SCHMITT INDUSTRIES INC
Form 10-Q
October 11, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

August 31, 2011 For the quarterly period ended: August 31, 2011

Or

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

For the transition period from: To:

Commission File Number: 000-23996

SCHMITT INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

Oregon	**93-1151989**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification Number)**

2765 NW Nicolai Street, Portland, Oregon 97210-1818

(Address of principal executive offices) (Zip Code)

(503) 227-7908

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant has (1) filed all reports required to be filed by Section 13 of 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 has submitted electronically and posted on its Corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ Nox

The number of shares of each class of common stock outstanding as of September 30, 2011

Common stock, no par value	2,895,635

Table of Contents

SCHMITT INDUSTRIES, INC.

INDEX TO FORM 10-Q

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

SCHMITT INDUSTRIES, INC.

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	August 31, 2011	May 31, 2011
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,674,074	$ 2,760,506
Accounts receivable, net of allowance of $21,541 and $21,580 at August 31, 2011 and May 31, 2011, respectively	1,973,304	1,831,811
Inventories	4,465,699	4,146,408
Prepaid expenses	151,094	166,779
Income taxes receivable	5,489	
	9,269,660	8,905,504
Property and equipment		
Land	299,000	299,000
Buildings and improvements	1,698,555	1,582,936
Furniture, fixtures and equipment	1,203,087	1,199,143
Vehicles	113,963	129,330
	3,314,605	3,210,409
Less accumulated depreciation and amortization	(1,891,473)	(1,876,234)
	1,423,132	1,334,175
Other assets		
Intangible assets, net	1,315,489	1,349,583
TOTAL ASSETS	$ 12,008,281	$ 11,589,262
LIABILITIES & STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 1,088,103	$ 841,416
Accrued commissions	293,658	308,396
Accrued payroll liabilities	147,894	116,129
Other accrued liabilities	153,281	163,940
Income taxes payable		2,073
Total current liabilities	1,682,936	1,431,954
Stockholders equity		
Common stock, no par value, 20,000,000 shares authorized, 2,895,635 shares issued and outstanding at both August 31, 2011 and May 31, 2011	9,994,057	9,943,910
Accumulated other comprehensive loss	(245,719)	(226,581)

Retained earnings	577,007	439,979
Total stockholders equity	10,325,345	10,157,308
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 12,008,281	$ 11,589,262

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

Table of Contents

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE MONTHS ENDED AUGUST 31, 2011 AND 2010

(UNAUDITED)

	Three Months Ended August 31, 2011	Three Months Ended August 31, 2010
Net sales	$ 3,471,485	$ 2,404,467
Cost of sales	1,763,581	1,304,721
Gross profit	1,707,904	1,099,746
Operating expenses:		
General, administration and sales	1,512,190	1,107,450
Research and development	61,551	108,698
Total operating expenses	1,573,741	1,216,148
Operating income (loss)	134,163	(116,402)
Other income (expense)	9,438	(5,322)
Income (loss) before income taxes	143,601	(121,724)
Provision (benefit) for income taxes	6,573	(9,099)
Net income (loss)	$ 137,028	$ (112,625)
Net earnings (loss) per common share:		
Basic	$ 0.05	$ (0.04)
Weighted average number of common shares, basic	2,895,635	2,894,802
Diluted	$ 0.05	$ (0.04)
Weighted average number of common shares, diluted	2,967,264	2,894,802

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

Page 4

Table of Contents

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE MONTHS ENDED AUGUST 31, 2011 AND 2010

(UNAUDITED)

	Three Months Ended August 31, 2011	2010
Cash flows relating to operating activities		
Net income (loss)	$ 137,028	$ (112,625)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	83,547	87,587
Gain on disposal of property and equipment	(5,214)	
Stock based compensation	50,147	9,699
(Increase) decrease in:		
Accounts receivable	(145,971)	(143,477)
Inventories	(320,759)	15,078
Prepaid expenses	15,632	(10,139)
Income taxes receivable	(5,489)	(5,100)
Increase (decrease) in:		
Accounts payable	247,380	(55,899)
Accrued liabilities and customer deposits	5,206	140,465
Net cash provided by (used in) operating activities	61,507	(74,411)
Cash flows relating to investing activities		
Purchase of property and equipment	(168,014)	(16,094)
Proceeds from sale of property and equipment	34,381	
Net cash used in investing activities	(133,633)	(16,094)
Effect of foreign exchange translation on cash	(14,306)	12,741
Decrease in cash and cash equivalents	(86,432)	(77,764)
Cash and cash equivalents, beginning of period	2,760,506	3,545,986
Cash and cash equivalents, end of period	$ 2,674,074	$ 3,468,222
Supplemental Disclosure of Cash Flow Information		
Cash paid during the period for income taxes	$ 14,135	$ 5,100

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

Table of Contents

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

AND COMPREHENSIVE INCOME

FOR THE THREE MONTHS ENDED AUGUST 31, 2011

(UNAUDITED)

	Shares	Amount	Accumulated other comprehensive loss	Retained earnings	Total	Total comprehensive income
Balance, May 31, 2011	2,895,635	$ 9,943,910	$ (226,581)	$ 439,979	$ 10,157,308	
Stock-based compensation		50,147			50,147	
Net income				137,028	137,028	$ 137,028
Other comprehensive loss			(19,138)		(19,138)	(19,138)
Balance, August 31, 2011	2,895,635	$ 9,994,057	$ (245,719)	$ 577,007	$ 10,325,345	
Comprehensive income, three months ended August 31, 2011						$ 117,890

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

Page 6

Table of Contents

SCHMITT INDUSTRIES, INC.

NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS

Note 1:

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial information included herein has been prepared by Schmitt Industries, Inc. (the Company or Schmitt) and its wholly owned subsidiaries. In the opinion of management, the accompanying unaudited Consolidated Financial Statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission and contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly its financial position as of August 31, 2011 and its results of operations and its cash flows for the periods presented. The consolidated balance sheet at May 31, 2011 has been derived from the Annual Report on Form 10-K for the fiscal year ended May 31, 2011. The accompanying unaudited financial statements and related notes should be read in conjunction with the audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended May 31, 2011. Operating results for the interim periods presented are not necessarily indicative of the results that may be experienced for the fiscal year ending May 31, 2012.

Revenue Recognition

The Company recognizes revenue for sales and billing for freight charges upon delivery of the product to the customer at a fixed and determinable price with a reasonable assurance of collection, passage of title to the customer as indicated by shipping terms and fulfilment of all significant obligations, pursuant to the guidance provided by Accounting Standards Codification (ASC) Topic 605. For sales to all customers, including manufacturer representatives, distributors or their third-party customers, these criteria are met at the time product is shipped. When other significant obligations remain after products are delivered, revenue is recognized only after such obligations are fulfilled. In addition, judgments are required in evaluating the credit worthiness of our customers. Credit is not extended to customers and revenue is not recognized until we have determined that collectability is reasonably assured.

Financial Instruments

The carrying value of all other financial instruments potentially subject to valuation risk (principally consisting of cash and cash equivalents, accounts receivable and accounts payable) also approximates fair value because of their short-term maturities.

Note 2:

INVENTORY

Inventory is valued at the lower of cost or market with cost determined on the average cost basis. Costs included in inventories consist of materials, labor and manufacturing overhead, which are related to the purchase or production of inventories. Write-downs, when required, are made to reduce excess inventories to their net realizable values. Such estimates are based on assumptions regarding future demand and market conditions. If actual conditions become less favorable than the assumptions used, an additional inventory write-down may be required. As of August 31, 2011 and May 31, 2011, inventories consisted of:

	Aug. 31, 2011	May 31, 2011
Raw materials	$ 1,736,566	$ 1,649,925
Work-in-process	938,393	892,541
Finished goods	1,790,740	1,603,942
	$ 4,465,699	$ 4,146,408

Page 7

Table of Contents

Note 3:

LINE OF CREDIT

In February 2011, the Company renewed its $1.0 million bank line of credit secured by U.S. accounts receivable, inventories and general intangibles that expires on March 1, 2012. Interest is payable at the bank s prime rate (3.25% as of August 31, 2011) or LIBOR plus 2.0% (2.22% as of August 31, 2011). There were no outstanding balances on the line of credit at August 31, 2011 and May 31, 2011.

Note 4:

STOCK OPTIONS AND STOCK-BASED COMPENSATION

Stock-based compensation includes expense charges for all stock-based awards to employees and directors granted under the Company s stock option plan. Stock-based compensation recognized during the period is based on the portion of the grant date fair value of the stock-based award that will vest during the period, adjusted for expected forfeitures. Compensation cost for all stock-based awards is recognized using the straight-line method. The Company uses the Black-Scholes option pricing model as its method of valuation for stock-based awards. The Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results. These variables include, but are not limited to:

Risk-Free Interest Rate. The Company bases the risk-free interest rate on the implied yield currently available on U.S. Treasury issues with an equivalent remaining term approximately equal to the expected life of the award.

Expected Life. The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determines the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules and pre-vesting and post-vesting forfeitures.

Expected Volatility. The Company estimates the volatility of its common stock at the date of grant based on the historical volatility of its common stock. The volatility factor the Company uses is based on its historical stock prices over the most recent period commensurate with the estimated expected life of the award. These historical periods may exclude portions of time when unusual transactions occurred.

Expected Dividend Yield. The Company does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero.

Expected Forfeitures. The Company uses relevant historical data to estimate pre-vesting option forfeitures. The Company records stock-based compensation only for those awards that are expected to vest.

The Company has computed, to determine stock-based compensation expense recognized for those options granted during the three months ended August 31, 2011 and 2010, the value of all stock options granted using the Black-Scholes option pricing model. No stock options were issued during the three months ended August 31, 2011 and 2010.

At August 31, 2011, the Company had a total of 377,776 outstanding stock options (297,776 vested and exercisable and 80,000 non-vested) with a weighted average exercise price of $3.46. The Company estimates that a total of approximately $149,000 will be recorded as additional stock-based compensation expense during the remainder of the year ending May 31, 2012 for all options that were outstanding as of August 31, 2011, but which were not yet vested.

Outstanding Options	Exercisable Options

Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (yrs)	Number of Shares	Weighted Average Exercise Price
76,110	$ 1.20	0.5	76,110	$ 1.20
61,666	2.30	2.8	61,666	2.30
160,000	3.65	9.8	80,000	3.65
5,000	5.80	4.2	5,000	5.80
75,000	6.16	6.7	75,000	6.16
377,776	$ 3.46	6.1	297,776	$ 3.41

Table of Contents

Options granted, exercised, and forfeited or canceled under the Company s stock option plan during the three months ended August 31, 2011 are summarized as follows:

	Three Months Ended August 31, 2011	
	Number of Shares	Weighted Average Exercise Price
Options outstanding beginning of period	387,776	$ 3.47
Options granted		
Options exercised		
Options forfeited/canceled	(10,000)	3.65
Options outstanding August 31, 2011	377,776	$ 3.46

Note 5:

EPS RECONCILIATION

	Three Months Ended August 31,	
	2011	2010
Weighted average shares (basic)	2,895,635	2,894,802
Effect of dilutive stock options	71,629	
Weighted average shares (diluted)	2,967,264	2,894,802

Basic earnings (loss) per share is computed using the weighted average number of common shares outstanding. Diluted earnings (loss) per share is computed using the weighted average number of common shares outstanding, adjusted for dilutive incremental shares attributed to outstanding options to purchase common stock. Common stock equivalents for stock options are computed using the treasury stock method. In periods in which a net loss is incurred, no common stock equivalents are included since they are antidilutive and as such all stock options outstanding are excluded from the computation of diluted net loss in those periods. 67,621 potentially dilutive common shares from outstanding stock options have been excluded from diluted earnings (loss) per share for the three months ended August 31, 2010.

Note 6:

INCOME TAXES

The Company accounts for income taxes using the asset and liability method. This approach requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax basis of assets and liabilities. Deferred tax assets are reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Each year the Company files income tax returns in the various national, state and local income taxing jurisdictions in which it operates. These tax returns are subject to examination and possible challenge by the taxing authorities. Positions challenged by the taxing authorities may be settled or appealed by the Company. As a result, there is an uncertainty in income taxes recognized in the Company s financial statements in accordance with ASC Topic 740. The Company applies this guidance by defining criteria that an individual income tax position must meet for any part of the benefit of that position to be recognized in an enterprise s financial statements and provides guidance on measurement, de-recognition, classification, accounting for interest and penalties, accounting in interim periods, disclosure, and transition.

Table of Contents

On June 1, 2007, the Company adopted the provisions of ACS Topic 740. Other long-term liabilities related to tax contingencies were $0 as of August 31, 2011 and May 31, 2011. Interest and penalties associated with uncertain tax positions are recognized as components of the Provision for income taxes. The liability for payment of interest and penalties was $0 as of August 31, 2011 and May 31, 2011.

Several tax years are subject to examination by major tax jurisdictions. In the United States, federal tax years for Fiscal 2007 and after are subject to examination. In the United Kingdom, tax years for Fiscal 2006 and after are subject to examination. In Canada, tax years for 2005 and after are subject to examination. In the United States, returns related to an acquired subsidiary for the year ended October 31, 1994 and the final return for the period ended May 19, 1995 are also subject to examination.

Effective Tax Rate

The effective tax rate on consolidated net income was 4.6% for the three months ended August 31, 2011. The effective tax rate on consolidated net income differs from the federal statutory tax rate primarily due to the amount of income from foreign jurisdictions, changes in the deferred tax valuation allowance and certain expenses not being deductible for income tax reporting purposes offset by tax credits related to research and experimentation expenses. Management believes the effective tax rate for Fiscal 2012 will be approximately 4.6% due to the items noted above.

Note 7:

SEGMENTS OF BUSINESS

The Company has two reportable business segments: dynamic balancing systems for the machine tool industry (Balancer) and laser-based test and measurement systems (Measurement). The Company operates in three principal geographic markets: North America, Europe and Asia.

Segment Information

	Three Months Ended August 31,			
	2011		2010	
	Balancer	Measurement	Balancer	Measurement
Gross sales	$ 2,810,593	$ 972,184	$ 1,693,973	$ 885,399
Intercompany sales	(290,054)	(21,238)	(166,556)	(8,349)
Net sales	$ 2,520,539	$ 950,946	$ 1,527,417	$ 877,050
Operating income (loss)	$ 46,494	$ 87,669	$ (53,812)	$ (62,590)
Depreciation expense	$ 33,461	$ 16,427	$ 31,438	$ 15,588
Amortization expense	$	$ 33,659	$	$ 40,561
Capital expenditures	$ 51,267	$ 116,747	$ 11,654	$ 4,440

Geographic Information-Net Sales by Geographic Area

	Three Months Ended August 31,	
	2011	2010
North America	$ 1,739,719	$ 1,298,946
Europe	323,047	236,767
Asia	1,226,083	782,321
Other markets	182,636	86,433

Total Net Sales	$ 3,471,485	$ 2,404,467

Table of Contents

	Three Months Ended August 31, 2011		2010	
	United States	Europe	United States	Europe
Operating income (loss)	$ 60,642	$ 73,521	$ (87,345)	$ (29,057)
Depreciation expense	$ 49,888	$	$ 47,026	$
Amortization expense	$ 33,659	$	$ 40,561	$
Capital expenditures	$ 168,014	$	$ 16,094	$

Note Europe is defined as the European subsidiary, Schmitt Europe, Ltd.

Segment and Geographic Assets

	August 31, 2011	May 31, 2011
Segment assets to total assets		
Balancer	$ 5,303,605	$ 5,284,244
Measurement	4,025,113	3,544,512
Corporate assets	2,679,563	2,760,506
Total assets	$ 12,008,281	$ 11,589,262
Geographic assets to long-lived assets		
United States	$ 1,423,132	$ 1,334,175
Europe		
Total assets	$ 1,423,132	$ 1,334,175
Geographic assets to total assets		
United States	$ 11,253,139	$ 10,882,569
Europe	755,142	706,693
Total assets	$ 12,008,281	$ 11,589,262

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Forward-Looking Statements

This Quarterly Report filed with the SEC on Form 10-Q (the Report), including Management s Discussion and Analysis of Financial Condition and Results of Operations in this Item 2, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 regarding future events and the future results of Schmitt Industries, Inc. and its consolidated subsidiaries (the Company) that are based on management s current expectations, estimates, projections and assumptions about the Company s business. Words such as expects, anticipates, intends, plans, believes, sees, estimates and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements due to numerous factors, including, but not limited to, those discussed in the Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Report as well as those discussed from time to time in the Company s other Securities and Exchange Commission filings and reports. In addition, such statements could be affected by general industry and market conditions. Such forward-looking statements speak only as of the date of this Report or, in the case of any document incorporated by reference, the date of that document, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Report. If we update or correct one or more forward-looking statements, investors and others should not conclude that we will make additional updates or corrections with respect to other forward-looking statements.

RESULTS OF OPERATIONS

Overview

Schmitt Industries, Inc. designs, manufactures and markets computer-controlled vibration detection and balancing equipment (the Balancer segment) to the worldwide machine tool industry and through its wholly owned subsidiary, Schmitt Measurement Systems, Inc., precision laser-based surface measurement products, laser-based distance measurement products and ultrasonic measurement systems (the Measurement segment) for a variety of industrial applications worldwide. The Company sells and markets its products in Europe through its wholly owned subsidiary, Schmitt Europe Ltd. (SEL), located in the United Kingdom. The Company is organized into two operating segments: the Balancer segment and the Measurement segment. The accompanying unaudited financial information should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended May 31, 2011.

SBS, SMS, Acuity, Xact and Lasercheck are registered trademarks owned by the Company.

For the three months ended August 31, 2011, total sales increased $1.1 million, or 44.4%, to $3.5 million from $2.4 million in the three months ended August 31, 2010. Balancer segment sales focus throughout the world on end-users, rebuilders and original equipment manufacturers of grinding machines with the target geographic markets in North America, South America, Asia and Europe. Balancer segment sales increased $993,000, or 65.0%, to $2.5 million for the three months ended August 31, 2011 compared to $1.5 million for the three months ended August 31, 2010. The increase in worldwide balancer sales is due to higher volumes of shipments as the worldwide automotive and manufacturing industries continue to recover from the global economic downturn. The Measurement segment product line consists of laser-based light-scatter, distance measurement and dimensional sizing products and remote tank monitoring products. Total Measurement segment sales increased $74,000, or 8.4%, to $951,000 for the three months ended August 31, 2011 compared to $877,000 for the three months ended August 31, 2010. The increase is primarily due to higher volumes of shipments of laser-based light scatter surface measurement products and remote tank monitoring products offset by decreases in distance measurement and dimensional sizing laser-based measurement products.

Operating expenses have increased $358,000, or 29.4%, to $1.6 million for the three months ended August 31, 2011 from $1.2 million for the three months ended August 31, 2010. General, administration and sales expenses have increased $405,000, or 36.5%, to $1.5 million for the three months ended August 31, 2011 from $1.1 million for the same period in the prior year. Research and development expenses have decreased $47,000, or 43.4%, to $62,000 for the three months ended August 31, 2011 from $109,000 for the three months ended August 31, 2010. Net income was $137,000, or $0.05 per fully diluted share, for the three months ended August 31, 2011 as compared to a net loss of $113,000, or $0.04 per fully diluted share, for the three months ended August 31, 2010.

Table of Contents

Critical Accounting Policies

There were no material changes in our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended May 31, 2011.

Discussion of Operating Results

	Three Months Ended August 31,			
	2011		2010	
Balancer sales	$ 2,520,539	72.6%	$ 1,527,417	63.5%
Measurement sales	950,946	27.4%	877,050	36.5%
Total sales	3,471,485	100.0%	2,404,467	100.0%
Cost of sales	1,763,581	50.8%	1,304,721	54.3%
Gross profit	1,707,904	49.2%	1,099,746	45.7%
Operating expenses:				
General, administration and sales	1,512,190	43.6%	1,107,450	46.1%
Research and development	61,551	1.8%	108,698	4.5%
Total operating expenses	1,573,741	45.3%	1,216,148	50.6%
Operating income (loss)	134,163	3.9%	(116,402)	-4.8%
Other income (expense)	9,438	0.3%	(5,322)	-0.2%
Income (loss) before income taxes	143,601	4.1%		