STEPHAN CO
Form 10-Q
August 31, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

For the Quarterly Period Ended: June 30, 2004

Commission File No. 1-4436

THE STEPHAN CO.
(Exact Name of Registrant as Specified in its Charter)

Florida	59-0676812
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

1850 West McNab Road, Fort Lauderdale, Florida	33309
(Address of principal executive offices)	(Zip Code)

Registrant's Telephone Number, including Area Code: (954) 971-0600

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).
YES NO X

Approximate number of shares of Common Stock outstanding
as of August 31, 2004

4,369,557

THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13

OF THE SECURITIES EXCHANGE ACT OF 1934
JUNE 30, 2004

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THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934
JUNE 30, 2004

CAUTIONARY STATEMENT FOR PURPOSES OF THE SAFE HARBOR
PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This quarterly report contains certain "forward-looking" statements. The Stephan Co. (the "Company") desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 and is including this statement for the express purpose of availing itself of the protections of such safe harbor with respect to all such forward-looking statements. Such forward-looking statements involve risks, uncertainties and other factors which may cause the actual results, condition (financial or otherwise), performance, trends or achievements of the Company and its subsidiaries to be materially different from any results, condition, performance, trends or achievements projected, anticipated or implied by such forward-looking statements.

Such factors include, but are not limited to, the following: general economic and business conditions; competition; relative success of operating initiatives; development and operating costs; advertising and promotional efforts; brand awareness; the existence or absence of adverse publicity; acceptance of any new product offerings; changing trends in customer tastes; the success of multi-branding; changes in business strategy or development plans; quality of management; costs and expenses incurred by the Company in pursuing strategic alternatives; availability, terms and deployment of capital; Stephan's ability to come into compliance with AMEX's continued listing requirements; regulatory approvals of the going-private transaction; business abilities and judgment of personnel; availability of qualified personnel; labor and employee benefit costs; availability and cost of raw materials and supplies; changes in or newly-adopted accounting principles; changes in, or failure to comply with, law; changes in product mix and associated gross profit margins; and other factors or events referenced in this Form 10-Q.

The Company does not undertake, subject to applicable law, any obligation to publicly release the results of any revisions which may be made to any forward-looking statements to reflect events or circumstances occurring after the date of such statements or to reflect the occurrence of anticipated or unanticipated events. Therefore, the Company cautions each reader of this report to carefully consider the specific factors and qualifications discussed herein with respect to such forward-looking statements, as such factors and qualifications could affect the ability of the Company to achieve its objectives and may cause actual results to differ materially from those projected, anticipated or implied herein.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

	June 30, 2004	December 31, 2003
CURRENT ASSETS		
Cash and cash equivalents	$12,701,724	$ 13,302,159
Accounts receivable, net	1,710,995	1,444,508
Inventories	7,377,961	7,497,262
Prepaid expenses and other current assets	130,355	784,601
TOTAL CURRENT ASSETS	21,921,035	23,028,530
CERTIFICATES OF DEPOSIT	5,087,500	5,642,500
PROPERTY, PLANT AND EQUIPMENT, net	1,658,549	1,702,330
GOODWILL, net	5,857,980	5,857,980
TRADEMARKS, net	8,664,809	8,664,809
DEFERRED ACQUISITION COSTS, net	257,013	298,773
OTHER ASSETS, net	3,044,339	2,867,958
TOTAL ASSETS	$ 46,491,225	$ 48,062,880

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

LIABILITIES AND STOCKHOLDERS' EQUITY

	June 30, 2004	December 31, 2003
CURRENT LIABILITIES		
Accounts payable and accrued expenses	$ 2,450,390	$ 2,614,731
Current portion of long-term debt	1,110,000	2,442,273
Income taxes payable	28,576	28,270

TOTAL CURRENT LIABILITIES	3,588,966	5,085,274
DEFERRED INCOME TAXES, net	1,399,652	1,133,051
LONG-TERM DEBT	3,792,500	4,347,500
TOTAL LIABILITIES	8,781,118	10,565,825
COMMITMENTS AND CONTINGENCIES (NOTE 3)		
STOCKHOLDERS' EQUITY		
Common stock, $.01 par value	44,106	44,106
Additional paid in capital	18,417,080	18,417,080
Retained earnings	20,600,484	20,387,432
	39,061,670	38,848,618
LESS: 125,000 CONTINGENTLY RETURNABLE SHARES	(1,351,563)	(1,351,563)
TOTAL STOCKHOLDERS' EQUITY	37,710,107	37,497,055
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 46,491,225	$ 48,062,880

See notes to unaudited condensed consolidated financial statements

THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Six Months Ended June 30,	
	2004	2003
NET SALES	$ 11,514,539	$ 13,350,355
COST OF GOODS SOLD	6,668,422	7,331,263
GROSS PROFIT	4,846,117	6,019,092
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	4,586,692	4,965,568
OPERATING INCOME	259,425	1,053,524
OTHER INCOME(EXPENSE)		
Interest income	98,811	127,330
Interest expense	(49,933)	(213,927)
Other income, net	318,145	25,000

INCOME BEFORE INCOME TAXES	626,448	991,927
INCOME TAX EXPENSE	236,973	377,870
NET INCOME	$ 389,475	$ 614,057
BASIC AND DILUTED EARNINGS PER SHARE	$ .09	$ .14
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	4,360,043	4,302,076

See notes to unaudited condensed consolidated financial statements

THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended June 30,	
	2004	2003
NET SALES	$ 5,555,554	$ 6,401,297
COST OF GOODS SOLD	3,213,060	3,407,071
GROSS PROFIT	2,342,494	2,994,226
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	2,175,998	2,745,217
OPERATING INCOME	166,496	249,009
OTHER INCOME(EXPENSE)		
Interest income	47,720	62,112
Interest expense	(24,302)	(111,877)
Other income, net	305,645	12,500
INCOME BEFORE INCOME TAXES	495,559	211,744

INCOME TAX EXPENSE	183,865	78,168
NET INCOME	$ 311,694	$ 133,576
BASIC AND DILUTED EARNINGS PER SHARE	$ .07	$ .03
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	4,365,376	4,303,254

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 389,475	$ 614,057
Adjustments to reconcile net income to cash flows provided by operating activities:		
Depreciation	81,007	163,920
Amortization of intangible assets	41,760	46,728
Deferred income tax provision	266,601	285,510
Provision for doubtful accounts	39,932	33,389
Changes in operating assets and liabilities:		
Accounts receivable	(306,419)	(266,521)
Inventories	119,301	(718,791)
Income taxes payable	306	4,684
Prepaid expenses and other current assets	654,246	149,981
Other assets	(176,381)	694,247
Accounts payable and accrued expenses	(164,341)	513,019

Total adjustments	556,012	906,166
Net cash flows provided by operating activities	945,487	1,520,223

See notes to unaudited condensed consolidated financial statements

THE STEPHAN CO. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
	2004	2003
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property, plant and equipment	(37,226)	(7,782)
Net cash flows used in investing activities	(37,226)	(7,782)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayments of long-term debt	(1,887,273)	(675,908)
Dividends paid	(176,423)	(176,423)
Change in certificates of deposit	555,000	555,000
Net cash flows used in financing activities	(1,508,696)	(297,331)
(DECREASE)/INCREASE IN CASH AND CASH EQUIVALENTS	(600,435)	1,215,110
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	13,302,159	10,785,995
CASH AND CASH EQUIVALENTS, END OF PERIOD	$12,701,724	$12,001,105
Supplemental Disclosures of Cash Flow Information:		
Interest paid	$ 152,681	$ 187,475
Income taxes paid	$ 46,595	$ 55,004

Supplemental Disclosure of Non-Cash
Investing and Financing Activities:

In connection with the retirement of the outstanding Colgate-Palmolive debt in April 2004, the $1,332,000 obligation was settled by a payment of $914,000.

See notes to unaudited condensed consolidated financial statements

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THE STEPHAN CO. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
QUARTERS ENDED JUNE 30, 2004 AND 2003

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION: In the opinion of management, all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the financial position and results of operations of The Stephan Co. and Subsidiaries (the "Company") are reflected in these unaudited interim financial statements.

The results of operations for the six-month period ended June 30, 2004 is not necessarily indicative of the results to be achieved for the year ending December 31, 2004. The December 31, 2003 condensed consolidated balance sheet was derived from the audited consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America ("generally accepted accounting principles"). These interim financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2003, previously filed with the Securities and Exchange Commission.

NATURE OF OPERATIONS: The Company is engaged in the manufacture, sale and distribution of hair and personal care grooming products principally throughout the United States. SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information", requires the reporting of segment information using a "management approach" as it relates to the operating segments of a business. The Company manages its business in three segments: (1) professional hair care products and distribution; (2) retail personal care products; and (3) manufacturing.

USE OF ESTIMATES: The preparation of condensed consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

CASH AND CASH EQUIVALENTS: Cash and cash equivalents include cash, money market investment accounts and short-term municipal bonds having maturities of 90 days or less. The Company maintains cash deposits at certain financial institutions in amounts in excess of the federally insured limit. Cash and cash equivalents held in interest bearing accounts as of June 30, 2004 and December 31, 2003 were approximately $11,639,000 and $12,698,000, respectively.

THE STEPHAN CO. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
QUARTERS ENDED JUNE 30, 2004 AND 2003

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

INVENTORIES: Inventories are stated at the lower of cost (determined on a first-in, first-out basis) or market, and are as follows:

	June 30, 2004	December 31, 2003
Raw materials	$ 1,990,364	$ 2,007,174
Packaging and components	2,658,298	2,612,798
Work in progress	256,000	257,476
Finished goods	5,370,223	5,338,369
	10,274,885	10,215,817
Less: Amount included in other assets	(2,896,924)	(2,718,555)
	$ 7,377,961	$ 7,497,262

Raw materials principally include surfactants, chemicals and fragrances used in the production process. Packaging materials include cartons, inner sleeves and boxes used in the actual product, as well as outer boxes and cartons used for shipping purposes. Components are the actual bottles or containers (plastic or glass), jars, caps, pumps and similar materials that become part of the finished product. Finished goods include hair dryers, electric clippers, lather machines, scissors and salon furniture.

Included in other assets is inventory not anticipated to be utilized within one year and is comprised primarily of packaging, components and finished goods. The Company reduces the carrying value of slow moving inventory, including the estimated costs of disposal, that may ultimately become unusable or obsolete. For the six months ended June 30, 2004, no additional write-down of this inventory was deemed necessary.

BASIC AND DILUTED EARNINGS PER SHARE: Basic and diluted earnings per share are computed by dividing net income by the weighted average number of shares of common stock outstanding. For the six months ended June 30, 2004 and 2003, the Company had 597,570 and 669,682 outstanding stock options, respectively, a significant portion of which were not materially dilutive. The inclusion of these dilutive stock options in the calculation of earnings per share did not have any impact on the earnings per share amounts for the six and three months ended June 30, 2004 and 2003.

THE STEPHAN CO. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
QUARTERS ENDED JUNE 30, 2004 AND 2003

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

STOCK-BASED COMPENSATION: The Company adopted the disclosure requirements of SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternate methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation and to require prominent disclosures in both annual and interim financial statements about the methods of accounting for stock-based compensation and the effect of the method used on reported results. As permitted by SFAS No. 148 and 123, the Company continues to apply the accounting provisions of APB No. 25, "Accounting for Stock Issued to Employees," and related interpretations, with regard to the measurement of compensation cost for options granted under the Company's existing plans. No stock-based compensation cost is reflected in net income as all options granted under the plans had an exercise price not less than the market value of the underlying common stock on the date of grant. Had expense been recognized using the fair value method described in SFAS No. 123, using the Black-Scholes option-pricing model, the Company would have reported the following results of operations (in thousands, except per share amounts):

	Six Months Ended June 30,		Three Months Ended June 30,	
	2004	2003	2004	2003
Net income, as reported	$ 389	$ 614	$ 312	$ 134
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	63	83	33	41
Pro forma net income	$ 326	$ 531	$ 279	$ 93
Net income per share:				
As reported	$ .09	$ .14	$ .07	$ .03
Pro forma	$ .07	$ .12	$ .06	$ .02

THE STEPHAN CO. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
QUARTERS ENDED JUNE 30, 2004 AND 2003

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

NEW FINANCIAL ACCOUNTING STANDARDS: In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"), an interpretation of ARB 51. FIN 46, as revised in December 2003, provides guidance on identifying entities for which control is achieved through means other than through voting rights, variable interest entities ("VIE"), and how to determine when and which business enterprises should consolidate the VIE. In addition, FIN 46 requires both the primary beneficiary and all other enterprises with a significant variable interest in a VIE to make additional disclosures. The consolidation provisions of FIN 46 are effective immediately for variable interests in VIE's created after January 31, 2003. For variable interests in VIE's created before February 1, 2003, the provisions of FIN 46 are effective for the first interim or annual period ending after December 15, 2003. The adoption of FIN 46 did not require a change in accounting treatment since the Company has no investments in any VIE's.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". This statement establishes standards for the classification and measurement of financial instruments that possess characteristics similar to both liability and equity instruments. SFAS No. 150 also addresses the classification of certain financial instruments that include an obligation to issue equity shares. On October 29, 2003, the FASB voted to defer, for an indefinite period, the application of certain provisions of the guidance in SFAS No. 150 until it could consider some of the resulting implementation issues. The Company has adopted certain provisions of SFAS No. 150 which did not have a material impact on the Company's financial condition or results of operations. The Company does not believe the effect of the provisions of SFAS No. 150 that have been deferred to future periods will have a material impact on the Company's financial statements.

NOTE 2: SEGMENT INFORMATION

In accordance with the guidelines established by SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," the Company has identified three reportable operating segments based upon how its management evaluates its business. These segments are Professional Hair Care Products and Distribution ("Professional"), Retail Personal Care Products ("Retail") and "Manufacturing". The Professional segment has a customer base consisting generally of distributors that purchase the Company's hair products and beauty and barber supplies for sale to salons and barbershops. The customer base for the Retail segment consists of mass merchandisers, chain drug stores and supermarkets that sell products to end-users. The Manufacturing segment manufactures products for different

NOTE 2: SEGMENT INFORMATION (continued)

subsidiaries of the Company and manufactures private label brands for customers.

The Company conducts operations principally in the United States and sales to international customers are not material to its consolidated net sales. Income Before Income Taxes as shown below reflects an allocation of corporate overhead expenses incurred by the Manufacturing segment. The following tables, in thousands, summarize Net Sales and Income Before Income Taxes:

	NET SALES Six Months Ended June 30, 2004	2003	NET SALES Three Months Ended June 30, 2004	2003
Professional	$ 8,604	$ 8,632	$ 4,218	$ 4,067
Retail	2,624	4,510	1,177	2,259
Manufacturing	2,763	3,660	1,519	1,879
Total	13,991	16,802	6,914	8,205
Intercompany Manufacturing	(2,476)	(3,452)	(1,358)	(1,804)
Consolidated	$11,515	$13,350	$ 5,556	$ 6,401

	INCOME BEFORE INCOME TAXES Six Months Ended June 30, 2004	2003	INCOME BEFORE INCOME TAXES Three Months Ended June 30, 2004	2003
Professional	$ 630	$ 624	$ 330	$ 255
Retail	378	551	344	99
Manufacturing	(382)	(183)	(178)	(142)
Consolidated	$ 626	$ 992	$ 496	$ 212

THE STEPHAN CO. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
QUARTERS ENDED JUNE 30, 2004 AND 2003

NOTE 3: COMMITMENTS AND CONTINGENCIES

In addition to the matters set forth below, the Company is involved in other litigation matters arising in the ordinary course of business. It is the opinion of management that none of such matters, at June 30, 2004, would likely, if adversely determined, have a material adverse effect on the Company's financial position, results of operations or cash flows. Additionally, there has been no material change in the status of any other pending litigation since the Company's last filing of Form 10-K with the Securities and Exchange Commission for the year ended December 31, 2003.

As indicated in the Company's Form 10-K for the year ended December 31, 2003, on April 7, 2004, the Company and Colgate-Palmolive mutually agreed to settle all outstanding claims and issues between them. The net result of this settlement was a reduction of the liability to Colgate-Palmolive for the acquisition of certain brands by approximately $418,000, and this amount is included in other income.

In June 2004, the Company settled litigation with a customer in connection with that customer's failure to perform on a purchase order issued by them to the Company in 2002. The Company received a lump sum payment of $150,000 (included in other income). In addition, the customer agreed to purchase merchandise at a sales price of approximately $124,000, to be delivered in the third quarter of 2004.

On July 15, 2004, with respect to the action commenced by New Image Laboratories, Inc. against the Company in the United States District Court for the Central District of California, the parties reached a settlement pursuant to a stipulation of settlement and amendments thereto which provided, among other things, as follows: (i) New Image will relinquish title to 65,000 of the 125,000 shares held in escrow and New Image will receive from the Company approximately $275,000, net of offsets below, in exchange for the remaining 60,000 shares, (ii) Stephan shall receive $44,000 in damages from New Image, (iii) dividends, and interest accrued thereon, held in the escrow account (which is currently estimated to be approximately $70,000) will be distributed with Stephan receiving 52% of such funds and New Image receiving 48% of such funds, and (iv) New Image's claim for diminution of the value of the shares held in escrow shall be heard before a special master in October 2004. As a result of this settlement, the Company has recorded an expense of approximately $275,000 in the second quarter. In the third quarter of 2004, the amount of the contingently returnable shares carried on the books of the Company will be reflected as treasury stock when the shares are received by the Company and then offset against additional paid in capital when the shares are retired. In connection with the diminution claim, the parties have agreed that any recovery recommended by the special master shall be limited to the diminution in the value of 60,000 shares of the Company's stock. The parties have reserved the right to challenge and appeal the recommendation

NOTE 3: COMMITMENTS AND CONTINGENCIES (continued)

of the special master in the federal court. The Company intends to vigorously defend the diminution claim and believes the claim lacks merit.

In the fourth quarter of 2003, Sorbie Acquisition Co. ("SAC"), a wholly-owned subsidiary of the Company, and Trevor Sorbie International, Plc. ("TSI") commenced arbitration proceedings against each other before the American Arbitration Association in Pittsburgh, Pennsylvania. In TSI's statement of claim, TSI alleges claims for breach of contract, trademark infringement and breach of certain implied covenants. Specifically, TSI alleges that SAC owes past due royalty payments and interest. TSI also alleges that SAC breached the contract between the parties by various acts and omissions which have diminished sales of Sorbie products and the value of the Sorbie trademarks. TSI further alleges that SAC has diverted product outside of SAC's territory. TSI seeks damages in the amount of the royalties allegedly due, termination of the agreement between the parties and cancellation and forfeiture of SAC's rights in the Sorbie Trademarks. SAC denies the allegations raised in the TSI statement of claim. In SAC's statement of claim against TSI, SAC alleges causes of action for declaratory relief, diversion, breach of contract for failure to support the brand, trademark infringement and injunctive relief. SAC alleges that TSI has been engaged in diversion of TSI product into SAC's territory and that TSI and Trevor Sorbie have failed to render assistance to SAC in violation of the parties' agreement. SAC further alleges that TSI and Trevor Sorbie have engaged in intentional and detrimental infringement of SAC's exclusive rights in the Sorbie Trademarks and rights to publicity to the name, likeness and image of Trevor Sorbie in SAC's territory. Among other things, SAC alleges that Trevor Sorbie and TSI infringed SAC's rights by appearing at shows in North and South America that promote Trevor Sorbie and non-SAC products. SAC seeks damages for the diversion, infringement and permanent injunctive relief. In addition, SAC further alleges that TSI's claim for royalties is premised upon an incorrect reading of the agreement and is at odds with the method by which the parties have calculated royalties since the inception of the agreement. SAC has also filed a claim against Trevor Sorbie individually, premised upon his involvement in certain of the acts alleged above. The Company intends to actively pursue its claims and aggressively defend itself against the claims asserted by TSI. The Company believes that this action will not have a material effect on its financial position and/or results of operations. Due to the complexities of the issues involved, however, discovery is ongoing and the Company is currently unable to predict the outcome of this proceeding.

As previously reported, on April 16, 2002, the Company announced that the previously-formed Special Committee (consisting of two outside directors) had accepted a bid by a management-led group to purchase all of

NOTE 3: COMMITMENTS AND CONTINGENCIES (continued)

the shares of common stock of the Company not already owned by such group. The acquisition group's initial bid was to purchase all of the Company's common stock at $4 per share in cash, which offer was later revised to $4.50 per share with $3.25 to be paid in cash, and $1.25 to be paid by a 42-month, unsecured debt instrument providing for interest at an annual rate of 4 1/2%. On March 22, 2004, the Company announced that the bid was further revised to an all cash price of $4.60 per share, to reflect the updated fairness opinion received from SunTrust Robinson Humphrey. On September 19, 2003, at no cost to shareholders, the Company entered into a Working Capital Management Account ("WCMA") agreement with Merrill Lynch Business Financial Services Inc. providing for the creation of a WCMA line of credit not to exceed $5,000,000. Borrowings against the line of credit will be collateralized by the Company's accounts receivable and inventories and the debt will bear a variable interest rate using a 1-month LIBOR rate plus 2.25%. The provisions of the credit line include periodic accounting and reporting requirements, maintenance of certain business and financial ratios as well as restrictions on additional borrowings. As of June 30, 2004, the credit line remains unused.

On April 30, 2003, the Board of Directors approved a definitive merger agreement (the "Merger Agreement") pursuant to which the Company would be acquired by Gunhill Enterprises, Inc., a wholly-owned subsidiary of Eastchester Enterprises, Inc. Eastchester Enterprises, Inc. is owned by

Frank F. Ferola, Thomas M. D'Ambrosio, John DePinto and Shouky A. Shaheen (all of whom are current Board members) together with their affiliates (the "Acquisition Group"). The Company entered into the Merger Agreement following approval by its Board of Directors based in part upon the unanimous recommendation of the Special Committee comprised of two non-management and disinterested directors of the Company's Board of Directors. The Special Committee had received an opinion from SunTrust Robinson Humphrey that the consideration to be paid pursuant to the Merger Agreement was fair from a financial point of view to the stockholders other than the Acquisition Group. On October 24, 2003, the Company executed an Amended and Restated Merger Agreement extending certain dates and making minor changes to the original Merger Agreement and on November 4, 2003, in connection with the "going-private" transaction, the Company filed a Preliminary Proxy with the Securities and Exchange Commission. In March 2004, the Company executed a further amendment to the Merger Agreement which, among other things, incorporated the new consideration offered by the acquisition group of $4.60 per share in cash.

On August 25, 2004, the Merger Agreement was terminated and the Acquisition Group withdrew its offer to acquire the shares of Stephan common stock not owned by it and informed Stephan that it has decided not to pursue such an acquisition at this time.

NOTE 3: COMMITMENTS AND CONTINGENCIES (continued)

Independent legal counsel and investment banking advisors have been retained to advise the Special Committee in connection with the transaction. The Company has incurred over $650,000 of expenses through June 30, 2004. The Company is unable, at this time, to continue to estimate the future remaining costs associated with the "going-private" process due to anticipated legal costs exceeding original estimates. As discussed above, the Company has secured a $5,000,000 line of credit with Merrill Lynch, a portion of which may be used in the "going-private" transaction.

As previously reported, due to the length of time for the "going private" transaction to be consummated, the Company has not submitted any matters to a vote of its security holders since the Company's September 1, 2000 Annual Meeting. In accordance with the rules and regulations of the American Stock Exchange (AMEX), the Company was required to promptly notify its stockholders and AMEX, in writing, indicating the reasons for the failure to have a meeting and to use good faith efforts to ensure that an annual meeting is held as soon as reasonably practicable. The Company included annual meeting materials in its revised proxy statement, filed with the Securities and Exchange Commission on April 13, 2004. In a press release issued by the Company on August 25, 2004, the Company indicated that it tentatively set November 10, 2004 as the date of its next annual meeting of shareholders, and it expects to formally notify all shareholders of the definitive date and location of such meeting in the near future. In addition, the Company believed it was in violation of certain AMEX rules with respect to the composition of the Board of Directors and the Audit Committee which could subject the Company to civil penalties and/or the delisting of the Company's stock. The Company, based upon on-going discussions with AMEX and the Company's legal counsel, now believes that none of the aforementioned issues are of a material nature and any penalties, if levied, would not be material to the Company's financial position or results of operations.

NOTE 4: SPECIAL DIVIDEND

On August 25, 2004, the Company announced that its Board of Directors approved the payment of a special dividend of $2.00 per share to all shareholders of record as of September 8, 2004, to be paid on September 15, 2004.

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THE STEPHAN CO. AND SUBSIDIARIES
QUARTERLY REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934
JUNE 30, 2004 AND 2003

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

RESULTS OF OPERATIONS

For the six months ended June 30, 2004, net sales were $11,515,000, compared to $13,350,000 achieved in the corresponding six months of 2003. The overall decrease in sales was principally due to the return to a normal level of military orders for Quinsana Medicated Talc. As indicated in previous filings, the first and second quarters of 2003 were favorably impacted by military orders as troops were deployed to the Middle East conflict. In addition, and for largely the same reason as above, the gross margin for the six months ended June 30, 2004 declined to 42.1% as compared to 45.1% for the six months ended June 30, 2003. Sales of other Retail products, as well as sales of the Professional segment, declined for the six-month period ended June 30, 2004, when compared to the sales achieved for the corresponding six-month period ended June 30, 2003.

Gross profit for the six months ended June 30, 2004, was $4,846,000 compared to gross profit of $6,019,000 achieved for the corresponding six-month period in 2003. Cost of sales for the six months ended June 30, 2004 was $6,668,000, when compared to the cost of sales of $7,331,000 for the six months ended June 30, 2003. Gross profit decreased overall as discussed above.

Selling, general and administrative expenses for the six months ended June 30, 2004 decreased by $379,000, to $4,587,000, when compared to the corresponding 2003 six-month period total of $4,966,000. This decrease was due, in large part, to a decline in expenses incurred in connection with the "going-private" transaction. The Company continues its efforts to control selling, general and administrative expenses even with the on-going costs associated with the Company's decision to evaluate strategic alternatives to enhance shareholder value, as discussed in Note 3 of the unaudited condensed consolidated financial statements. No assurance can be given that it can continue reducing these expenses.

Interest expense for the six months ended June 30, 2004 was $50,000, a decrease of approximately $164,000 from the $214,000 incurred in the corresponding period of 2003, primarily because the obligation to Colgate-Palmolive was paid in full on April 2, 2004. As indicated in previously filed reports, on April 7, 2004, the Company and Colgate-Palmolive mutually agreed to settle all outstanding claims and issues between them. The net result of this settlement was a reduction of the outstanding obligation by approximately $418,000. This amount is reflected in other income in the second quarter of 2004. Interest income of $99,000 for the six months ended June 30, 2004 was lower than the $127,000 earned in the corresponding

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

six months of 2003. Although the Company had more cash invested in 2004, it received lower interest rates on its investments as overall interest rates remained low. In addition to the Colgate-Palmolive settlement above, other income was impacted by the settlement of two lawsuits. In one case, the Company received payment of $150,000 in connection with a customer's failure to perform on a purchase order issued by them to the Company. In July 2004, the Company also settled a portion of the New Image litigation by agreeing to pay New Image approximately $275,000, net of offsets, for 60,000 of the 125,000 shares of stock held in escrow. The Company will retain the balance of the shares and anticipates retiring all 125,000 shares in the third quarter of 2004. Other income also includes royalty fees received from the licensing of Frances Denney products.

As a result of reduced income for the six-month period ended June 30, 2004, the provision for income taxes decreased $141,000, to $237,000 from the $378,000 incurred for the corresponding period in 2003. Net income for the six-month period ended June 30, 2004 was $389,000, compared to $614,000 for the six months ended June 30, 2003. Basic and diluted earnings per share were $0.09 for the six months ended June 30, 2004, compared to $0.14 for the six months ended June 30, 2003, based on a weighted average number of shares of 4,360,043 and 4,302,076 for the six months ended June 30, 2004 and 2003, respectively.

For the three months ended June 30, 2004, net sales were $5,556,000, compared to $6,401,000 for the three months ended June 30, 2003, a decline of $846,000. Sales of the Professional segment increased slightly, but the Retail segment declined significantly due to the reduced sales of Quinsana Medicated Talc to the military. Gross profit for the three months ended June 30, 2004 was $2,342,000, compared to gross profit of $2,994,000 achieved for the corresponding three-month period in 2003. The gross profit margin decreased to 42.2% for the three months ended June 30, 2004, from 46.8% for the corresponding period in 2003 as discussed above.

Selling, general and administrative expenses for the three months ended June 30, 2004 decreased by $569,000, from $2,745,000 to $2,176,000, when compared to the corresponding three-month period of 2003, largely as a result of the "going-private" expenses discussed previously.

Interest income for the three-month period ended June 30, 2004 was $48,000, a decrease of approximately $14,000 when compared to $62,000 earned in the corresponding three-month period of 2003, as a result of lower interest rates. Due in large part to the retirement of the Colgate debt, interest expense for the three-month period ended June 30, 2004 was

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

$24,000, a decrease of $88,000 from the $112,000 in the corresponding three-month period of 2003.

Income taxes for the three months ended June 30, 2004 was $184,000 compared to $78,000, an increase of $106,000 over the corresponding period in 2003. Net income of $312,000 for the three months ended June 30, 2004, increased from $134,000 achieved in the three months ended June 30, 2003. Income taxes and net income increased as a direct result of the settlements reached in the second and third quarters, as discussed above. Basic and diluted earnings per share were $0.07 for the three months ended June 30, 2004 and $0.03 for the three months ended June 30, 2003, based on a weighted average number of shares of 4,365,376 and 4,303,254 for the three months ended June 30, 2004 and 2003, respectively.

LIQUIDITY & CAPITAL RESOURCES

Cash and cash equivalents decreased $600,000 from December 31, 2003, to $12,701,000 at June 30, 2004. Total cash of $17,789,000 at June 30, 2004 includes $5,088,000 of cash invested in a certificate of deposit pledged as collateral for a bank loan. As indicated in the Company's Form 10-Q filed for the first quarter ended March 31, 2004, the decline in cash was due to payments made in the second quarter of 2004 for officers bonuses and the retirement of the Colgate-Palmolive debt, which totaled $1,681,000. Accounts receivable were $1,711,000 at June 30, 2004, an increase of $266,000 from the $1,445,000 at December 31, 2003; inventories decreased approximately $119,000 from $7,497,000 at December 31, 2003 to $7,378,000 at June 30, 2004.

Total current assets at June 30, 2004 were $21,921,000 compared to $23,029,000 at December 31, 2003. Working capital increased $389,000 when compared to December 31, 2003, due to a decrease in the current portion of long-term debt as a result of the settlement with Colgate-Palmolive referred to above. In addition to renewal premiums due in July 2004 on the Company's insurance policies and the New Image settlement discussed above, (both totaling approximately $600,000), the Company will also utilize approximately $8,750,000 of cash to pay a special dividend of $2.00 per share to all shareholders of record as of September 8, 2004, to be paid on September 15, 2004.

The Company does not have any off-balance sheet financing or similar arrangements.

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JUNE 30, 2004 AND 2003

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

NEW FINANCIAL ACCOUNTING STANDARDS

See Note 1 to the Financial Statements included in Part I, Item 1 for a discussion of new financial accounting standards.

DISCUSSION OF CRITICAL ACCOUNTING POLICIES

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results would differ significantly from those estimates if different assumptions were used or unexpected events transpire. Please see Item 7 in the Company's Annual Report on Form 10-K for the year ended December 31, 2003 filed with the Securities and Exchange Commission.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company does not participate in derivative or other financial instruments for which fair value disclosure would be required under SFAS No. 107. In addition, the Company does not invest in securities that would require disclosure of market risk, nor does it have floating rate loans or foreign currency exchange rate risks.

ITEM 4. CONTROLS AND PROCEDURES

(a) EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES: Based upon an evaluation of the Company's disclosure controls and procedures, which was completed as of June 30, 2004 (the "Evaluation Date"), the Company's principal executive officer and chief financial officer have concluded that the disclosure controls and procedures in place were effective as of the Evaluation Date.

(b) CHANGES IN INTERNAL CONTROLS: To the best of the Company's knowledge and belief, there have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the Evaluation Date.

JUNE 30, 2004 AND 2003

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 3 to the Financial Statements included in Part I, Item 1 for a discussion of legal proceedings.

Other than the above, there has been no material change in the status of any other pending litigation since our last periodic report.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

10.18 Employment Agreement between David Spiegel and The Stephan Co. dated April 29, 2004.

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

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

32.1 Certification by the 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 by the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K during the quarter ended June 30, 2004:

Current report on Form 8-K filed on April 15, 2004, in connection with the receipt of a warning letter from the American Stock Exchange regarding the previously disclosed failure to hold an annual meeting of stockholders.

Current report on Form 8-K filed on June 10, 2004, in connection with the response, by Counsel to the Special Committee, to a stock acquisition proposal by Richard L. Scott Investments, LLC.

SIGNATURES

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

THE STEPHAN CO.

/s/ Frank F. Ferola

Frank F. Ferola
President and Chief Executive Officer
August 31, 2004

/s/ David A. Spiegel

David A. Spiegel
Chief Financial Officer
August 31, 2004