

SCHMITT INDUSTRIES INC
Form 10-Q
January 09, 2013
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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**

For the quarterly period ended: November 30, 2012

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)

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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 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

The number of shares of each class of common stock outstanding as of December 31, 2012

Common stock, no par value	2,990,910
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Table of Contents**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements****SCHMITT INDUSTRIES, INC.****CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

	November 30, 2012	May 31, 2012
ASSETS		
Current assets		
Cash and cash equivalents	\$ 2,662,321	\$ 2,776,817
Accounts receivable, net of allowance of \$27,080 and \$26,720 at November 30, 2012 and May 31, 2012, respectively	2,107,730	2,493,889
Inventories	4,422,475	3,975,600
Prepaid expenses	138,196	186,489
Income taxes receivable	23,482	7,780
	9,354,204	9,440,575
Property and equipment		
Land	299,000	299,000
Buildings and improvements	1,805,951	1,723,273
Furniture, fixtures and equipment	1,279,829	1,247,720
Vehicles	121,835	121,835
	3,506,615	3,391,828
Less accumulated depreciation and amortization	(2,098,186)	(2,019,692)
	1,408,429	1,372,136
Other assets		
Intangible assets, net	1,145,595	1,213,204
TOTAL ASSETS	\$ 11,908,228	\$ 12,025,915
LIABILITIES & STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	\$ 591,773	\$ 770,586
Accrued commissions	310,199	335,104
Accrued payroll liabilities	220,873	142,665
Other accrued liabilities	224,053	286,319
Total current liabilities	1,346,898	1,534,674
Long-term liabilities		
	7,500	7,500
Stockholders equity		
Common stock, no par value, 20,000,000 shares authorized, 2,990,910 shares issued and outstanding at both November 30, 2012 and May 31, 2012	10,324,738	10,279,636
Accumulated other comprehensive loss	(303,852)	(313,295)
Retained earnings	532,944	517,400

Total stockholders equity		10,533,830	10,483,741
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$	11,908,228	\$ 12,025,915

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

Table of Contents**SCHMITT INDUSTRIES, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****FOR THE THREE AND SIX MONTHS ENDED NOVEMBER 30, 2012 AND 2011****(UNAUDITED)**

	Three Months Ended November 30,		Six Months Ended November 30,	
	2012	2011	2012	2011
Net sales	\$ 2,702,259	\$ 3,476,225	\$ 6,382,924	\$ 6,947,710
Cost of sales	1,160,031	2,009,687	2,966,748	3,773,268
Gross profit	1,542,228	1,466,538	3,416,176	3,174,442
Operating expenses:				
General, administration and sales	1,523,918	1,520,528	3,156,733	3,032,718
Research and development	131,365	44,305	246,674	105,856
Total operating expenses	1,655,283	1,564,833	3,403,407	3,138,574
Operating income (loss)	(113,055)	(98,295)	12,769	35,868
Other income	7,915	16,692	8,427	26,130
Income (loss) before income taxes	(105,140)	(81,603)	21,196	61,998
Provision (benefit) for income taxes	(536)	(3,427)	5,652	3,146
Net income (loss)	\$ (104,604)	\$ (78,176)	\$ 15,544	\$ 58,852
Net earnings (loss) per common share:				
Basic	\$ (0.03)	\$ (0.03)	\$ 0.01	\$ 0.02
Weighted average number of common shares, basic	2,990,910	2,896,448	2,990,910	2,896,039
Diluted	\$ (0.03)	\$ (0.03)	\$ 0.01	\$ 0.02
Weighted average number of common shares, diluted	2,990,910	2,896,448	3,003,828	2,945,594

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

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SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE THREE AND SIX MONTHS ENDED NOVEMBER 30, 2012 AND 2011

(UNAUDITED)

	Three Months Ended November 30,		Six Months Ended November 30,	
	2012	2011	2012	2011
Net income (loss)	\$ (104,604)	\$ (78,176)	\$ 15,544	\$ 58,852
Other comprehensive income (loss), net of tax				
Foreign currency translation adjustments	(1,930)	(26,133)	9,443	(45,271)
Comprehensive income (loss)	\$ (106,534)	\$ (104,309)	\$ 24,987	\$ 13,581

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

Table of Contents**SCHMITT INDUSTRIES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****FOR THE SIX MONTHS ENDED NOVEMBER 30, 2012 AND 2011****(UNAUDITED)**

	Three Months Ended November 30,	
	2012	2011
Cash flows relating to operating activities		
Net income	\$ 15,544	\$ 58,852
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	173,642	168,745
Gain on disposal of property and equipment		(18,014)
Stock based compensation	45,102	99,707
(Increase) decrease in:		
Accounts receivable	398,602	(527,216)
Inventories	(439,232)	(12,720)
Prepaid expenses	48,849	31,251
Income taxes receivable	(15,702)	(9,612)
Increase (decrease) in:		
Accounts payable	(181,015)	(104,110)
Accrued liabilities and customer deposits	(10,482)	70,847
Net cash provided by (used in) operating activities	35,308	(242,270)
Cash flows relating to investing activities		
Purchase of property and equipment	(142,617)	(260,988)
Proceeds from sale of property and equipment		47,180
Net cash used in investing activities	(142,617)	(213,808)
Cash flows relating to financing activities		
Proceeds from exercise of stock options		39,600
Net cash provided by operating activities		39,600
Effect of foreign exchange translation on cash	(7,187)	(23,640)
Decrease in cash and cash equivalents	(114,496)	(440,118)
Cash and cash equivalents, beginning of period	2,776,817	2,760,506
Cash and cash equivalents, end of period	\$ 2,662,321	\$ 2,320,388
Supplemental Disclosure of Cash Flow Information		
Cash paid during the period for income taxes	\$ 21,353	\$ 14,831

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

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SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

AND COMPREHENSIVE INCOME

FOR THE SIX MONTHS ENDED NOVEMBER 30, 2012

(UNAUDITED)

	Shares	Amount	Accumulated other comprehensive loss	Retained earnings	Total
Balance, May 31, 2012	2,990,910	\$ 10,279,636	\$ (313,295)	\$ 517,400	\$ 10,483,741
Stock-based compensation		45,102			45,102
Net income				15,544	15,544
Other comprehensive income			9,443		9,443
Balance, November 30, 2012	2,990,910	\$ 10,324,738	\$ (303,852)	\$ 532,944	\$ 10,553,830

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

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 November 30, 2012 and its results of operations and its cash flows for the periods presented. The consolidated balance sheet at May 31, 2012 has been derived from the Annual Report on Form 10-K for the fiscal year ended May 31, 2012. 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, 2012. 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, 2013.

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 fulfillment 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 November 30, 2012 and May 31, 2012, inventories consisted of:

	November 30, 2012	May 31, 2012
Raw materials	\$ 1,798,473	\$ 1,638,280
Work-in-process	1,053,076	980,092
Finished goods	1,570,926	1,357,228
	\$ 4,422,475	\$ 3,975,600

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Note 3:

LINE OF CREDIT

In February 2012, the Company extended its bank line of credit secured by U.S. accounts receivable, inventories and general intangibles through March 1, 2014 and raised the lending limit from \$1.0 million to \$2.0 million. Interest is payable at the bank's prime rate (3.25% as of November 30, 2012) or LIBOR plus 2.0% (2.21% as of November 30, 2012). There were no outstanding balances on the line of credit at November 30, 2012 and May 31, 2012.

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 and six months ended November 30, 2012 and 2011, the value of all stock options granted using the Black-Scholes option pricing model. No stock options were issued during the six months ended November 30, 2012 and 2011.

At November 30, 2012, the Company had a total of 281,666 outstanding stock options (228,330 vested and exercisable and 53,336 non-vested) with a weighted average exercise price of \$4.16. The Company estimates that a total of approximately \$45,000 will be recorded as additional stock-based compensation expense during the remainder of the year ending May 31, 2013 for all options that were outstanding as of November 30, 2012, but which were not yet vested.

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Outstanding Options			Exercisable Options		
Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (yrs)	Number of Shares	Weighted Average Exercise Price	
41,666	\$ 2.30	1.5	41,666	\$ 2.30	
160,000	3.65	8.5	106,664	3.65	
5,000	5.80	2.9	5,000	5.80	
75,000	6.16	5.5	75,000	6.16	
281,666	\$ 4.16	6.6	228,330	\$ 4.28	

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Options granted, exercised, and forfeited or canceled under the Company's stock option plan during the three and six months ended November 30, 2012 are summarized as follows:

	Three Months Ended November 30, 2012		Six Months Ended November 30, 2012	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding - beginning of period	281,666	\$ 4.16	281,666	\$ 4.16
Options granted				
Options exercised				
Options forfeited/canceled				
Options outstanding - November 30, 2012	281,666	\$ 4.16	281,666	\$ 4.16

Note 5:**EPS RECONCILIATION**

	Three Months Ended November 30,		Six Months Ended November,	
	2012	2011	2012	2011
Weighted average shares (basic)	2,990,910	2,896,448	2,990,910	2,896,039
Effect of dilutive stock options			12,918	49,555
Weighted average shares (diluted)	2,990,910	2,896,448	3,003,828	2,945,594

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. 11,177 and 49,234 potentially dilutive common shares from outstanding stock options have been excluded from diluted earnings (loss) per share for the three months ended November 30, 2012 and 2011, respectively.

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.

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On June 1, 2007, the Company adopted the provisions of ACS Topic 740. Other long-term liabilities related to tax contingencies were \$7,500 as of both November 30, 2012 and May 31, 2012. 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 November 30, 2012 and May 31, 2012.

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 26.7% for the six months ended November 30, 2012. 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. Management believes the effective tax rate for Fiscal 2013 will be approximately 6.7% 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 and ultrasonic test and measurement systems (Measurement). The Company operates in three principal geographic markets: North America, Europe and Asia.

Segment Information

	Three Months Ended November 30,			
	2012		2011	
	Balancer	Measurement	Balancer	Measurement
Gross sales	\$ 2,081,866	\$ 854,077	\$ 2,563,362	\$ 1,133,332
Intercompany sales	(220,205)	(13,479)	(200,077)	(20,392)
Net sales	\$ 1,861,661	\$ 840,598	\$ 2,363,285	\$ 1,112,940
Operating income (loss)	\$ 6,380	\$ (119,435)	\$ 105,837	\$ (204,132)
Depreciation expense	\$ 35,252	\$ 18,083	\$ 33,887	\$ 17,653
Amortization expense	\$	\$ 33,658	\$	\$ 33,658
Capital expenditures	\$	\$ 87,428	\$ 75,283	\$ 17,691

	Six Months Ended November 30,			
	2012		2011	
	Balancer	Measurement	Balancer	Measurement
Gross sales	\$ 4,515,570	\$ 2,286,444	\$ 5,373,955	\$ 2,105,516
Intercompany sales	(390,886)	(28,204)	(490,131)	(41,630)
Net sales	\$ 4,124,684	\$ 2,258,240	\$ 4,883,824	\$ 2,063,886
Operating income (loss)	\$ 99,239	\$ (86,470)	\$ 152,331	\$ (116,463)

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Depreciation expense	\$ 70,214	\$ 36,111	\$ 67,348	\$ 34,080
Amortization expense	\$	\$ 67,317	\$	\$ 67,317
Capital expenditures	\$ 39,830	\$ 102,787	\$ 126,550	\$ 134,438

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Table of Contents**Geographic Information-Net Sales by Geographic Area**

	Three Months Ended November 30,		Six Months Ended November 30,	
	2012	2011	2012	2011
North America	\$ 1,701,398	\$ 2,182,659	\$ 4,092,619	\$ 3,922,378
Europe	380,988	291,075	671,493	614,122
Asia	514,866	875,063	1,441,937	2,101,146
Other markets	105,007	127,428	176,875	310,064
Total Net Sales	\$ 2,702,259	\$ 3,476,225	\$ 6,382,924	\$ 6,947,710

	Three Months Ended November 30,			
	2012		2011	
	United States	Europe	United States	Europe
Operating income (loss)	\$ (105,732)	\$ (7,323)	\$ (68,476)	\$ (29,819)
Depreciation expense	\$ 53,335	\$	\$ 51,540	\$