2003 and March 31, 2003 (based on the Company's recent sales trends and industry turnover standards), the Company has developed a fiscal 2004 sales plan that it believes will allow it to sell such inventory and recover its costs in the normal course of business.



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NOTE 3 - RESTATEMENT OF FINANCIAL STATEMENTS FOR THE FISCAL YEARS 2002 AND 2001

In June 2003, management revised its position on taxation of its subsidiary's income by the United States and by the Hong Kong tax authorities.

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With regard to taxation in Hong Kong, the Company's subsidiary had previously applied for a Hong Kong offshore claim income tax exemption based on the locality of profits of the Hong Kong subsidiary. Management believed that the exemption would be approved because the source of all profits of the Hong Kong subsidiary is from exporting to customers outside of Hong Kong. Accordingly, no provision for income taxes was provided in the consolidated financial statements as of March 31, 2002 and 2001. However, full disclosure was previously reflected in the audited financial statements for years ended March 31, 2002 and 2001 of the estimated amount that would be due to the Hong Kong tax authority should the exemption be denied. Management is continuing its exemption application process. However, due to the extended period of time that the application has been outstanding, as well as management's reassessment of the probability that the application will be approved, management has determined to restate the 2002 and 2001 consolidated financial statements to provide for such taxes. The effect of such restatement is to increase income tax expense by \$748,672 and \$468,424 in fiscal 2002 and 2001, respectively. However, the Company can claim United States foreign tax credits in 2002 for these Hong Kong taxes, which is reflected in the final restated amounts.

With regard to United States taxation of foreign income, the Company had originally taken the position that the foreign income of the Hong Kong subsidiary qualified for a deferral under the Internal Revenue Code allowing for such income to be indefinitely deferred and not taxed in the United States until such income is repatriated. Full disclosure of the amount and nature of the indefinite deferral for fiscal year 2002 was reflected in the income tax footnote of the consolidated financial statements for that year. The internal revenue code, regulations and case law regarding international income taxation is quite complex and subject to interpretation. Each case is determined based on the individual facts and circumstances. Due to certain inter-company loans made in 2002 and 2003, the profits previously considered to be indefinitely deferred became partially taxable as "deemed dividends" under section 956 of the Internal Revenue Code. Although certain arguments against the imposition of a "deemed dividend" may be asserted, management has determined to restate the fiscal year 2002 consolidated financial statements based on its reassessment of its original position. The effect of such restatement is to increase income tax expense by \$1,027,545 in fiscal year 2002, which includes the utilization of the foreign tax credits referred to above.

The net effect of the above two adjustments for the quarter ended June 30, 2002 is to decrease net income by \$118,334. The net effect on net income per share is to decrease net income per share basic and diluted by \$0.01 for the quarter ended June 30, 2002.

In September, 2004, the management revised the cash flow for the period ended March 31, June 30, September 30, and December 31, 2003. The amendments are related to the reclassification of the "Restrict Cash" and "Bank Overdraft". There is no effect to the Statement of Operations. The following table shows the reclassification of the cash flow:

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THE SINGING MACHINE COMPANY, INC. AND SUBSIDIARY  
COMPRESSED CONSOLIDATED STATEMENT OF CASH FLOWS  
(UNAUDITED EXCEPT FOR PERIOD ENDING 3/31/03)

	FOR PERIOD ENDING		
	03/31/03	03/31/03	06/30/03
	AS REPORTED	AS AMENDED	AS REPORTED
CASH FLOWS FROM OPERATING ACTIVITIES			
Net Income	\$ 1,217,812	\$ 1,217,812	\$ (2,117,812)
Net Cash Used in Operating Activities	(11,532,761)	(11,524,680)	(11,532,761)
CASH FLOWS FROM INVESTING ACTIVITIES			
Net cash used in Investing Activities	(1,144,064)	(1,468,791)	(1,144,064)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net cash provided by Financing Activities	7,424,943	7,741,589	7,424,943
DECREASE IN CASH AND CASH EQUIVALENTS	(5,251,882)	(5,251,882)	(5,251,882)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	5,520,147	5,520,147	5,520,147
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 268,265	\$ 268,265	\$ 268,265
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid during the year for interest	\$ 406,126	\$ 406,126	\$ 406,126
Cash paid during the year for income taxes	\$ 153,849	\$ 153,849	\$ 153,849
	FOR PERIOD ENDING		
	09/30/03	09/30/03	12/31/03
	AS REPORTED	AS AMENDED	AS REPORTED
CASH FLOWS FROM OPERATING ACTIVITIES			
Net Income	\$ (2,974,021)	\$ (2,974,021)	\$ (13,974,021)
Net Cash Used in Operating Activities	(4,678,328)	(4,380,280)	(4,678,328)
CASH FLOWS FROM INVESTING ACTIVITIES			
Net cash used in Investing Activities	(157,178)	(186,370)	(157,178)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net cash provided by Financing Activities	5,673,244	5,404,388	5,673,244

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DECREASE IN CASH AND CASH EQUIVALENTS	837,738	837,738
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	268,265	268,265
	-----	-----
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 1,106,003	\$ 1,106,003
	=====	=====
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the year for interest	\$ 350,192	\$ 350,192
	=====	=====
Cash paid during the year for income taxes	\$ 205,000	\$ 205,000
	=====	=====

### NOTE 4 - LOANS AND LETTERS OF CREDIT

#### CREDIT FACILITY

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The Company's Hong Kong Subsidiary maintains separate credit facilities at two international banks.

The Company maintains a facility with a maximum credit available of \$5.5 million U.S. dollars. The primary purpose of the facilities is to provide the Subsidiary with the following abilities:

- o Overdraft facilities
- o Issuance and negotiation of letters of credit, both regular and discrepant
- o Trust receipts
- o A Company credit card

The facilities are secured by a corporate guarantee from the U.S. Company, maintain restricted cash on deposit with the lender and maintain net worth as outlined in the agreement.

The Company executed a short term loan with an international bank in May of 2003. The \$2,000,000 loan carries interest at a SIBOR (Singapore Interbank Money Offer Rate) rate plus 2.75%. The rate at June 30, 2003 was 4.02%. The loan must be paid in full by October 31, 2003 and a deposit of \$350,000 must be retained in a restricted depository account with the lender until such time as the loan is paid in full.

#### LOAN AND SECURITY AGREEMENT

On April 26, 2001, the Company executed a Loan and Security Agreement (the "Agreement") with a commercial lender (the "Lender"). On July 31, 2003, this loan was amended through August 20, 2003. The following is a description of the terms as amended.

The Lender will advance up to 70% of the Company's eligible accounts receivable, plus up to 20% of the eligible inventory up to \$6,000,000, plus up to 40% of the commercial letters of credit opened for the purchase of eligible inventory up to

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\$3 million, less reserves at the discretion of the lender.

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The outstanding loan limit varies between zero and \$10,000,000, as stipulated in the Agreement. The Lender also provides the Company the ability to issue commercial letters of credit up to \$3,000,000, which shall reduce the loan limits above. The loans bear interest at the commercial lender's prime rate plus 0.5% and an annual fee equal to 1% of the maximum loan amount or \$100,000 is payable. All amounts under the loan facility are due within 90 days of demand. The loans are secured by a first lien on all present and future assets of the Company except for certain tooling located at a vendor in China. This amendment expires August 20, 2003.

The Agreement contains covenants including a restriction on the payment of dividends as well as a financial covenant stipulating a minimum tangible net worth of \$30,000,000 as of December 31, 2002 with escalations as defined in the Agreement. On March 15, 2003, the lender notified the Company that they are in default of this covenant and the agreement. The balance outstanding at March 31, 2003 was \$6,782,824 and was classified as a current liability under revolving credit facility on the balance sheet. At March 31, 2003, the Company was over advanced under the agreement by approximately \$3 million. The June 30, 2003 amendment gave the Company an additional \$4.5 million in availability which gave the Company working capital and cured the over advance; however, the Amendment requires the Company to raise \$2 million in subordinated debt.

The Company is currently negotiating a restructuring of the agreement with the lender.

### NOTE 5 - COMMITMENTS AND CONTINGENCIES

#### LEGAL MATTERS

Class Action. From July 2, 2003 through August 11, 2003, ten securities class action lawsuits were filed against The Singing Machine and certain of its officers and directors in the United States District Court for the Southern District of Florida on behalf of all persons who purchased The Singing Machine's securities during the various class action periods specified in the complaints. The Company expects that all of these actions will be consolidated in the United States District Court for the Southern District of Florida.

The complaints that have been filed allege violations of Section 10(b) and Section 20(a) of the Securities Exchange Act of 1934 and Rule 10(b)-5. The complaints seek compensatory damages, attorney's fees and injunctive relief. While the specific factual allegations vary slightly in each case, the complaints generally allege that defendants falsely represented the Company's financial results for the years ended March 31, 2002 and 2001.

The Company believes that the allegations in these cases are without merit and the Company intends to vigorously defend these actions. However, as the outcome of litigation is difficult to predict, significant changes in the estimated exposures could occur which could have a material affect on the Company's operations.

In July 2003, a shareholder filed a derivative action against the Company, its board of directors and senior management purporting to pursue the action on behalf of the Company and for its benefit. No pre-lawsuit demand to investigate the allegations or bring action was made on the board of directors. The Company is named as a nominal defendant in this case.

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The Complaint alleges claims for breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The complaint alleges that the individual defendants breached their fiduciary duties and engaged in gross mismanagement by allegedly ignoring indicators of the lack of control over the Company's accounting and management practices, allowing the Company to engage in improper conduct and otherwise failing to carry out their duties and obligations to the Company. The plaintiff's seek damages for breach of fiduciary duties, punitive and compensatory damages, restitution, and bonuses or other incentive-based or equity based compensation received by the CEO and CFO under the Sarbanes-Oxley Act of 2002.

The Company believes that the allegations in this derivative lawsuit are without merit and intends to vigorously defend this action.

### OTHER MATTERS.

The Company is also subject to various other legal proceedings and other claims that arise in the ordinary course of its business. In the opinion of management, the amount of ultimate liability, if any, in excess of applicable insurance coverage, is not likely to have a material effect on the financial condition, results of operations or liquidity of the Company. However, as the outcome of litigation or other legal claims is difficult to predict, significant changes in the estimated exposures could occur, which could have a material impact on the Company's operations.

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### NOTE 6 - STOCKHOLDERS' EQUITY

#### COMMON STOCK ISSUANCES

During the first quarter of fiscal 2004 and 2003, the Company issued the following shares of stock upon exercise of outstanding options and warrants.

JUNE 30,	NUMBER OF SHARES ISSUED	PROCEEDS TO COMPANY
	-----	-----
2004	128,500	\$207,735
	-----	-----
2003	69,000	\$ 81,785
	-----	-----

#### EARNINGS PER SHARE

In accordance with Statement of Financial Accounting Standards No. 128, "Earnings per Share," basic earnings per share are computed by dividing the net earnings for the period by the weighted average number of common shares outstanding. Diluted earnings per share is computed by dividing net earnings by the weighted average number of common shares outstanding including the effect of common stock equivalents.

The following table presents a reconciliation of basic and diluted earnings per share:

JUNE 30,	
-----	-----
2003	2002
-----	-----
(as restated)	

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Net loss	\$ (2,317,352)	\$ (1,427,421)
Loss available to common shares	\$ (2,317,352)	\$ (1,427,421)
Weighted average shares outstanding - basic & diluted	8,278,469	8,061,277
Loss per share - Basic & Diluted	\$ (0.28)	\$ (0.18)

For the quarter ended June 30, 2003 and 2002, 637,681 and 784,331 common stock equivalents were excluded from the computation of diluted earnings per share because their effect was antidilutive.

### NOTE 7 - SEGMENT INFORMATION

The Company operates in one segment and maintains its records accordingly. The majority of sales to customers outside of the United States are made by the Company's Subsidiary. Sales by geographic region for the quarters ended June 30 were as follows:

SALES	2003	2002
United States	\$ 3,863,002	\$ 3,494,039
France	1,018,046	--
Italy	792,720	--
United Kingdom	1,532,065	429,496
Other	422,142	373,306
Consolidated Net Sales	\$ 7,627,975	\$ 4,296,841

The geographic area of sales is based primarily on the location where the product is delivered.

### NOTE 8 - SUBSEQUENT EVENTS

As of July 10, 2003, the Company obtained \$1 million in subordinated debt financing from a certain officer, directors and an associate of a director. The Company has not finalized the terms of this loan; however, the Company has immediate use and access to the \$1 million of funding.

As of July 28, 2003, an unrelated party posted a \$1 million standby letter of credit as further collateral on the revolving credit facility. The consideration to be paid in return for this has not been finalized.

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

### FORWARD-LOOKING STATEMENTS

Certain statements contained in this Quarterly Report on Form 10-Q, including

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without limitation, statements containing the words believes, anticipates, estimates, expects, and words of similar import, constitute forward-looking statements. You should not place undue reliance on these forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us described below and elsewhere in this Quarterly Report, and in other documents we file with the Securities and Exchange Commission.

Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management's opinions only as of the date hereof. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements.

### OVERVIEW

The Singing Machine Company, Inc., a Delaware corporation, and Subsidiary (the "Company", or "The Singing Machine") are primarily engaged in the production, marketing, and sale of consumer karaoke audio equipment, accessories, and musical recordings. The products are sold directly to distributors and retail customers. Our electronic karaoke machines and audio software products are marketed under The Singing Machine(R) trademark.

Our products are sold throughout the United States, primarily through department stores, lifestyle merchants, mass merchandisers, direct mail catalogs and showrooms, music and record stores, national chains, specialty stores and warehouse clubs.

Our karaoke machines and karaoke software are currently sold in such retail outlets as Best Buy, Circuit City, Costco, Toys R Us, Target and J.C. Penney.

We had a net loss after estimated tax expense of \$2,317,352 for the three month period ended June 30, 2003. Our working capital as of June 30, 2003, was approximately \$14 million.

### RESTATEMENT OF FINANCIAL STATEMENTS

In June 2003, management revised its position on taxation of its subsidiary's income by the United States and by the Hong Kong tax authorities.

With regard to taxation in Hong Kong, the Company's subsidiary had previously applied for a Hong Kong offshore claim income tax exemption based on the locality of profits of the Hong Kong subsidiary. Management believed that the exemption would be approved because the source of all profits of the Hong Kong subsidiary is from exporting to customers outside of Hong Kong.

Accordingly, no provision for income taxes was provided in the consolidated financial statements as of March 31, 2002 and 2001. However, full disclosure was previously reflected in the audited financial statements for years ended March 31, 2002 and 2001 of the estimated amount that would be due to the Hong Kong tax authority should the exemption be denied. Management is continuing its exemption application process. However, due to the extended period of time that the application has been outstanding, as well as management's reassessment of the probability that the application will be approved, management has determined to restate the 2002 and 2001 consolidated financial statements to provide for such taxes. The effect of such restatement is to increase income tax expense by \$748,672 and 468,424 in fiscal 2002 and 2001, respectively. However, the Company can claim United States foreign tax credits in 2002 for these Hong Kong taxes, which is reflected in the final restated amounts.

With regard to United States taxation of foreign income, the Company had originally taken the position that the foreign income of the Hong Kong subsidiary qualified for a deferral under the Internal Revenue Code allowing for

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such income to be indefinitely deferred and not taxed in the United States until such income is repatriated. Full disclosure of the amount and nature of the indefinite deferral for fiscal year 2002 was reflected in the income tax footnote of the consolidated financial statements for that year. The Internal Revenue Code, regulations and case law regarding international income taxation is quite complex and subject to interpretation. Each case is determined based on the individual facts and circumstances. Due to certain inter-company loans made in 2002 and 2003, the profits previously considered to be indefinitely deferred became partially taxable as "deemed dividends" under section 956 of the Internal Revenue Code.

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Although certain arguments against the imposition of a "deemed dividend" may be asserted, management has determined to restate the fiscal year 2002 consolidated financial statements based on its reassessment of its original position. The effect of such restatement is to increase income tax expense by \$1,027,545 in fiscal year 2002, which includes the utilization of the foreign tax credits referred to above.

The net effect of the above two adjustments for the quarter ended June 30, 2002 is to decrease net income by \$118,334. The net effect on net income per share is to decrease net income per share basic and diluted by \$0.01 for the quarter ended June 30, 2002.

QUARTER ENDED JUNE 30, 2003 COMPARED TO THE QUARTER ENDED JUNE 30, 2002

### NET SALES

Net sales for the quarter ended June 30, 2003 increased 77.5% to \$7,627,975 compared to \$4,296,841 for the quarter ended June 30, 2002. The increase in the Company's sales for this quarter is due to the acquisition of new customers in Europe, as well as increased sales to existing customers. Sales in European countries increased \$2.6 million over the same period in the prior year. The Company believes that sales in this segment will continue to increase over the remaining fiscal year.

### GROSS PROFIT

Gross profit for the quarter ended June 30, 2003 was \$1,726,109 or 22.6% of sales as compared to \$1,305,960 or 32.2% of sales for the quarter ended June 30, 2002. The decrease in gross margin percentage compared to the prior year is due primarily to increased sales from our Hong Kong subsidiary to international customers. International sales were primarily in Europe for the quarter. Sales to international customers historically maintain lower selling prices, and thus a lower gross profit margin. Due to the increased inventory levels at June 30, 2003, which was carried from the prior year, the Company anticipates that the gross profit percentage for the remainder of the fiscal year will fall below last year.

### OPERATING EXPENSES

Operating expenses were \$3,860,347 or 50.6% of total revenues for the quarter ended June 30, 2003. The expenses increased over prior year by \$1,221,344, but, as a percentage of sales, decreased from 61.4% at June 30, 2002. This decreased percentage is a result of a higher revenue base over which to spread operating fixed costs. The primary factors that contributed to the increase of approximately \$1.2 million in operating expenses for the quarter ended June 30, 2003 are:



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- (i) increased advertising expenses of \$105,000, due primarily to increased sales
- (ii) compensation and related expenses in the amount of \$341,000.
- (iii) Increased expenses of \$300,000 due to the increased need for space to hold our high level of inventory in California.
- (iv) Increased accounting and legal fees of \$214,000
- (v) Various other smaller expenses contributed to the remainder of the increase.

As a result of the merchandise license agreements and minimum guarantee requirements, the Company expects royalty expense to increase in fiscal 2004.

### OTHER EXPENSES

Other expenses were \$180,799 for the quarter ended June 30, 2003, as compared with net other income of \$23,956 at June 30, 2002. Our interest expense increase is due to the increased use of our credit facility at the default rate of interest during this period. For the quarter ended June 2002, the Company had cash reserves to fund operations and did not need to borrow on the revolving credit facility. The Company expects interest expense to continue to increase for the remainder of fiscal 2004 due to the credit facility accruing interest at the default rate of prime plus 2.5% (6.75% at June 30, 2003).

### INCOME TAX EXPENSE (BENEFIT)

The Company's tax expense is based on an aggregation of the taxes on earnings of its Hong Kong and domestic operations on an annualized basis. Income tax rates in Hong Kong are approximately 16%, while the statutory income tax

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rate in the United States is 34%. The Company's effective tax rate during the first quarter of fiscal 2004 was 0% as compared to 19% during the first quarter of fiscal 2003. This decrease in the effective tax rate is a result of estimated tax benefits for fiscal 2004 resulting from estimated United States pretax loss for fiscal 2004 offset by estimated tax expense related to the estimated Hong Kong pretax income for fiscal 2004. As the effective tax rates are based on estimates, the Company's future effective income tax rate will fluctuate based on the changes in the estimates

### LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2003, the Company had cash on hand of \$86,413 and a bank overdraft of \$46,652 compared to cash on hand of \$268,265 and a bank overdraft of \$316,646 at March 31, 2003. Our current liabilities increased to \$21,990,213 as of June 30, 2003, compared to \$21,249,930 at June 30, 2002.

Because we had minimal liquidity as of June 30, 2003 and had defaulted under a credit agreement with our commercial lender, we received a going concern paragraph from our independent auditors for our financial statements for fiscal 2003. On March 14, 2003, we received a letter from LaSalle informing us that we were in violation of a net worth covenant in our credit agreement. In this letter, LaSalle also advised us that we were in default under the credit agreement and that it could accelerate the payment of all liabilities due under this agreement at any time. In July 2003, LaSalle amended the agreement through August 20, 2003 but did not waive the condition of default.

As of July 10, 2003, we obtained \$1 million in subordinated debt financing from a certain officer, directors and an associate of a director. As of July 28, 2003, an unrelated party posted a \$1 million standby letter of credit as further

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collateral on the revolving credit facility. It is presently expected that these will be short-term loans, which will be due on or before October 31, 2003. However, we have not yet determined the interest rate or if any compensation, such as warrants, will be awarded to the unrelated party and management investment group for these loans.

We are currently in negotiations with LaSalle to restructure the loan for the remainder of fiscal 2004. We hope that these negotiations will be successful and that a restructured loan agreement will be in place prior to August 21, 2003. However, we cannot assure you that these efforts will be successful. We entered into our credit facility with LaSalle in April 2001 and have entered into several amendments subsequently. We last amended the credit facility effective as of July 31, 2003 and it provides that the agreement expires on August 20, 2003. Under the amended credit facility, LaSalle Bank will, at its discretion, advance up to 70% of the Company's eligible accounts receivable, plus up to 20% of eligible inventory, plus us up to 60% of commercial letters of credit issue by LaSalle minus reserves as set forth in the loan documents. The loan is secured by a first lien on all present and future assets of the Company, except specific tooling located in China.

Due to the increased levels of inventory and accounts payable as of June 30, 2003, the Company has an increased need for working capital. As of June 30, 2003, the Company had current assets of \$35.1 million, which consisted primarily of accounts receivable and inventory; and current liabilities of approximately \$21.9 million. Our inventory levels remained relatively stable at approximately \$26 million between March 31 and June 30, 2003. Despite sales of approximately \$7.6 million during our first quarter, our inventory levels increased because 58% of our sales were direct sales made from International SMC and some purchases were received in the first quarter. The most significant current liabilities include (i) approximately \$9.8 million in accounts payable, of which approximately \$4.8 million is amounts payable to the Company's factories in China and (ii) \$4.9 million outstanding under the Company's credit facility with LaSalle Bank. Over the past few months, the Company has had discussions with its factories in China and they have indicated that they are willing to extend the payment dates for the Company's obligations. The Company also has been negotiating with LaSalle Bank to increase the credit available to the Company and has identified other sources of capital.

Our Hong Kong subsidiary, International SMC, has letters of credit and other various credit facilities available to finance its inventory purchases. International SMC also has a short term loan with the Hong Kong Shanghai Banking Corporation for \$2 million which is due by October 31, 2003. Additionally, one of our directors advanced \$400,000 to International SMC in March 2003. As of June 30, 2003, the remaining balance of the loan was \$200,000 and is due on October 31, 2003, bearing interest at the rate of 8% per annum.

In the event that we are not able to renegotiate an agreement with LaSalle, we have considered alternative sources of financing, including but not limited to inventory and accounts receivable financing and other high risk financing such as venture capital funds. Without such financing, our ability to continue our operations is in significant doubt.

During fiscal 2004, we plan on significantly decreasing our capital expenditures. We currently expect to order \$8-\$12 million in new inventory for domestic stock. During fiscal 2004, we will attempt to liquidate the excess inventory from fiscal 2003. We believe this inventory is highly marketable and saleable; however, there can be no assurances that we will be able to liquidate this inventory during our upcoming fiscal year.

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The Company's commitments for debt and other contractual arrangements are summarized as follows:

	YEARS ENDING MARCH 31,				
	TOTAL	2004	2005	2006	2007
Merchandise License Guarantee	\$ 1,595,000	\$ 1,395,000	\$ 150,000	\$ 50,000	
Property Leases	\$ 3,638,771	\$ 1,330,158	\$ 924,338	\$ 517,071	\$ 49,000
Equipment Leases	\$ 86,016	\$ 46,525	\$ 19,965	\$ 10,322	\$ 10,000

We should be able to satisfy our liquidity requirements until August 20, 2003 by using credit that has been extended to us under our credit agreement with LaSalle. However, we are currently in default of the loan and LaSalle could accelerate the loan at any time. We hope that our renegotiations are successful, but can not guarantee that this will occur. If we are not able to obtain adequate financing, we may not be able to continue as a going concern.

Except for the foregoing, we do not have any present commitment that is likely to result in our liquidity increasing or decreasing in any material way. In addition, except for the Company's need for additional capital to finance inventory purchases, the Company knows of no trend, additional demand, event or uncertainty that will result in, or that is reasonably likely to result in, the Company's liquidity increasing or decreasing in any material way.

Cash flows provided by operating activities were \$282,757 for the quarter ended June 30, 2003. Cash flows were provided by operating activities primarily due to decreases in accounts receivable in the amount of \$1.5 million and increases in accounts payable of \$1.3 million

Cash used in investing activities for the quarter ended June 30, 2003 was \$322,897. Cash used in investing activities primarily resulted from the purchase of fixed assets in the amount of \$299,186. The purchase of fixed assets consists of the tooling and molds required for production of new machines for this fiscal year. Tooling and molds are depreciated over five years.

Cash flows used in financing activities were \$141,712 for the quarter ended June 30, 2003. This consisted of proceeds from the exercise of options in the amount of \$207,735, the payment of the bank in the amount of \$269,994, proceed from note payable in the amount of \$2,000,000 and the payment of the credit facility in the amount of \$1,879,453.

### EXCHANGE RATES

We sell all of our products in U.S. dollars and pay for all of our manufacturing costs in either U.S. or Hong Kong dollars. Operating expenses of the Hong Kong office are paid in Hong Kong dollars. We cannot assure you that the exchange rate fluctuations between the United States and Hong Kong currencies will not have a material adverse effect on our business, financial condition or results of operations.

### SEASONAL AND QUARTERLY RESULTS

Historically, the Company's operations have been seasonal, with the highest net

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sales occurring in the second and third quarters (reflecting increased orders for equipment and music merchandise during the Christmas selling months) and to a lesser extent the first and fourth quarters of the fiscal year. Sales in the Company's fiscal second and third quarter, combined, accounted for approximately 85% of net sales in fiscal 2003, 81% of net sales in fiscal 2002 and 75% of net sales in fiscal 2001.

The Company's results of operations may also fluctuate from quarter to quarter as a result of the amount and timing of orders placed and shipped to customers, as well as other factors. The fulfillment of orders can therefore significantly affect results of operations on a quarter-to-quarter basis.

### INFLATION

Inflation has not had a significant impact on the Company's operations. The Company has historically passed any price increases on to its customers since prices charged by the Company are generally not fixed by long-term contracts.

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### RISK FACTORS THAT MAY AFFECT FUTURE RESULTS AND MARKET PRICE OF STOCK

#### WE RECEIVED A GOING CONCERN PARAGRAPH FROM OUR INDEPENDENT AUDITORS

We received a going concern paragraph from our independent auditors for the fiscal year ended March 31, 2003. We have minimal liquidity as of June 24, 2003, the date of the audit report, and our commercial lender declared us in default under the terms of our credit agreement, on March 14, 2003. For these reasons, our independent auditors were concerned about our ability to continue as a going concern. We are attempting to restructure our credit agreement with our lender. Effective as of July 31, 2003, our lender extended our credit agreement until August 20, 2003, but did not waive any of the current events of default.. Based upon cash flow projections, the Company believes the anticipated cash flow from operations and most importantly, the expected net proceeds from future earnings will be sufficient to finance the Company's operating needs until inventory is sold and the receivables subsequently collected. However, there can be no assurances that we will achieve our forecasted results and that our cash flow from operations will be sufficient to finance our operating needs until our inventory is sold. We are also seeking other sources of long and short term capital. Because we can give no assurance that we can achieve any of the foregoing, there is substantial uncertainty about our ability to continue as a going concern. Because we have a going concern qualification, it may be more difficult for us to raise capital.

#### WE HAVE SIGNIFICANT WORKING CAPITAL NEEDS WHICH ARE SUBJECT TO THE UNCERTAINTY OF ADDITIONAL FINANCING

If we are not able to restructure our credit agreement with our commercial lender by August 20, 2003, we will need to seek additional funds to operate our business. Although we have been looking for alternative sources of capital (in addition to our credit line with our commercial lender), we are not certain that we will be able to locate and secure such additional financing on a timely basis and on terms that are acceptable to the Company. We are also trying to sell our excess inventory to provide us with more cash for operations. If we do not have adequate financing, it will have a material adverse effect on our business, results of operation and financial condition and we may need to change our business strategy or reduce our operations. If we have a severe shortage of working capital, we may not be able to continue our business operations and may be required to file a petition for Chapter 11 or enter into some liquidation or reorganization proceeding. In addition, any issuance of additional equity

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securities will dilute the ownership interest of our existing stockholders and issuance of debt securities may increase the perceived risk of investing in us.

### WE ARE CURRENTLY IN DEFAULT UNDER OUR CREDIT AGREEMENT WITH OUR COMMERCIAL LENDER

On March 14, 2003, we received a letter from LaSalle informing us that we were in breach of our credit agreement as a result of our failure to maintain the minimum tangible net worth requirement. In this letter, LaSalle also advised us that it could accelerate the payment of all liabilities due under the credit agreement at any time. As of August 12, 2003, LaSalle has not filed a lawsuit against us to accelerate the payment of any liabilities due under the credit agreement. If LaSalle were to exercise its right to foreclose on our assets, primarily our accounts receivable and inventory, this action might disrupt our current business operations. If LaSalle were to liquidate a significant amount of our inventory at one time, it might be more difficult for us to place inventory with other retailers. We would also need to find financing from a third party and there are no assurances that we will be able to do so.

### WE ARE NAMED AS A DEFENDANT IN SEVERAL CLASS ACTION LAWSUITS

We are involved in a number of litigation matters. An unfavorable resolution of pending litigation could have a material adverse effect on our financial condition. Litigation may result in substantial costs and expenses and significantly divert the attention of the Singing Machine's management regardless of the outcome. There can be no assurance that the Singing Machine will be able to achieve a favorable settlement of pending litigation or obtain a favorable resolution of litigation if it is not settled. In addition, current litigation could lead to increased costs or interruptions of normal business operations of the Singing Machine.

### WE RELY ON SALES TO A LIMITED NUMBER OF KEY CUSTOMERS, WHICH ACCOUNT FOR A LARGE PORTION OF OUR NET SALES

As a percentage of total revenues, our net sales to our five largest customers during the fiscal period ended March 31, 2003, 2002 and 2001 were approximately 67%, 77% and 87% respectively. In fiscal 2003, three major customers accounted for 21%, 17% and 15% of our net sales. Although we have long-established relationships with many of our customers, we do not have long-term contractual arrangements with any of them. A substantial reduction in or termination of orders from any of our largest customers could adversely affect our business, financial

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condition and results of operations. In addition, pressure by large customers seeking price reductions, financial incentives, changes in other terms of sale or requesting that we bear the risks and the cost of carrying inventory, such as consignment agreements, could adversely affect our business, financial condition and results of operations. The Company has significantly broadened its base of customers, decreasing the amount of reliance on their largest customers. If one or more of our major customers were to cease doing business with us, significantly reduced the amount of their purchases from us or returned substantial amounts of our products, it could have a material adverse effect on our business, financial condition and results of operations.

### WE MAY HAVE SIGNIFICANT RETURNS, MARKDOWNS AND PURCHASE ORDER CANCELLATIONS

As is customary in the consumer electronics industry, the Company has, on

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occasion, (i) permitted certain customers to return slow-moving items for credit, (ii) provided price protection to certain customers by making price reductions effective as to certain products then held by customers in inventory and (iii) accepted customer cancellations of purchase orders issued to the Company. The Company expects that it will continue to be required to make such accommodations in the future. Any significant increase in the amount of returns, markdowns or purchaser order cancellations could have a material adverse effect on the Company's results of operations.

### OUR LICENSING AGREEMENTS ARE IMPORTANT TO OUR BUSINESS

We value all of our merchandise license agreements and feel that if any of them were to be terminated or fail to be renewed, our business, financial condition and results of operations could be adversely affected. Our license with MTV is particularly important to our business. We generated \$30,884,344 million or 32.3% of our net sales from products sold under the MTV license in fiscal 2003. However, management believes that our company has developed a strong brand name in the karaoke industry and that it will be able to continue to develop and grow its business, even if the merchandise license agreements did not exist.

### INVENTORY MANAGEMENT AND CONSIGNMENT ARRANGEMENTS

Because of our reliance on manufacturers in Asia for our machine production, our production lead times are relatively long. Therefore, we must commit to production in advance of customers orders. If we fail to forecast customers or consumer demand accurately we may encounter difficulties in filling customer orders or liquidating excess inventories, or may find that customers are canceling orders or returning products. Distribution difficulties may have an adverse effect on our business by increasing the amount of inventory and the cost of storing inventory. As of March 31, 2003, we had \$25 million in inventory. We will attempt to liquidate this excess inventory during fiscal 2004. We believe that this entire inventory is highly marketable and saleable; however, there can be no assurances that we will be able to liquidate this inventory during our upcoming fiscal year.

As of June 30, 2003, we had one remaining consignment agreement with a customer. Only one product line is included in this consignment agreement, our music. The Company does not believe that any changes to this arrangement will have a material adverse effect on our business, financial condition and results of operations.

### OUR INABILITY TO COMPETE AND MAINTAIN OUR NICHE IN THE ENTERTAINMENT INDUSTRY COULD HURT OUR BUSINESS

The business in which we are engaged is highly competitive. Our major competitors for karaoke machines and related products are Craig, Curtis, Grand Prix and Memorex. We believe that competition for karaoke machines is based primarily on price, product features, reputation, delivery times, and customer support. Our primary competitors for producing karaoke music are Pocket Songs, Sybersound, UAV and Sound Choice. We believe that competition for karaoke music is based primarily on popularity of song titles, price, reputation, and delivery times. To the extent that we lower prices for to attempt to enhance or retain market share, we may adversely impact our operating margins. Conversely, if we opt not to match competitor's price reductions we may lose market share, resulting in decreased volume and revenue.

We believe that our new product introductions and enhancements of existing products are material factors for our continued growth and profitability. In fiscal 2003, we produced new lines of karaoke machines. However, many of our competitors have significantly greater financial, marketing and operating resources than we have. No assurance can be given that we will continue to be successful in introducing new products or further enhancing our existing

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products.

In addition, we must compete with all the other existing forms of entertainment including, but not limited to: motion pictures, video arcade games, home video games, theme parks, nightclubs, television and prerecorded tapes, CD's and video cassettes.

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WE ARE SUBJECT TO SEASONALITY, WHICH IS AFFECTED BY VARIOUS ECONOMIC CONDITIONS AND CHANGES RESULTING IN FLUCTUATIONS IN QUARTERLY RESULTS

Sales of consumer electronics and toy products in the retail channel are highly seasonal, causing the substantial majority of our sales to occur during the second quarter ended September 30 and the third quarter ended December 31. Sales in our second and third quarter, combined, accounted for approximately 85.6% of net sales in fiscal 2003, 81% of net sales in fiscal 2002 and 75% of net sales in fiscal 2001.

The seasonal pattern of sales in the retail channel requires significant use of our working capital to manufacture and carry inventory in anticipation of the holiday season, as well as early and accurate forecasting of holiday sales. Failure to predict accurately and respond appropriately to consumer demand on a timely basis to meet seasonal fluctuations, or any disruption of consumer buying habits during their key period, would harm our business and operating results. In fiscal 2003, we overestimated the demand for our product and held \$25 million of inventory as of March 31, 2003. Our increased inventory levels led to a shortage in our available working capital and our current liquidity crisis. Additional factors that can cause our sales and operating results to vary significantly from period to period include, among others, the mix of products, fluctuating market demand, price competition, new product introductions by competitors, fluctuations in foreign currency exchange rates, disruptions in delivery of components, political instability, general economic conditions, and the other considerations described in this section entitled Risk Factors.

A DISRUPTION IN THE OPERATION OF OUR WAREHOUSE CENTERS IN CALIFORNIA AND FLORIDA WOULD IMPACT OUR ABILITY TO DELIVERY MERCHANDISE TO OUR STORES, WHICH COULD ADVERSELY IMPACT OUR REVENUES AND HARM OUR BUSINESS AND FINANCIAL RESULTS

A significant amount of our merchandise is shipped to our customers from one of our three warehouses, which are located in Compton, California, Rancho Dominguez, California and Coconut Creek, Florida. Events such as fire or other catastrophic events, any malfunction or disruption of our centralized information systems or shipping problems may result in delays or disruptions in the timely distribution of merchandise to our customers, which could adversely impact our revenues and our business and financial results.

OUR BUSINESS OPERATIONS COULD BE DISRUPTED IF THERE ARE LABOR PROBLEMS ON THE WEST COAST

During fiscal 2003, approximately 48% of our sales were domestic sales, which were made from our warehouses in California and Florida. During the third quarter of fiscal 2003, the dock strike on the West Coast affected sales of two of our karaoke products and we estimate that we lost between \$3 and \$5 million in orders because we couldn't get the containers of these products off the pier. If another strike or work slow-down were to occur and we do not have a sufficient level of inventory, a strike or work slow-down would result in increased costs to our company and may reduce our profitability.

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OUR PRODUCTS ARE SHIPPED FROM CHINA AND ANY DISRUPTION OF SHIPPING COULD HARM OUR BUSINESS

We rely principally on four contract ocean carriers to ship virtually all of the products that we import to our warehouse facility in Compton, California. Retailers that take delivery of our products in China rely on a variety of carriers to import those products. Any disruptions in shipping, whether in California or China, caused by labor strikes, other labor disputes, terrorism, and international incidents or otherwise could significantly harm our business and reputation.

WE MAY NOT BE ABLE TO SUSTAIN OR MANAGE OUR RAPID GROWTH

We experienced rapid growth in net sales and net income over the last few years. Our net sales for the fiscal year ended March 31, 2003 increased 53% to \$95.6 million compared to \$62.5 million for the fiscal year ended March 31, 2002. Our net income for fiscal 2003 was \$1.2 million compared to \$6.3 million for fiscal 2002. As a result, comparing our period-to-period operating results may not be meaningful, and results of operations from prior periods may not be indicative of future results. We cannot assure you that we will continue to experience growth in, or maintain our present level of, net sales or net income.

Our growth strategy calls for us to continuously develop and diversify our karaoke products by (i) developing new and innovative karaoke machines and music products, (ii) entering into additional license agreements (iii) expanding into international markets, (iv) developing new retail customers in the United States and (v) obtaining additional financing. Our growth strategy will place additional demands on our management, operational capacity and financial resources and systems. To effectively manage future growth, we must continue to expand our operational, financial and management information systems and train, motivate and manage our work force.

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In addition, implementation of our growth strategy is subject to risks beyond our control, including competition, market acceptance of new products, changes in economic conditions, our ability to maintain our licensing agreements and our ability to finance increased levels of accounts receivable and inventory necessary to support our sales growth, if any. Accordingly, we cannot assure you that our growth strategy will be implemented successfully.

THE MARKET PRICE OF OUR COMMON STOCK MAY BE VOLATILE

- o Market prices of the securities of companies in the toy and entertainment industry are often volatile. The market prices of our common stock may be affected by many factors, including:
- o our ability to resolve our present liquidity crisis, by extending our credit facility with LaSalle or by finding alternative sources of financing,
- o our ability to resell our excess inventory as of March 31, 2003;
- o unpredictable consumer preferences and spending trends;
- o the actions of our customers and competitors (including new product line announcements and introduction;
- o changes in our pricing policies, the pricing policies of our competitors and general pricing trends in the consumer and



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electronics and toy markets;

- o regulations affecting our manufacturing operations in China;
- o other factors affecting the entertainment and consumer electronics industries in general; and
- o sales of our common stock into the public market.

In addition, the stock market periodically has experienced significant price and volume fluctuations which may have been unrelated to the operating performance of particular companies.

OUR MANUFACTURING OPERATIONS ARE LOCATED IN THE PEOPLE'S REPUBLIC OF CHINA, SUBJECTING US TO RISKS COMMON IN INTERNATIONAL OPERATIONS

We are dependent upon six factories in the People's Republic of China to manufacture all of our electronic products. Our arrangements with these factories are subject to the risks of doing business abroad, such as import duties, trade restrictions, work stoppages, and foreign currency fluctuations, limitations on the repatriation of earnings, political instability, and other factors, which could have an adverse impact on our business. Furthermore, we have limited control over the manufacturing processes themselves. As a result, any difficulties encountered by the third-party manufacturers that result in product defects, production delays, cost overruns or the inability to fulfill orders on a timely basis could adversely affect our business, financial condition and results of operations. We believe that the loss of any one or more of our manufacturers would not have a long-term material adverse effect on us because other manufacturers with whom we do business would be able to increase production to fulfill our requirements. However, the loss of certain of our manufacturers, could, in the short-term, adversely affect our business until alternative supply arrangements were secured.

WE DEPEND ON THIRD PARTY SUPPLIERS FOR PARTS FOR OUR KARAOKE MACHINES AND RELATED PRODUCTS, AND IF WE CANNOT OBTAIN SUPPLIES AS NEEDED, OUR OPERATIONS WILL BE SEVERELY DAMAGED

Our growth and ability to meet customer demand depends in part on our capability to obtain timely deliveries of karaoke machines and our electronic products. We rely on third party suppliers to produce the parts and materials we use to manufacture and produce these products. If our suppliers are unable to provide our factories with the parts and supplies, we will be unable to produce our products. We cannot guarantee that we will be able to purchase the parts we need at reasonable prices or in a timely fashion. In the last several years, there have been shortages of certain chips that we use in our karaoke machines. We, however, have anticipated this shortage and have made commitments to our factories to purchase chips in advance. If we are unable to anticipate any shortages of parts and materials in the future, we may experience severe production problems, which would impact our sales.

CONSUMER DISCRETIONARY SPENDING MAY AFFECT KARAOKE PURCHASES AND IS AFFECTED BY VARIOUS ECONOMIC CONDITIONS AND CHANGES

Our business and financial performance may be damaged more than most companies by adverse financial conditions affecting our business or by a general weakening of the economy. Purchases of karaoke machines and music

are considered discretionary for consumers. Our success will therefore be

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influenced by a number of economic factors affecting discretionary and consumer spending, such as employment levels, business, interest rates, and taxation rates, all of which are not under our control. Adverse economic changes affecting these factors may restrict consumer spending and thereby adversely affect our growth and profitability.

### WE MAY BE INFRINGING UPON THE COPYRIGHTS OF THIRD PARTIES

Each song in our catalog is licensed to us for specific uses. Because of the numerous variations in each of our licenses for copyrighted music, there can be no assurance that we have complied with scope of each of our licenses and that our suppliers have complied with these licenses. Additionally, third parties over whom we exercise no control may use our sound recordings in such a way that is contrary to our license agreement and by violating our license agreement we may be liable for contributory copyright infringement. Any infringement claims may have a negative effect on our ability to sell products.

### WE HAVE SIGNIFICANT RELIANCE ON LARGE RETAILERS, WHICH ARE SUBJECT TO CHANGES IN THE ECONOMY

We sell products to retailers, including department stores, lifestyle merchants, direct mail retailers, which are catalogs and showrooms, national chains, specialty stores, and warehouse clubs. Certain of such retailers have engaged in leveraged buyouts or transactions in which they incurred a significant amount of debt, and some are currently operating under the protection of bankruptcy laws. Despite the difficulties experienced by retailers in recent years, we have not suffered significant credit losses to date. Deterioration in the financial condition of our customers could have a material adverse effect on our future profitability.

### OUR BUSINESS OPERATIONS COULD BE SIGNIFICANTLY DISRUPTED IF WE LOSE MEMBERS OF OUR MANAGEMENT TEAM

Our success depends to a significant degree upon the continued contributions of our executive officers, both individually and as a group. Although we have entered into employment contracts with Yi Ping Chan, our Chief Operating Officer, April Green, our Chief Financial Officer and Jack Dromgold, our Executive Vice President of Sales and Marketing, the loss of the services of any of these individuals could prevent us from executing our business strategy. We also intend to enter into an employment agreement with our new CEO, Robert Weinberg. We cannot assure you that we will be able to find appropriate replacements for Robert Weinberg, Yi Ping Chan, April Green or Jack Dromgold, if the need should arise, and any loss or interruption of Mr. Weinberg, Mr. Chan, Ms. Green or Mr. Dromgold's services could adversely affect our business, financial condition and results of operations.

### OUR OBLIGATION TO MAKE SEVERANCE PAYMENTS COULD PREVENT OR DELAY TAKEOVERS.

Our employment agreements with Yi Ping Chan, April Green and Jack Dromgold require us, under certain conditions, to make substantial severance payments to them if they resign after a change of control. These provisions could delay or impede a merger, tender, offer or other transaction resulting in a change in control of the Company, even if such a transaction would have significant benefits to our shareholders. As a result, these provisions could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

### WE MAY BE SUBJECT TO CLAIMS FROM THIRD PARTIES FOR UNAUTHORIZED USE OF THEIR PROPRIETARY TECHNOLOGY, COPYRIGHTS OR TRADE SECRETS

We believe that we independently developed the technology used in our electronic

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and audio software products and that it does not infringe on the proprietary rights, copyrights or trade secrets of others. However, we cannot assure you that we have not infringed on the proprietary rights of third parties or those third parties will not make infringement violation claims against us. Any infringement claims may have a negative effect on our ability to manufacture our products.

### YOUR INVESTMENT MAY BE DILUTED

If additional funds are raised through the issuance of equity securities, your percentage ownership in our equity will be reduced. Also, you may experience additional dilution in net book value per share, and these equity securities may have rights, preferences, or privileges senior to those of yours.

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### RISKS ASSOCIATED WITH OUR CAPITAL STRUCTURE

#### FUTURE SALES OF OUR COMMON STOCK HELD BY CURRENT STOCKHOLDERS MAY DEPRESS OUR STOCK PRICE

As of June 30, 2003, there were 8,300,178 shares of our common stock outstanding. We have filed two registration statements registering an aggregate 3,794,250 of shares of our common stock (a registration statement on Form S-8 to registering the sale of 1,844,250 shares underlying options granted under our 1994 Stock Option Plan and a registration statement on Form S-8 to register 1,950,000 shares of our common stock underlying options granted under our Year 2001 Stock Option Plan). The market price of our common stock could drop due to the sale of large number of shares of our common stock, such as the shares sold pursuant to the registration statements or under Rule 144, or the perception that these sales could occur.

#### ADVERSE EFFECT ON STOCK PRICE FROM FUTURE ISSUANCES OF ADDITIONAL SHARES

Our Certificate of Incorporation authorizes the issuance of 18,900,000 million shares of common stock. As of June 30, 2003, we had 8,300,178 shares of common stock issued and outstanding and an aggregate of 1,417,250 outstanding options and warrants. As such, our Board of Directors has the power, without stockholder approval, to issue up to 9,182,572 shares of common stock.

Any issuance of additional shares of common stock, whether by us to new stockholders or the exercise of outstanding warrants or options, may result in a reduction of the book value or market price of our outstanding common stock. Issuance of additional shares will reduce the proportionate ownership and voting power of our then existing stockholders.

#### PROVISIONS IN OUR CHARTER DOCUMENTS AND DELAWARE LAW MAY MAKE IT DIFFICULT FOR A THIRD PARTY TO ACQUIRE OUR COMPANY AND COULD DEPRESS THE PRICE OF OUR COMMON STOCK.

Delaware law and our certificate of incorporation and bylaws contain provisions that could delay, defer or prevent a change in control of our company or a change in our management. These provisions could also discourage proxy contests and make it more difficult for you and other stockholders to elect directors and take other corporate actions. These provisions of our restated certificate of incorporation include: authorizing our board of directors to issue additional preferred stock, limiting the persons who may call special meetings of stockholders, and establishing advance notice requirements for nominations for election to our board of directors or for proposing matters that can be acted on by stockholders at stockholder meetings.

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We are also subject to certain provisions of Delaware law that could delay, deter or prevent us from entering into an acquisition, including the Delaware General Corporation Law, which prohibits a Delaware corporation from engaging in a business combination with an interested stockholder unless specific conditions are met. The existence of these provisions could limit the price that investors are willing to pay in the future for shares of our common stock and may deprive you of an opportunity to sell your shares at a premium over prevailing prices.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk represents the risk of loss that may impact our financial position, results of operations or cash flows due to adverse changes in financial and commodity market prices and rates. We are exposed to market risk in the areas of changes in United States and international borrowing rates and changes in foreign currency exchange rates. In addition, we are exposed to market risk in certain geographic areas that have experienced or remain vulnerable to an economic downturn, such as China. We purchase substantially all of our inventory from companies in China, and, therefore, we are subject to the risk that such suppliers will be unable to provide inventory at competitive prices. While we believe that, if such an event were to occur we would be able to find alternative sources of inventory at competitive prices, we cannot assure you that we would be able to do so. These exposures are directly related to our normal operating and funding activities. Historically and as of June 30, 2003, we have not used derivative instruments or engaged in hedging activities to minimize market risk.

#### INTEREST RATE RISK:

Our exposure to market risk resulting from changes in interest rates relates primarily to debt under our credit facility with LaSalle. Under our credit facility, our interest rate is LaSalle's prime rate plus 1/2 of 1% per annum ("current interest rate"). As of June 30, 2003, we are accruing interest at the default rate, which is the current interest rate under the credit agreement plus 2.5% per annum. We do not believe that near-term changes in the interest rates, if any, will result in a material effect on our future earnings, fair values or cash flows.

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#### FOREIGN CURRENCY RISK:

We have a wholly owned subsidiary in Hong Kong. Sales by these operations made on a FOB China or Hong Kong basis are dominated in U.S. dollars. However, purchases of inventory and Hong Kong operating expenses are typically denominated in Hong Kong dollars, thereby creating exposure to changes in exchange rates. Changes in the Hong Kong dollar/U.S. dollar exchange rates may positively or negatively affect our gross margins, operating income and retained earnings. We do not believe that near-term changes in the exchange rates, if any, will result in a material effect on our future earnings, fair values or cash flows, and therefore, we have chosen not to enter into foreign currency hedging transactions. We cannot assure you that this approach will be successful, especially in the event of a significant and sudden change in the value of the Hong Kong dollar.

### ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation (the "Evaluation") of the effectiveness of the design and operation

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of our disclosure controls and procedures, as defined in Rules 13a-14(c) and 15d-15(c) under the Securities Exchange Act of 1934, within 90 days of the filing date of this report (the "Evaluation Date"). Based on this Evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic SEC reports. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

In addition, we reviewed our internal controls, and there have been no significant changes in our internal controls or in other factors that could significantly affect those controls subsequent to the date of their last evaluation.

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### PART II - OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

From July 2, 2003 through August 11, 2003, ten securities class action lawsuits were filed against the Singing Machine and certain of its officers and directors in the United States District Court for the Southern District of Florida on behalf of all persons who purchased the Singing Machine's securities during the various class action periods specified in the complaints. We expect that all of these actions will be consolidated into one case the United States District Court for the Southern District of Florida. The complaints that have been filed allege violations of Section 10(b) and Section 20(a) of the Securities Exchange Act of 1934 and Rule 10(b)-5. The complaints seek compensatory damages, attorney's fees and injunctive relief. While the specific factual allegations vary slightly in each case, the complaints generally allege that defendants falsely represented the Singing Machine's financial results during the relevant class periods.

We believe the allegations in these class action lawsuits are without merit and we intend to vigorously defend these actions.

In July 2003, a shareholder filed a derivative action against the Company, its board of directors and senior management purporting to pursue the action on behalf of the Company and for its benefit. No pre-lawsuit demand to investigate the allegations or bring action was made on the board of directors. The Company is named as a nominal defendant in this case.

The Complaint alleges claims for breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The complaint alleges that the individual defendants breached their fiduciary duties and engaged in gross mismanagement by allegedly ignoring indicators of the lack of control over the Company's accounting and management practices, allowing the Company to engage in improper conduct and otherwise failing to carry out their duties and obligations to the Company. The plaintiff's seek damages for breach of fiduciary duties, punitive and compensatory damages, restitution, and bonuses or other incentive-based or equity based compensation received by the CEO and CFO under the Sarbanes-Oxley Act of 2002.

We believe the allegations in this derivative lawsuit are without merit and we intend to vigorously defend this action.

#### ITEM 2. CHANGES IN SECURITIES

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(a) Not Applicable.

(b) Not Applicable.

(c) During the three month period ended June 30, 2003, four employees exercised stock options issued under our 1994 Amended and Restated Management Stock Option Plan. The employee exercised options to acquire an aggregate of 128,500 shares of our common stock. The names of the option holder, the grant date of the options, the dates of exercise, the number of shares purchased, the exercise price and the proceeds received by the Company are listed below.

NAME	GRANT DATE	NO. OF OPTIONS EXERCISED	EXERCISE PRICE	EXERCISE DATE	PROCEEDS
John Steele	9/5/2000	30,000	2.04	4/9/2003	61,200
Allen Schor	9/5/2000	7,500	2.04	4/9/2003	15,300
Alicia Haskamp	9/5/2000	7,500	2.04	4/18/2003	15,300
Alicia Haskamp	9/5/2000	10,000	2.04	4/1/2003	20,400
John Klecha	9/5/2000	58,500	1.11	4/22/2003	64,935
John Klecha	6/25/1999	15,000	2.04	4/22/2003	30,600

All of the above issuances were paid for with cash. The above employees exercised their options in reliance upon Section 4(2) of the Securities Act of 1933, because they are knowledgeable, sophisticated and had access to comprehensive information about the Company. The shares issued to our employees were registered under the Securities Act on a registration statement on Form S-8. As such, no restrictive legends were placed on the shares.

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(d) Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

31(a) Certifying Statement of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act

31(b) Certifying Statement of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act

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32(a) Certifying Statement of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act

32(a) Certifying Statement of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act

(b) Reports on Form 8-K

The Company filed the following Current Reports on Form 8-K during the quarterly period ended June 30, 2003:

DATE OF REPORT	ITEMS REPORTED	FINANCIAL STATEMENTS FILED
May 6, 2003	Item 5	None
May 22, 2003	Item 5	None
June 5, 2003	Item 5	None
June 30, 2003	Item 5	None

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SIGNATURES

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

THE SINGING MACHINE COMPANY, INC.

Dated January 3, 2005

By: /s/ Jeffrey Barocas

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 Jeffrey Barocas  
 Chief Financial Officer

Dated January 3, 2005

By: /s/ Yi Ping Chang

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 Yi Ping Chang  
 Chief Executive Officer

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EXHIBIT INDEX

EXHIBIT NO.	DESCRIPTION
31(a)	Certifying Statement of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act
31(b)	Certifying Statement of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act

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32(a) Certifying Statement of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act

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