SCHMITT INDUSTRIES INC
Form 10-K
August 08, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended: May 31, 2014

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 incorporation or organization)	**(IRS Employer Identification Number)**

2765 N.W. Nicolai Street

Portland, Oregon 97210

(Address of principal executive offices) (Zip Code)

(503) 227-7908

(Registrant s telephone number, including area code)

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

Title of each class	**Name of each exchange on which registered**
Common Stock - no par value	**The NASDAQ Stock Market LLC**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark whether the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No x

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer, 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 ¨ No x

The aggregate market value of the voting stock held by non-affiliates of the registrant as of November 30, 2013, the last business day of the registrant s most recently completed second fiscal quarter, was approximately $4,622,100 based upon the closing price of $2.63 reported for such date on the NASDAQ Capital Market. For purposes of this disclosure, shares of Common Stock held by persons who hold more than 10% of the outstanding shares of Common Stock and shares held by officers and directors of the registrant, have been excluded because such persons may be deemed to be affiliates. This determination is not necessarily conclusive for other purposes.

As of July 31, 2014, the registrant had 2,995,910 outstanding shares of Common Stock.

Documents Incorporated by Reference

Portions of the registrant s definitive Proxy Statement for its 2014 Annual Meeting of Shareholders are incorporated by reference into Part III hereof.

PART I

Item 1. Business

Forward-Looking Statements

This Annual Report on Form 10-K (the Report), including Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7, 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 section in Item 1A, Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7 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.

Introduction

Schmitt Industries, Inc. (the Company), an Oregon corporation, designs, manufactures and sells high precision test and measurement products for two main business segments: the Balancer Segment and the Measurement Segment. The Company designs, manufactures and sells computer-controlled vibration detection, balancing and process control systems for the worldwide machine tool industry, particularly for grinding machines (the Balancer Segment). Through its wholly owned subsidiary, Schmitt Measurement Systems, Inc. (SMS), an Oregon corporation, the Company designs, manufactures and sells laser and white light sensors for distance, dimensional and area measurement for a wide variety of commercial applications, laser-based microroughness measurement products for the semiconductor wafer and hard disk drive industries and for other industrial applications, laser-based surface analysis and measurement products for a variety of scientific applications, and ultrasonic measurement products that measure the levels of propane tanks and transmit that data via satellite to a secure web site for display (the Measurement Segment). The Company also provides sales and service for Europe and parts of Asia through its wholly owned subsidiary, Schmitt Europe Limited (SEL), located in Coventry, England and through its sales representative office located in Shanghai, China. The Company s corporate office is located at 2765 N.W. Nicolai Street, Portland, Oregon.

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

Balancer Segment

The Company s principal product line for this segment is the Schmitt Dynamic Balance System (SBS), which consists of a vibration sensor, a computer control unit, and a balance head that is placed either externally on the grinding wheel spindle with the use of a spindle mounted adaptor or internally inside the spindle bore. The SB-5500 control panel contains up to four slots for additional circuit boards designed for specific functions, such as manual balancing,

balancing using hydro chambers and process monitoring, which involves the detection and analysis of high frequency noise, known as acoustic emission or AE, generated by the grinding process. SBS products are designed as economical yet highly precise measurement and control devices for permanent or portable installation on grinding machines that can detect and correct imbalance caused by vibration as small as 0.02 microns. Customers can also detect and analyze the AE signal generated during grinding or wheel dressing to help monitor and improve the grinding process. Customers include both end user operators as well as manufacturers of grinding machines worldwide for a wide variety of industries that utilize the grinding process, including the automotive, industrial, aerospace, and medical industries where specifications and operating tolerances on machined parts are increasingly precise.

The SB-5500 is fully automated, eliminating the need to pre-balance parts such as grinding wheels. This reduces machine setup time and ensures a smoother and more efficient grinding process. Operating on a principle of mass compensation for wheel imbalance, the balance head contains two movable eccentric weights, each driven by electric motors through a precision gear train. These weights are repositioned to offset any imbalance in a grinding wheel or other application. Imbalance or vibration is picked up by the vibration sensor that feeds the detected signal to the control unit, which filters the signal by revolutions per minute. The controller then automatically drives the balance head weights in a direction that reduces the amplitude of the vibration signal. The balance cycle is complete when the weights are positioned to achieve the lowest vibration level, as low as 0.02 microns.

The SB-5500 also includes an optional Acoustic Emission Monitoring System (AEMS) control card, which uses proprietary acoustic sensor technology to monitor the very high frequency signals (known as acoustic emission or AE) generated on the grinding machine during key events in the grinding process. The AEMS card allows rapid, automatic grinding wheel in-feed, right up to the point of initial contact of the grinding wheel with a new part loaded in the machine. The system can automatically detect the initial contact and very quickly report this event to the machine control, stopping the wheel in-feed without operator intervention. Part crash occurs when a part or fixture is incorrectly loaded into a grinding machine or some abnormal condition occurs. Rapid in-feed of the wheel may then result in a dangerous or expensive crash. The AEMS card allows the grinding machine s operating system (known as a computer numeric control or CNC system) on the machine to monitor the acoustic levels and detect any unexpected contact when it happens. The system then reports that abnormal contact and instructs the CNC program to stop the grinding process, usually within one millisecond.

The SB-5500 also offers the ExactDress process control card as part of the AEMS system to automatically monitor and control the grinding wheel dressing process by comparing the AE signal pattern of a wheel dress to a stored master AE signal pattern and by indicating when the dressing process has been successfully completed. Monitoring for AE levels during wheel dressing permits the operator or CNC control to determine if the wheel is being dressed fully across its width, control the aggressiveness of the process and maintain the quality of the dressed wheel to conserve wheel material.

Additional SBS products include the SB-2000 and the AE-1000. The SB-2000 is an easy-to-use, compact manual balancing system offering both one and two plane manual balancing capabilities. The system comes in a dedicated machine installation version (SB-2000) and a portable version (SB-2000-P). Each version of the system displays up to four digits of resolution for vibration and six digits for RPM readings and supports a spindle speed range of 30 to 100,000 RPM. The portable SB-2000-P version attaches magnetically to any location on the machine for easy setup and use. The AE-1000 is a dedicated AE control platform that reduces air machine grinding time and alerts the operator to potential grinding wheel crash conditions by using proprietary AE detection technology to monitor the high frequency signals generated by the grinding process.

Notable features of the SBS system include its ability to fit almost all grinding machines, ease of installation, compact and modular construction, ability to balance a wheel while on a machine, virtual elimination of wheel vibration, automatic monitoring of balancing, display in a variety of languages and in metric units of measurement, instrument grade calibration, short balance process, measurement of both displacement and/or velocity and minimal operator maintenance. The SB-5500 also offers the capability of fully integrating its operation and output within any grinding machine s CNC operating system by the use of its IVIS (Intelligent Visualization) software.

Benefits of using the SBS system include improved quality of finished parts, elimination of grinding gap time in the grind cycle resulting in increased efficiency and part throughput, ease of product adaptation, monitoring and correction of part crash, minimal downtime, complete and ready installation, elimination of static balancing, longer life of the grinding wheel, diamond dressings and spindle bearings, the ability to balance within 0.02 microns and its adaptability to all types of machines.

Precision grinding is necessary in major manufacturing areas including the automotive industry (gear trains, camshafts, crankshafts, valves), bearings (roller and tapered types), ceramics (precision shaping), electric motors (shafts), pumps (shafts and turbines), aircraft (engine parts such as turbine blades), and general manufacturing. Precision grinding has an established worldwide presence in all industrialized countries and is expanding as a method of material removal and part processing. Within the Company s customer base for the SBS system, there are three major market segments:

Machine Tool Builders These companies design and manufacture a variety of specialty application grinding machines. SBS systems are distributed to markets throughout the world through machine tool original equipment manufacturers (OEMs), who incorporate the SBS system into their products.

Examples of some well-known worldwide machine tool builders who have offered and/or installed the SBS system include Shanghai Machine Tool Works, ANCA, Capco Machinery, Drake Manufacturing, Ecotech/SMTW, Erwin Junker, Matrix Machine Tool, Schleifring Group, Shaanxi Qinchuan Machinery Development Co., Cinetic Landis Grinding, Koyo Machinery, Micron Machinery Limited, USACH Technologies (U.S.), Tschudin and Weldon Solutions. The Company currently sells its products directly to major machine builders throughout the world.

Machine Tool Rebuilders These customers, found in most, if not all, industrialized nations, develop their business by offering to completely update and refurbish older grinding machines. These rebuilders typically tear the old machine apart and install new components, such as the SBS system. The Company currently sells its products directly to major machine rebuilders throughout the world.

Grinding Machine Users These end users become aware of the SBS system through trade shows, trade magazine advertising, distributors, field representatives, referrals and new machine suppliers. The Company s business is conducted worldwide with some better known customers including: Black & Decker, Briggs and Stratton, Schaeffler, Caterpillar, Eaton, Emerson Power Transmission, Cummins Engine, Ford Motor Company, General Electric, General Motors, Ingersoll Rand, Komatsu, Sumitomo Heavy Industries, SKF Bearing Industries, Timken, TRW Automotive Components and Universal Bearing.

For the years ended May 31, 2014, May 31, 2013 and May 31, 2012 (Fiscal 2014, 2013 and 2012), net sales of the Company s balancing products totaled $7,721,211, $7,714,122 and $9,265,008, respectively. Net sales of balancing products accounted for 64%, 62% and 64% of the Company s total sales in Fiscal 2014, 2013 and 2012, respectively. See Note 6 to Consolidated Financial Statements.

Competition

Competitors in the Balancer Segment primarily come from Germany and Italy. These competitors produce electromechanical and water balancers and process control products similar to SBS. The Company s primary competitors are Marposs S.p.A., MPM Micro Prazision Marx GmbH and Balance Systems S.r.l.

Measurement Segment

Within the Measurement Segment, the Company designs, manufactures and sells laser and white light sensors for distance, dimensional and area measurement for a wide variety of commercial applications, laser-based microroughness measurement products for the semiconductor wafer and hard disk drive industries and for other industrial applications, laser-based surface analysis and measurement products for a variety of scientific applications, and ultrasonic measurement products that accurately measure the fill levels of propane tanks and transmit that data via satellite to a secure web site for display.

Laser and White Light Sensors

These products include lasers utilizing both triangulation and time-of-flight methods of measurement, and confocal chromatic white light sensors that are used in a wide range of industrial applications including manufacturing, lumber production, steel casting, glass and paper production, medical imaging, crane control and micron-level part and surface inspection and are sold under the Acuity brand. Presently, there are 11 products offered under the Acuity brand: The AccuRange (AR)1000, AR2000, AR2500 and AR3000 distance measurement sensors, the AR700, AR500 and AR200 series of triangulating laser displacement sensors, the AR CCS Prima and the AR CCS Initial chromatic confocal sensors and the AccuProfile (AP)400 and AP820 laser line scanners. The Company designs, manufactures and sells the AR200 and AR700 and distributes the AR500, AR1000, AR2000, AR2500, AR3000, AR CCS Prima, AR CCS Initial, AP400 and the AP820, primarily into North America.

The AR1000, AR2000, AR2500 and AR3000 distance measurement lasers utilize pulsed time of flight measurement principles to accurately measure distances of up to 30 meters (up to 300 meters with retro-reflective tape) with the AR1000, up to 100 meters (500 meters with retro-reflective tape) with the AR2000, up to 50 meters (500 meters with retro-reflective tape) with the AR2500 and up to 300 meters (3000 meters with retro-reflective tape) with the AR3000. These products are highly versatile, being able to measure distances both indoors and outdoors. Applications include, but are not limited to, load confirmation, alignment, lumber positioning, crane monitoring, fill level measurement, velocity measurement and laser altimeter.

The AR700 is a triangulation laser displacement sensor that provides superior performance in terms of accuracy, repeatability, and sample speed. The AR700 boasts output speeds up to 9400 Hz and resolutions as a micron. The laser will output 9400 distance readings in a single second. The unit is also very compact, measuring approximately 80% smaller than its predecessor, the AR600. Model variations permit applications up to 50 inches in range. Applications include high speed road profiling, product dimensional or thickness measurement, rubber thickness measurement, lumber or plywood thickness measurement, carton dimensioning and product positioning.

The AR500 is a compact triangulation laser displacement sensor that provides accurate measurements (+/- 0.15% linearity) at high speeds (standard to 9400 Hz, high speed option up to 56K Hz). The same compact enclosure houses models with ranges from 5 to 1000 millimeters. Sensor options include blue laser diodes, faster speeds and cooling jackets. Applications include radiating surfaces and high speed applications such as road texture, ballistics and high speed event monitoring.

The AR200 line is the Company s most compact series of triangulating laser displacement sensors. Four models cover metric measurement ranges from 6 to 100 millimeters. All models boast a 1/500 accuracy rating for measurements within twelve microns. All models are standard with analog, limit switch and serial outputs. The AR200 sensors, much like the longer-range AR700 sensors, project a beam of visible laser light that creates a spot on the target surface. Reflected light from the surface is viewed from an angle by a line scan camera and the target s distance is computed from the image pixel data. The AR200-6M, -12M, -25M, -50M, and -100M have ranges in millimeters that match their model number. The AR200 displacement sensor cannot be overloaded and measures accurately even when a mirror reflects the entire light beam back to the detector.

The AR CCS Prima white light confocal-chromatic displacement sensor is the most precise measurement system from Acuity. Using a novel optical principle of measuring the reflected light s component wavelengths, these confocal sensors measure distance and position to within nanometers. These compact probes can measure to opaque, shiny or even transparent surfaces. Unlike the other Acuity distance sensors, the Prima Confocal systems are comprised of an optical measurement pen and a separate controller. This controller houses all of the electronics, light source, etc. Only emitted white light and reflected signals are passed between the pen and the controller via a thin fiber-optic transmission cable. The Confocal-Chromatic Sensors (CCS) are offered in a variety of measurement ranges and standoff distances, each with a corresponding resolution. The shortest-range models resolve to 5 nanometers of height change.

The AR CCS Initial confocal sensor is an extremely precise point sensor for measuring displacement and thickness. Each system includes a controller unit, a fiber optic cable, a measuring probe and all necessary cables and software. The CCS Initial measures distance and topography of varied targets, including silicon, polished metals, glass, contoured lenses, polymers, semiconductor masks and natural materials. The technology in the CCS Initial supports nanometer-scale resolutions and the system comes in five different measurement models that range from 0.4 to 12.0 mm.

The AP400 series line sensors are entry-level two-dimensional CMOS digital sensors for industrial surface dimensioning and measurement applications. The scanner quickly and accurately generates low noise 2D profile scans of objects, surface or scenes. The sensor has an onboard processor and memory and comes with AcuityView image analysis software. Typical applications include weld gap tracking and weld bead profiling, positional control of objects and surfaces, tire profiling, wheel profiling, surface profiling, 3D profile generation and dimensional measurement.

The AP820 is a two-dimensional laser line scanner that measures surface height profiles by projecting a beam of visible laser light that creates a line on a targeted surface. The AP820 is a highly accurate sensor for industrial surface dimensional and measurement applications. The scanner quickly and accurately generates low-noise 2D or 3D profile scans of objects, surfaces or scenes. The sensor automatically adjusts laser power and detector exposure to compensate

for varying surface conditions. Typical scanner applications include weld gap tracking and weld bead profiling, positional control of objects and surfaces, tire profiling, wheel profiling, surface profiling, 3D profile generation and dimensional measurement.

Surface Roughness Measurement Products

These products use a patented technology using laser light scatterometry to perform rapid, accurate, repeatable, non-destructive and non-contact surface measurement tests that quantify surface micro-roughness. The technology is extremely precise, measuring surface roughness at the molecular (sub-Angstrom) level. Products are sold to manufacturers of hard disk drives, semiconductors, silicon wafers and optical products and industries involved in fabrication processes that require precise and reliable measurements.

Computer hard disk drives require exact manufacturing control and a narrow tolerance band for acceptable roughness, with surface roughness outside that narrow band resulting in a reduction in data density or storage capacity. The Company s technology simultaneously measures disk surface roughness in two directions, radially, when the read/write head is moving to another disk sector, and circumferentially, when the read/write head is processing information on the disk. The two separate roughness levels are required for proper head operation. The Company believes the precise measurement methods provided by its products are not possible through any other cost-effective measurement means.

The Company s product for the disk industry is the TMS (Texture Measurement System) 2000-RC, an accurate non-contact texture measurement system. The product (used on aluminum substrates) is currently used worldwide by most major disk drive manufacturers, providing fast, accurate and repeatable microroughness measurements while quadrupling production throughput when compared to other testing devices. Surface roughness can be measured to levels below 0.5 Angstroms. An Angstrom (Å) is a unit of measure equal to 1 hundred-millionth of a centimeter (the point of a needle is one million Å in diameter).

Customers include Hitachi/IBM, Seagate Substrates, Western Digital, Showa Denko, MMC and Komag.

The Company offers two products devoted to the semiconductor wafer industry: the TMS2000W-RC and TMS3000W-RC. Both products provide fast, accurate, repeatable measurements for manufacturers of silicon wafers, device quality semiconductors and memory devices. This industry demands manufacturing precision to increase performance and capacity and these products help achieve those goals. Silicon wafers are carefully cut and polished to provide the base upon which a computer or memory chip is produced. Therefore, chip manufacturing is extremely dependent on the beginning surface roughness of the wafer. Since all silicon wafers exhibit a microscopic level of surface roughness stemming from production techniques such as chemical deposition, grinding, polishing and etching, some method of measuring surface roughness is required. The Company s wafer measurement products provide a way for customers to quantify and control their manufacturing process. The system provides measurements to less than 0.5 Å.

The Company also offers the Lasercheck line of surface roughness measurement gauges. Lasercheck is a unique laser-based non-contact roughness gauge incorporating patented laser light-scatter technology that can make precise and repeatable surface roughness measurements in the 0.025 to 2 micron (<1.0 to 80 micro inches) range. Lasercheck provides high-speed in-process measurements in a fraction of a second and is optimized for surface measurements of ground, sanded, polished, hone, super-finished and shot-blasted surfaces.

Laser Light-Scatter Surface Measurement Products

The Company s CASI (Complete Angle Scatter Instrument) Scatterometers are sold to companies and institutions involved in scientific research and development. The CASI Scatterometer uses visible, ultraviolet or infrared laser light as a nondestructive probe to measure surface quality, optical performance, smoothness, appearance, defects and contamination on a wide variety of materials. These products are scientific measurement instruments providing customers with molecular-level precision in roughness measurement of optical surfaces, diffuse materials, semiconductor wafers, magnetic storage media and precision-machined surfaces, as well as surfaces affecting the cosmetic appearance of consumer products.

The MicroScan system is a portable device consisting of a hand-held control unit, an interchangeable measurement head and a separate charging unit. To perform a measurement, the operator places the measurement head on the objective area and presses a button. Each measurement takes less than five seconds with results displayed and stored in system memory. The MicroScan can store 700 measurements in 255 files and provides the capability to program pass/fail criteria. Software is available for control, analysis and file conversion. From a single measurement, a user can determine Ra (Roughness Average) surface roughness, RMS (Root Mean Squared) surface roughness, reflectance and

scatter light levels (BRDF) on either flat or curved surfaces and under any lighting conditions.

Competition

Management believes the TMS and Lasercheck surface measurement products are two of only a few systems that provide fast, accurate, repeatable non-contact microroughness measurement for a wide variety of commercial customers including computer hard disk and silicon wafer manufacturers. The Company believes its surface

measurement products are currently the only systems that can provide measurements as low as a few hundredths of an Å, with reproducibility +/- 0.2Å or 1% and repeatability of +/-0.1Å. There are differences between our surface measurement products and other optical techniques (which include profilometers, scanning tunneling microscopes, atomic force microscopes or interferometers). These other technologies require the intervention of a skilled operator to perform measurements relatively slowly, whereas our surface measurement products are much simpler and, consequently, can make measurements more rapidly while still maintaining excellent repeatability and accuracy. Stylus profilometers are simpler devices that require less skilled operators. However, measurements must be conducted under vibration isolation conditions, and large areas require numerous scans; thus, stylus profilometers are generally destructive to soft materials such as most coated optics.

The market for distance measurement and dimensional sizing products is extremely competitive, characterized by rapidly changing technology. The Company believes the principal elements of competition include quality of ongoing technical support and maintenance coupled with responsiveness to customer needs, as well as price, product quality, reliability and performance. The differences between the Company s sensors and competitive products include pushbutton selection of output signals in certain models and sensors that can be programmed using serial commands through a PC computer. The AR200 displacement sensor cannot be overloaded and measures accurately even when a mirror reflects the entire light beam back to the detector.

Competing surface measurement products and dimensional sizing products come from established multinational competitors, most of which are significantly larger and have greater financial, engineering, manufacturing and marketing resources. Company pricing is intended to obtain market share and meet competitive supplier prices. The market strategy is to establish measurement products with the best quality, reliability and performance and superior economic value.

Remote Tank Monitoring Products

The Company s Xact Tank Monitoring System provides remote fuel level monitoring of propane tanks, large or small, anywhere in the world. Accessing accurate fuel level information is essential to effectively manage inventory, improve delivery efficiency, reduce operating costs and increase profitability, and justify capital expenditures. The Xact system utilizes an ultrasonic sensor that is applied externally to the tank to calculate the fill level inside the tank with great accuracy (+/- 2% for large tanks, +/-1% for small tanks). The Xact system can also be installed to measure the fill levels of bobtail and transport trucks. For smaller tanks that are difficult to access or where the precise accuracy provided by the ultrasonic sensor is not as important, Xact also offers a sensor that is affixed to the dial of a preinstalled float gauge (known as a gauge reader) which detects the fill level that is reported by the gauge. Float gauges have a typical accuracy of +/- 8% to 12%. Tank fill data is then transmitted via the Globalstar® satellite network to a secure website for display. There is no reliance on phone land lines or cellular networks and therefore no dropped data. The use of satellite telemetry permits monitoring of any tank anywhere in the world. With the Xact system, minimum or maximum alarm or fill levels can be set to automatically notify operators anytime a particular tank reading exceeds thresholds or needs refilling. The Xact system can be used to monitor tanks as small as 125 gallons (473 liters) and as large as 90,000 gallons (340,686 liters). With Xact, operators can obtain timely and accurate readings of inventory levels and tank refill requirements instantly.

There are three main components to the Xact Tank Monitoring System:

Tank Sensor

The Xact ultrasonic sensor incorporates patented technology and is externally mounted to the bottom of the propane tank. The sensor produces a small electrical pulse, or a ping, that travels through the tank s steel shell, which is reflected off the bottom surface of the liquid stored in the tank in the form of an echo that is detected by the sensor. The time of flight between the ping and the echo, which is measured in milliseconds, is then calculated to determine,

based upon additional data regarding tank size and shape, the volume of liquid the tank contains. This information is then remotely transmitted via a satellite radio transmitter. For smaller tanks that are difficult to access or where the precise accuracy provided by the ultrasonic sensor is not as important, Xact also offers a sensor that is affixed to the dial of a preinstalled float gauge (known as a gauge reader). The gauge reader detects the fill level that is reported by the gauge and transmits that data by satellite in the same manner as the ultrasonic sensor. Float gauges have a typical accuracy range of +/- 8% to 12%.

Satellite Radio Transmitter

The Xact radio transmitter is placed on the top of the tank and is connected by cable to the tank sensor or gauge reader. The satellite transmitter transmits the tank data using the GlobalStar® satellite network to a GlobalStar® ground station and then to the Xact secure website where the tank data is displayed or is automatically directed to a customer s automated inventory or delivery management system.

Xact Website

The Xact website is a secured location providing controlled access to the tank data for each customer s various tank locations. The tank fill level data and geometry of the tank are used to calculate and display the precise fill level at predetermined measurement times along with additional information such as temperature, battery status, GPS coordinates and map location, fill levels that trigger email notification and the list of email recipients. In addition to the data being displayed on the website, the data can also be automatically directed to a customer s automated inventory or delivery management system for full automation of the delivery process. Operators can now obtain highly accurate readings and tank information from even the most remote tanks conveniently and cost-effectively using their desktop computer, laptop, tablet or smart phone.

Benefits

Benefits of using the Xact Tank Monitoring System include external mounting with no reliance on existing mechanical gauges when using the ultrasonic sensors, tank fill data is sent directly and instantly from the tank to the user via satellite, no reliance on telephone lines or cellular networks and no dropped data, temperature adjusted readings for accuracy within +/- 2% for large tanks and +/- 1% for smaller tanks when using the ultrasonic sensor, user-set alarm levels and automatic low tank-level messaging via email or cell phone, the ability to operate in a wide range of operating environments from -40ºC to 60ºC, long battery life, quick and easy installation, secure data transmission via satellite, the ability to integrate directly into delivery scheduling management systems and the ability to monitor any tank anywhere in the world.

Customers

Customers of the Xact Tank Monitoring System include large, regional and local propane distributors, such as Superior Propane (Canada), Suburban Propane, AmeriGas, Pacific Propane and TermoGas. The Company is focusing its business development efforts on the propane industry in the United States, Canada, Mexico, Central and South America.

Competition

Management believes that the Xact Tank Monitoring System offers the only ultrasonic sensor specifically designed to provide independent precise tank level calculation while most other competitors utilize gauge-reading technology, which reads the tank fill level from a pre-installed float gauge and is less accurate. Competitors offer telemetry options based on cellular or closed loop communication networks whereas Xact telemetry is satellite based. Competitors include, but are not limited to, Independent Technologies, Inc. (Wesroc), NasCorp (SkyTracker), WacnGo, Silicon Controls, TankLink, Centeron, TankScan and Enertrack.

In Fiscal 2014, 2013 and 2012, net sales of Measurement products totaled $4,413,295, $4,738,130 and $5,172,014, respectively, and accounted for 36%, 38% and 36% of the Company s total sales in Fiscal 2014, 2013 and 2012, respectively. See Note 6 to Consolidated Financial Statements.

Sales by Geographic Area

In Fiscal 2014, 2013 and 2012, the Company recorded net sales of its products in the United States, its country of domicile, of $6,704,239, $7,431,528 and $8,112,431, respectively. Net sales in the last three fiscal years by geographic areas were:

	North America	Europe	Asia	Others
Fiscal 2014	$ 7,474,067	$ 1,773,928	$ 2,693,767	$ 192,744
Fiscal 2013	$ 8,413,970	$ 1,192,049	$ 2,499,593	$ 346,640
Fiscal 2012	$ 9,074,152	$ 1,145,449	$ 3,814,656	$ 402,765

Business and Marketing Strategy

The Company designs, manufactures and markets all of its products with operations divided into a number of different channels and geographies.

Balancer Segment Products

The Company markets and sells its SBS products in a variety of ways. First are the channels provided by independent manufacturers representatives and distributors. There are currently approximately 65 individuals and/or organizations throughout the world acting in one of these capacities, including approximately 15 in the United States and 15 in China.

Second, OEMs integrate the Balancer Segment products on the machine tools they produce. Users thus purchase the SBS products concurrently with the machine tools. Conversely, end users of grinding machines that have purchased the SBS system directly from the Company, and after enjoying the benefits of the products, often request that SBS products be included with the new equipment they order from OEMs. The SBS Systems are often installed by machine tool builders prior to displaying their own machine tools at various trade shows, becoming endorsements that prove beneficial to the Company s sales efforts.

Third, worldwide trade shows have proven to be an excellent source of business. Company representatives, usually one or more of the marketing managers and the CEO, attend these events along with local Company representatives. These individuals operate a display booth featuring an SBS System demonstration stand and product and technical literature. Representatives from all facets of the Company s target markets attend these trade shows.

In North America and Asia, products are shipped directly to customers from the Company s factory in Portland, Oregon. Where the Company has distributors, the product is shipped to the distributor, who in turn pays the Company directly and then delivers and installs the product for the end user. European distribution to customers is handled by shipping the product directly from the Company s Portland headquarters to its European subsidiary in the United Kingdom, which in turn sells and distributes the products.

Measurement Segment Products

Similar to the Balancer Segment, the Measurement Segment uses a variety of methods to market and sell its products. First, sales and marketing managers direct the overall worldwide marketing efforts for surface measurement, laser and white light sensor and remote tank monitoring products. Second, both a marketing manager and a sales manager direct the overall worldwide marketing and sales efforts for distance measurement and dimensional sizing products. Third, the Company uses distributors for international markets for the promotion and sale of surface measurement products in China, Taiwan, Japan and Korea. The Xact product line utilizes two business development personnel, in addition to

distributors for selected markets. All Measurement Segment products are assembled in the Portland, Oregon facility and shipped worldwide directly to customers.

Backlog

The Company does not generally track backlog. Normally, orders are shipped within one to two weeks after receipt unless the customer requests otherwise.

Manufacturing

There are no unique sources of supply or raw materials in any product lines. Essential electronic components, available in large quantities from various suppliers, are assembled into the Balancing and Measurement electronic control units under the Company s quality and assembly standards. Company-owned software and firmware are coupled with the electronic components to provide the basis of the Company s various electronic control units. Management believes several supply sources exist for all electronic components and assembly work incorporated into its electronic control systems. Mechanical parts for the Company s products are produced by high quality machine shops. The Company is not dependent on any one supplier of mechanical components. In the event of supply problems, the Company believes that two or three alternatives could be developed within 30 days. The Company is subject to availability and pricing on the various components parts purchased, which has had, and may continue to have, a material impact on operations.

The Company uses in-house skilled assemblers to construct and test vendor-supplied components. Component inventory of finished vendor-supplied parts is held on Company property to assure adequate flow of parts to meet customer order requirements. Inventory is monitored by a computer control system designed to assure timely re-ordering of components. In-house personnel assemble various products and test all finished components before placing them in the finished goods inventory. Finished goods inventory is maintained via computer to assure timely shipment and service to customers. All customer shipments are from the finished goods inventory.

The Company s Quality Control Program first received full ISO 9001 certification in 1996. In 2005, the Company received its certification to the newer ISO 9001:2000 requirements and in 2011 received its recertification.

Proprietary Technology

The Company s success depends in part on its proprietary technology, which the Company protects through patents, copyrights, trademarks, trade secrets and other measures. The Company has U.S. patents covering both Balancer and Measurement products, processes and methods that the Company believes provide it with a competitive advantage. The Company has a policy of seeking patents where appropriate on inventions concerning new products and improvements developed as part of its ongoing research, development and manufacturing activities. While patents provide certain legal rights of enforceability, there can be no assurance the historic legal standards surrounding questions of validity and enforceability will continue to be applied or that current defenses with respect to issued patents will, in fact, be considered substantial in the future. There can be no assurance as to the degree and range of protection any patent will afford and whether patents will be issued or the extent to which the Company may inadvertently infringe upon patents granted to others.

The Company manufactures its Balancer Segment products under copyright protection in the U.S. for electronic board designs. Encapsulation of the finished product further protects the Company s technologies including software.

The Company also relies upon trade secret protection for its confidential and proprietary information. There can be no assurance that others will not independently develop substantially equivalent proprietary information and techniques or otherwise gain access to the Company s trade secrets or disclose such technology or that the Company can meaningfully protect its trade secrets.

While the Company pursues patent, trademark, trade secret and copyright protection for products and various trademarks, it also relies on know-how and continuing technology advancement, manufacturing capabilities, affordable high-quality products, new product introduction and direct marketing efforts to develop and maintain its competitive position.

Product Development

The Company maintains an ongoing research and development program to expand the product lines and capabilities of its business segments. The goal of this program is to expand the product base in historic markets and to enter new market areas so as to reduce reliance on historic market segments. For example, in the past fiscal year, the Company has developed and introduced the SB-2000, a dual plane manual balancing system, a control card to control the dressing process of grinding wheels, and a new vibration sensor and internal balancer design. The Company has also introduced several new laser products under the Acuity line.

During Fiscal 2014, 2013 and 2012, the Company s research and development expense totaled $475,430, $573,461 and $317,993, respectively.

Employees

As of July 31, 2014, the Company employed 44 individuals worldwide on a full-time basis. There were also two part-time or temporary employees. None of the Company s employees are covered by a collective bargaining agreement.

Item 1A. RISK FACTORS

The following are important factors that could cause actual results or events to differ materially from those contained in any forward-looking statements made by or on behalf of the Company (see the forward-looking statements disclaimer at the beginning of Part 1, Item 1 in this Report). In addition, the risks and uncertainties described below are not the only ones that the Company faces. Unforeseen risks could arise and problems or issues that the Company now views as minor could become more significant. If the Company were unable to adequately respond to any risks, the Company s business, financial condition or results of operations could be materially adversely affected. In addition, the Company cannot be certain that any actions taken to reduce known or unknown risks and uncertainties will be effective.

General economic conditions and uncertainties may adversely affect the Company s business, operating results and financial condition

The Company s operations and performance depend significantly on worldwide economic conditions, particularly in the industrial, manufacturing and automotive sectors in the U.S., Asia and Europe, and their impact on levels of capital spending, which have deteriorated significantly in the past and may become depressed, or be subject to further deterioration. Economic factors that could adversely influence demand for the Company s products include uncertainty about global economic conditions leading to reduced levels of investment, reduction in demand for our customers products, customers and suppliers access to credit and the stability of the global financial system, the overall health of our markets, unemployment and other macroeconomic factors generally affecting commercial and industrial spending behavior.

The past distress in the global financial markets and global economy has resulted in reduced liquidity and a tightening of credit markets for some customers in our markets. Other customers are delaying investment decisions in response to the slow recovery. As a result of these conditions, the Company could experience several potential adverse effects, including the inability of customers to obtain credit to finance purchases of the Company s products, the insolvency of customers resulting in reduced sales and bad debts, and the insolvency of key suppliers resulting in product development and production delays.

The Company s primary markets are volatile and unpredictable

The Company s business depends on the demand for our various products in a variety of commercial and industrial markets. In the past, demand for our products in these markets has fluctuated due to a variety of factors, some of which are beyond our control, including: general economic conditions, both domestically and internationally, the timing, number and size of orders from, and shipments to, our customers as well as the relative mix of those orders and variations in the volume of orders for a particular product line in a particular quarter.

The Company s efforts to accelerate growth of the Xact Tank Monitoring System may not be successful

The Company s efforts to accelerate the growth of Xact in its two primary markets of North America and Latin America may not be successful, anticipated market demand for the products may not materialize, and additional products or market opportunities may not be identified, developed and brought to market in a timely and cost-effective manner. All of this could continue to negatively impact future operating results and result in large and immediate write-offs of recorded intangible asset balances.

New products may not be developed to satisfy changes in consumer demands

The failure to develop new products or enhance existing products or react to changes in existing technologies could result in decreased revenues and a loss of market share to competitors. Financial performance depends on the ability to design, develop, manufacture, assemble, test, market and support new products and enhancements on a timely and

cost-effective basis. New product opportunities may not be identified and developed and brought to market in a timely and cost-effective manner. Products or technologies developed by other companies may render products or technologies obsolete or noncompetitive, or a fundamental shift in technologies in the product markets could have a material adverse effect on the Company s competitive position within historic industries.

Competition is intense and the Company s failure to compete effectively would adversely affect its business

Competition in the markets for the Company s products is intense. The speed with which the Company can identify new applications for the Company s various technologies, develop products to meet those needs and supply commercial quantities at low prices to those new markets are important competitive factors. The principal competitive factors in the Company s markets are product features, performance, reliability and price. Many of the Company s competitors have greater financial, technical, engineering, production and marketing resources than we do. Those competitors with greater resources may, in addition to other things, be able to better withstand periodic downturns, compete more effectively on the basis of price and technology, or more quickly develop enhancements to products that compete with the products we manufacture and market. New companies may enter the markets in which we compete, further increasing competition in those markets. No assurance can be given that the Company will be able to compete effectively in the future, and the failure to do so would have a material adverse effect on the Company s business, financial condition and results of operations.

The Company may experience increased pricing pressure

We have experienced and continue to experience pricing pressure in the sale of our products, from both competitors and customers. Pricing pressures typically have become more intense during cyclical downturns when competitors seek to maintain or increase market share, reduce inventory or introduce more technologically advanced products or lower cost products. In addition, we may agree to pricing concessions or extended payment terms with our customers in connection with volume orders or to reduce cost of ownership in highly competitive applications. Our business, financial condition, margins or results of operations may be materially and adversely affected by competitive pressure and intense price-based competition.

The Company may experience uncertainties resulting from conflict minerals regulation

On August 22, 2012, the SEC adopted a new rule requiring disclosures of specified minerals, known as conflict minerals, that are necessary to the functionality or production of products manufactured or contracted to be manufactured by companies filing public reports. The new rule requires a disclosure report to be filed annually with the SEC and this report will require companies to perform due diligence, disclose and report whether such minerals originate from the Democratic Republic of Congo or an adjoining country. The new rule could affect sourcing at competitive prices and availability in sufficient quantities of certain minerals used in the manufacture of our products. The number of suppliers who provide conflict-free minerals may be limited. In addition, there may be material costs associated with complying with the disclosure requirements, such as costs related to determining the source of certain minerals used in our products as well as costs of possible changes to products, processes, or sources of supply as a consequence of such verification activities. Since our supply chain is complex, we may not be able to sufficiently verify the origins of the relevant minerals used in our products through the due diligence procedures that we implement, which may harm our reputation. In addition, we may encounter challenges to satisfy those customers who require that all of the components of our products be certified as conflict-free, which could place us at a competitive disadvantage if we are unable to do so.

Production time and the overall cost of products could increase if any of the primary suppliers are lost or if a primary supplier increased the prices of raw materials

Manufacturing operations depend upon obtaining adequate supplies of raw materials on a timely basis. The results of operations could be adversely affected if adequate supplies of raw materials cannot be obtained in a timely manner or if the costs of raw materials increased significantly.

The Company may not be able to ramp up manufacturing to satisfy increasing orders, which may lead to the loss of significant revenue opportunities

The Company manufactures several different product lines, all of which involve complicated technology and individual attention for each product made. The production time for each product can vary, depending on a variety of circumstances, including component availability, timing of delivery of components from suppliers and employee availability. Should the Company receive a large increase in orders, an increase in the size of orders or a shortening of the required delivery time on existing orders, the Company may not be able to ramp up manufacturing to satisfy customer expectations, which may lead to the loss of significant revenue opportunities.

The Company maintains a significant investment in inventories in anticipation of future sales

The Company believes it maintains a competitive advantage by shipping product to its customers more rapidly than its competitors. As a result, the Company has a significant investment in inventories. These inventories are recorded using the lower of cost or market method, which requires management to make certain estimates. Management evaluates the recorded inventory values based on customer demand, market trends and expected future sales, and changes these estimates accordingly. A significant shortfall of sales may result in carrying higher levels of inventories of finished goods and raw materials thereby increasing the risk of inventory obsolescence and corresponding inventory write-downs. As a result, the Company may not carry adequate reserves to offset such write-downs.

The Company s existing cash and credit facilities may not be sufficient to fund future growth

The Company had an operating line of credit of $2.0 million and a cash balance of $1.5 million as of May 31, 2014; as of that date, the Company had no outstanding balance on its line of credit and the line will expire on September 1, 2014. The Company believes that its existing cash and investments combined with the cash from operating activities will be sufficient to meet its cash requirements for the near term. However, if sales continue to weaken and the Company is unable to reduce its operating costs in a timely manner or access additional financing, the Company may have to continue to reduce its cash balance, which could significantly impact the liquidity or operations of the Company.

Fluctuations in quarterly and annual operating results make it difficult to predict future performance

Quarterly and annual operating results are likely to fluctuate in the future due to a variety of factors, some of which are beyond management s control. As a result of quarterly operating fluctuations, it is important to realize quarter-to-quarter comparisons of operating results are not necessarily meaningful and should not be relied upon as indicators of future performance.

The Company may experience a downturn due to the risks of operating a global business

The Company markets and sells its products worldwide and international sales have accounted for and are expected to continue to account for a significant portion of future revenue. Sales to customers outside the U.S. accounted for 44.8% of total sales in Fiscal 2014. We expect that sales to customers outside the U.S. will continue to represent a significant percentage of sales in the future. We currently have a sales and service office in Coventry, England and a sales office in Shanghai, China. We may need to increase our foreign operations in the future. International sales are subject to a number of risks, including: the imposition of governmental controls; trade restrictions; difficulty in collecting receivables; changes in tariffs and taxes; difficulties in protecting intellectual property; shipping delays and disruptions; local labor disputes; difficulties in staffing and managing international operations; political and economic instability; general economic conditions; and fluctuations in the relative value of foreign currencies. No assurances can be given that these factors will not have a material adverse effect on future international sales and operations and, consequently, on business, financial condition and results of operations.

The Company may not be able to reduce operating costs quickly enough if sales decline

Operating expenses are generally fixed in nature and largely based on anticipated sales. However, should future sales decline significantly and rapidly, there is no guarantee management could take actions that would further reduce operating expenses in either a timely manner or without seriously impacting the operations of the Company.

Future success depends in part on attracting and retaining key management and qualified technical and sales personnel

Future success depends on the efforts and continued services of key management, technical and sales personnel. Significant competition exists for such personnel and there is no assurance key technical and sales personnel can be retained or that other highly qualified technical and sales personnel as required can be attracted, assimilated and retained. There is also no guarantee that key employees will not leave and subsequently compete against the Company. The inability to attract and retain key personnel could adversely impact the business, financial condition and results of operations.

Changes in the effective tax rate may have an adverse effect on the Company s results of operations

The Company s future effective tax rate may be adversely affected by a number of factors including: the jurisdictions in which profits are determined to be earned and taxed; the resolution of issues arising from future, potential tax audits with various tax authorities; changes in the valuation of our deferred tax assets and liabilities; adjustments to estimated taxes upon finalization of various tax returns; increases in expenses not deductible for tax purposes; changes in available tax credits; changes in stock-based compensation expense; changes in tax laws or the interpretations of such tax laws and changes in generally accepted accounting principles.

Failure to protect intellectual property rights could adversely affect future performance and growth

Failure to protect existing intellectual property rights may result in the loss of valuable technologies or paying other companies for infringing on their intellectual property rights. The Company relies on patent, trade secret, trademark and copyright law to protect such technologies. There is no assurance any of the Company s U.S. patents will not be invalidated, circumvented, challenged or licensed to other companies.

Changes in securities laws and regulations have increased and could continue to increase Company expenses

Changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules promulgated by the Securities and Exchange Commission, have increased and may continue to increase Company expenses as the Company devotes resources to ensure compliance with all applicable laws and regulations. In addition, the NASDAQ Capital Market, on which the Company s common stock is listed, has also adopted comprehensive rules and regulations relating to corporate governance. These laws, rules and regulations have increased the scope, complexity and cost of corporate governance, reporting and disclosure practices. The Company may be required to hire additional personnel and use outside legal, accounting and advisory services to address these laws, rules and regulations. The Company also expects these developments to make it more difficult and more expensive for the Company to obtain director and officer liability insurance in the future, and the Company may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Further, the Company s board members, Chief Executive Officer and Chief Financial Officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified board members and executive officers, which would adversely affect the Company.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Company s design and assembly facilities and executive offices are located in Portland, Oregon in three company-owned buildings totaling approximately 40,500 square feet. SEL occupies a 1,080-square foot facility in Coventry, England pursuant to a three-year lease, renewable for an additional three-year period. In March 2014, the Company exercised the lease renewal. The current basic monthly rent amount is £1,002 ($1,680 as of May 31, 2014) and the lease will expire in March 2017.

Item 3. Legal Proceedings

There are no material legal proceedings currently pending against the Company.

Item 4. Mine Safety Disclosures

None.

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company s Common Stock is traded on the NASDAQ Capital Market under the symbol SMIT.

The following tables set forth the high and low closing prices of the Company s Common Stock as reported on the NASDAQ Capital Market for the periods indicated.

Year Ended May 31, 2013	**High**	**Low**
First Quarter	$ 3.75	$ 3.26
Second Quarter	$ 3.55	$ 2.90
Third Quarter	$ 3.03	$ 2.90
Fourth Quarter	$ 3.02	$ 2.70

Year Ended May 31, 2014	**High**	**Low**
First Quarter	$ 3.05	$ 2.51
Second Quarter	$ 2.70	$ 2.44
Third Quarter	$ 2.70	$ 2.51
Fourth Quarter	$ 3.03	$ 2.65

As of July 31, 2014, there were 2,995,910 shares of Common Stock outstanding held by approximately 80 holders of record. The number of holders does not include individual participants in security position listings; the Company believes that there are more than 900 individual holders of shares of Common Stock.

The Company has not paid any dividends on its Common Stock since 1994. The Company s current policy is to retain earnings to finance the Company s business. Future dividends will be dependent upon the Company s financial condition, results of operations, current and anticipated cash requirements, acquisition plans and plans for expansion and any other factors that the Company s Board of Directors deems relevant. The Company has no present intention of paying dividends on its Common Stock in the foreseeable future.

This table shows information about equity awards under the Company s equity compensation plans at May 31, 2014:

Plan Category	Number of Securities to be issued upon exercise of outstanding options (a)	Weighted-average exercise price of outstanding options (b)	Number of Securities remaining available for future issuance under equity compensation plans (excluding securities in column a) (c)
	281,666	$ 3.77	60,000

Equity compensation plans approved by security holders				
Equity compensation plans not approved by security holders	0		0	0
	281,666	$	3.77	60,000

Recent Sales of Unregistered Securities

None.

Issuer Purchases of Equity Securities

None.

Item 6. Selected Financial Data
In thousands, except per share information

Year Ended	5/31/2014	5/31/2013	5/31/2012	5/31/2011	5/31/2010
Net sales	$ 12,135	$ 12,452	$ 14,437	$ 11,493	$ 6,806
Net income (loss)	$ (540)	$ (540)	$ 77	$ (205)	$ (1,711)
Net income (loss) per common share, basic	$ (0.18)	$ (0.18)	$ 0.03	$ (0.07)	$ (0.59)
Weighted average number of common shares, basic	2,996	2,991	2,930	2,895	2,887
Net income (loss) per common share, diluted	$ (0.18)	$ (0.18)	$ 0.03	$ (0.07)	$ (0.59)
Weighted average number of common shares, diluted	2,996	2,991	2,944	2,895	2,887
Stockholders equity	$ 9,613	$ 10,015	$ 10,484	$ 10,157	$ 10,121
Total assets	$ 10,824	$ 11,625	$ 12,026	$ 11,589	$ 11,352
Long-term debt (including current portion)	$ 0	$ 0	$ 0	$ 0	$ 0

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations
RESULTS OF OPERATIONS

Overview

Schmitt Industries, Inc. (the Company), an Oregon corporation, designs, manufactures and sells high precision test and measurement products for two main business segments: the Balancer Segment and the Measurement Segment. The Company designs, manufactures and sells computer-controlled vibration detection, balancing and process control systems for the worldwide machine tool industry, particularly for grinding machines (the Balancer Segment). Through its wholly owned subsidiary, Schmitt Measurement Systems, Inc. (SMS), an Oregon corporation, the Company designs, manufactures and sells laser and white light sensors for distance, dimensional and area measurement for a wide variety of commercial applications, laser-based microroughness measurement products for the semiconductor wafer and hard disk drive industries and for other industrial applications, laser-based surface analysis and measurement products for a variety of scientific applications, and ultrasonic measurement products that accurately measure the fill levels of propane tanks and transmit that data via satellite to a secure web site for display (the Measurement Segment). The Company also provides sales and service for Europe and parts of Asia through its wholly owned subsidiary, Schmitt Europe Limited (SEL), located in Coventry, England and through its sales representative office located in Shanghai, China.

For the fiscal year ended May 31, 2014 (Fiscal 2014), total sales decreased $317,746, or 2.6%, to $12,134,506 from $12,452,252 in the fiscal year ended May 31, 2013 (Fiscal 2013). Balancer Segment sales focus throughout the world on end-users, rebuilders and original equipment manufacturers of grinding machines with the target geographic

markets of North America, South America, Asia and Europe. Balancer sales increased $7,089, or 0.1%, to $7,721,211 in Fiscal 2014 compared to $7,714,122 in Fiscal 2013. Sales into Europe and Asia increased $344,424, or 10.8%, for Fiscal 2014 as compared to Fiscal 2013. These sales were offset by lower volumes of shipments into North America and other regions of the world. The Measurement Segment product line consists of laser-based light-scatter, distance measurement and dimensional sizing products and remote tank monitoring products. Total Measurement sales decreased $324,835, or 6.9%, to $4,413,295 for the year ended May 31, 2014 as compared to $4,738,130 for the year ended May 31, 2013. The decrease is primarily due to lower volumes of shipments of laser-based distance measurement and dimensional-sizing products, offset by increases in sales of remote tank monitoring products and related services and laser-based light-scatter surface measurement products.

Operating expenses decreased $518,521, or 7.8%, to $6,138,551 in Fiscal 2014 from $6,657,072 in Fiscal 2013. General, administrative and sales expenses decreased $420,490, or 6.9%, in Fiscal 2014 to $5,663,121 as compared to $6,083,611 in the prior fiscal year. Research and development expenses decreased $98,031, or 17.1%, to $475,430 in Fiscal 2014 from $573,461 in Fiscal 2013.

Net loss was $539,624, or $0.18 per fully diluted share, for the year ended May 31, 2014 as compared to net loss of $539,882, or $0.18 per fully diluted share, for the year ended May 31, 2013.

Critical Accounting Policies

Revenue Recognition The Company recognizes revenue for sales and billing for freight charges upon delivery of the product to the customer at a fixed or 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 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. The Company estimates customer product returns based on historical return patterns and reduces sales and cost of sales accordingly.

Allowance for Doubtful Accounts The Company maintains credit limits for all customers based upon several factors, including but not limited to financial condition and stability, payment history, published credit reports and use of credit references. Management performs various analyses to evaluate accounts receivable balances to ensure recorded amounts reflect estimated net realizable value. This review includes accounts receivable agings, other operating trends and relevant business conditions, including general economic factors, as they relate to the Company s domestic and international customers. If these analyses lead management to the conclusion that potential significant accounts are uncollectible, a reserve is provided.

Inventories Inventories are 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.

Deferred Taxes The Company applies the asset and liability method in recording income taxes, under which deferred income tax assets and liabilities are determined, based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using currently enacted tax rates and laws. Additionally, deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the deferred tax asset will not be realized. Management continues to review the level of the valuation allowance on a quarterly basis. There can be no assurance that the Company s future operations will produce sufficient earnings so that the deferred tax assets can be fully utilized.

Intangible Assets Intangible and other long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. Recoverability is determined by comparing the forecasted future undiscounted net cash flows from the operations to which the assets relate, based on management s best estimates using the appropriate assumptions and projections at the time, to the carrying amount of the assets. If the carrying value is determined to be in excess of future operating cash flows, the asset is considered impaired and a loss is recognized equal to the amount by which the carrying amount exceeds the estimated fair value of the assets.

Recently issued accounting pronouncements

Refer to Note 2 of the Notes to Consolidated Financial Statements for a discussion of recently issued accounting pronouncements.

Discussion of Operating Results

	Year Ended May 31,					
	2014		2013		2012	
Balancer sales	$ 7,721,211	63.6%	$ 7,714,122	61.9%	$ 9,265,008	64.2%
Measurement sales	4,413,295	36.4%	4,738,130	38.1%	5,172,014	35.8%
Total sales	12,134,506	100.0%	12,452,252	100.0%	14,437,022	100.0%
Cost of sales	6,508,360	53.6%	6,357,452	51.1%	8,094,386	56.1%
Gross profit	5,626,146	46.4%	6,094,800	48.9%	6,342,636	43.9%
Operating expenses:						
General, administration and sales	5,663,121	46.7%	6,083,611	48.9%	5,967,359	41.3%
Research and development	475,430	3.9%	573,461	4.6%	317,993	2.2%
Total operating expenses	6,138,551	50.6%	6,657,072	53.5%	6,285,352	43.5%
Operating income (loss)	(512,405)	(4.2%)	(562,272)	(4.5%)	57,284	0.4%
Other income (expense)	(17,887)	(0.1%)	14,106	0.1%	37,260	0.3%
Income (loss) before income taxes	(530,292)	(4.4%)	(548,166)	(4.4%)	94,544	0.7%
Provision (benefit) for income taxes	9,332	0.1%	(8,284)	(0.1%)	17,123	0.1%
Net income (loss)	$ (539,624)	(4.4%)	$ (539,882)	(4.3%)	$ 77,421	0.5%

Sales Sales in the Balancer Segment increased $7,089, or 0.1%, to $7,721,211 for Fiscal 2014 compared to $7,714,122 for Fiscal 2013. This increase was primarily due to increased sales into Europe and Asia, offset by lower shipments into North America and other regions of the world. Sales into Europe increased $199,287, or 21.5%, in Fiscal 2014 compared to Fiscal 2013. Sales into Asia increased $145,137, or 6.4%, in Fiscal 2014 compared to the prior year. North American sales decreased $218,349, or 5.1%, in Fiscal 2014 compared to Fiscal 2013. Sales in other regions of the world decreased $118,986, or 52.4%, during Fiscal 2014 as compared to the prior year. The increases in sales in Europe and Asia were due to a gradual increase in demand for the Company s SBS products, while the decline in sales in North America and other regions of the world reflected fluctuations in demand due to uncertainties about the pace of economic recovery in the markets we serve. The levels of demand for our Balancer products in any of these geographic markets cannot be forecasted with any certainty given current economic trends and the historical volatility experienced in this market.

Sales in the Measurement Segment decreased $324,835, or 6.9%, to $4,413,295 in Fiscal 2014 compared to $4,738,130 in Fiscal 2013. Sales of laser-based distance measurement and dimensional-sizing products decreased $626,701, or 20.1%, primarily due to a reduction in orders as the uncertainty and inconsistency in the U.S. economic recovery continues to have a negative impact in the markets we serve. Sales of laser-based surface measurement products increased $196,281, or 37.5%, primarily due to an increase in demand for these products. Sales of remote tank monitoring products increased $95,691 to $972,344 during Fiscal 2014 due to the higher volume of shipments and the developing monitoring revenues associated with unit sales. Future sales of laser-based or ultrasonic measurement products cannot be forecasted with any certainty given the historical volatility experienced in this market.

Sales in the Balancer Segment decreased $1,550,886, or 16.7%, to $7,714,122 for Fiscal 2013 compared to $9,265,008 for Fiscal 2012. This decrease was primarily due to lower volumes of shipments into Asia, particularly China, and also to a lesser extent to North America. North American sales decreased $310,871, or 6.7%, in Fiscal 2013 compared to Fiscal 2012. Sales into Asia decreased $1,198,772, or 34.7%, in Fiscal 2013 compared to the prior year. Sales into Europe increased $34,086, or 3.8%, in Fiscal 2013 compared to Fiscal 2012. Sales in other regions of the world decreased $75,329, or 24.9%, during Fiscal 2013 as compared to the prior year. The decreases in Asia and North America were due to reductions in orders as economic growth in China has slowed and the uncertainty regarding the U.S. economy continued to have a negative impact on manufacturing in the markets we serve. The levels of demand for our Balancer products in any of these geographic markets cannot be forecasted with any certainty given current economic trends and the historical volatility experienced in this market.

Sales in the Measurement Segment decreased $433,884, or 8.4%, to $4,738,130 in Fiscal 2013 compared to $5,172,014 in Fiscal 2012. Sales of laser-based distance measurement and dimensional-sizing products decreased $379,667, or 10.9%, primarily due to a large sale during the fourth quarter of Fiscal 2012 that was not repeated in the fourth quarter of Fiscal 2013. Sales of remote tank monitoring products increased $295,771 to $876,653 during Fiscal 2013 due to the higher volume of shipments and the developing monitoring revenues associated with unit sales. Sales of laser-based surface measurement products decreased $360,963, or 40.8%, primarily due to slowing demand for these products. Future sales of laser-based or ultrasonic measurement products cannot be forecasted with any certainty given the historical volatility experienced in this market.

Gross margin Gross margin in Fiscal 2014 decreased to 46.4% compared to 48.9% in Fiscal 2013. The variance in gross margin was primarily due to shifts in the product sales mix involving our five product lines and the impact of increased costs associated with the products sold. Gross margin in Fiscal 2013 increased to 48.9% compared to 43.9% in Fiscal 2012. This increase was primarily due to the impact of lower sales volumes through the Asian distribution channels, which typically have higher discounts and lower margins, and as a result of the Company s efforts to reduce the material costs from certain key suppliers and a shift in the product sales mix towards higher margin products.

Operating expenses Operating expenses decreased $518,521, or 7.8%, to $6,138,551 for Fiscal 2014 compared to $6,657,072 in Fiscal 2013. General, administrative and sales expenses decreased $420,490, or 6.9%, to $5,663,121 in Fiscal 2014 compared to $6,083,611 in the prior year. This decrease was the result of lower sales and marketing and travel and entertainment expenses. Research and development expenses decreased $98,031, or 17.1%, to $475,430 in Fiscal 2014 compared to $573,461 in Fiscal 2013. The decrease in research and development expense was primarily due to the completion of some of the development projects within our existing product lines.

Operating expenses increased $371,720, or 5.9%, to $6,657,072 for Fiscal 2013 compared to $6,285,352 in Fiscal 2012. General, administrative and sales expenses increased $116,252, or 1.9%, to $6,083,611 in Fiscal 2013 compared to $5,967,359 in the prior year. This increase was due primarily to higher expenses associated with an international trade show that occurs every two years. Research and development expenses increased $255,468, or 80.3%, to $573,461 in Fiscal 2013 compared to $317,993 in Fiscal 2012. The increase in research and development expense was primarily due to new product development and product enhancements related to existing product lines.

Other income (expense) Other income (expense) consists of interest income, foreign currency exchange gain (loss) and other income (expense). Interest income was $1,558, $1,226 and $1,726 in Fiscal 2014, 2013 and 2012, respectively. Fluctuations in interest income are impacted by the levels of our average cash and investment balances and changes in interest rates. Foreign currency exchange loss was $23,375 in Fiscal 2014. Foreign currency exchange gain was $12,884 and $17,565 in Fiscal 2013 and 2012, respectively. The foreign currency exchange gain (loss) fluctuated with the strength of foreign currencies against the U.S. dollar during the respective periods. In Fiscal 2014, other income consisted of a gain in the amount of $13,667 on the sale of fixed assets.

Income tax provision The effective tax rate in Fiscal 2014 was 1.8%. The effective tax rate on consolidated net loss in Fiscal 2014 differed from the federal statutory tax rate primarily due to changes in the deferred tax valuation allowance and certain expenses not being deductible for income tax reporting, offset by tax credits related to research and experimentation expenses. The effective tax rate in Fiscal 2013 was (1.5)%. The effective tax rate on consolidated net loss in Fiscal 2013 differed from the federal statutory tax rate primarily due to changes in the deferred tax valuation allowance and certain expenses not being deductible for income tax reporting offset by tax credits related to research and experimentation expenses. The effective tax rate in Fiscal 2012 was 18.1%. The effective tax rate on consolidated net income in Fiscal 2012 differed 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, offset by tax credits related to research and experimentation expenses.

Net income (loss) Net loss decreased $258 to a net loss of $539,624, or $0.18 per diluted share, for Fiscal 2014 as compared to net loss of $539,882, or $0.18 per diluted share, for Fiscal 2013. Net loss for Fiscal 2014 reflected decreased sales and a lower gross margin percentage, which was partially offset by reduced operating expenses. Net income decreased $617,303 to a net loss of $539,882, or $0.18 per diluted share, for Fiscal 2013 as compared to net income of $77,421, or $0.03 per diluted share, for Fiscal 2012. Net income (loss) decreased due primarily to lower sales and related gross profit, higher research and development expenses and higher general, administrative and selling expenses, offset by higher gross margin percentage during Fiscal 2013.

LIQUIDITY AND CAPITAL RESOURCES

The Company s working capital decreased $123,877 to $7,478,073 as of May 31, 2014 compared to $7,601,950 as of May 31, 2013. Cash and cash equivalents decreased $398,506 from $1,909,071 as of May 31, 2013 to $1,510,565 as of May 31, 2014.

Cash used in operating activities was $392,376 in Fiscal 2014 as compared to cash used in operations of $679,112 in Fiscal 2013. The decrease in the amount of cash used for operating activities was primarily due to the reduction in inventories, offset by the decrease in accounts payable and accrued liabilities and the increase in accounts receivable.

At May 31, 2014, accounts receivable increased $254,509 to $2,235,194 compared to $1,980,685 as of May 31, 2013. The increase in accounts receivable was due to the timing of receipts. Inventories decreased $264,265 to $4,789,822 as of May 31, 2014 compared to $5,054,087 at May 31, 2013 as a result of our targeted inventory purchase program

which was focused on right-sizing the levels of inventories held for each of the Company s product lines. At May 31, 2014, total current liabilities decreased $398,396 to $1,211,084 as compared to $1,609,480 at May 31, 2013. The decrease was primarily due to the timing of payments on accounts payable and lower accruals for commissions resulting from the decrease in sales, offset by an increase in other accrued liabilities.

During the year ended May 31, 2014, net cash used in investing activities was $36,692, which primarily consisted of additions to property and equipment for new manufacturing equipment, offset by the disposition of one of the Company s vehicles.

The Company has a $2.0 million bank line of credit secured by U.S. accounts receivable, inventories, general intangibles, and a depository account. Interest is payable at the bank s prime rate (3.25% as of May 31, 2014), or LIBOR plus 2.0%, (2.15% as of May 31, 2014). The agreement expires on September 1, 2014. There were no outstanding balances on the line of credit at May 31, 2014 and 2013.

We believe that our existing cash and investments combined with the cash we anticipate to generate from operating activities, and our available line of credit and financing available from other sources will be sufficient to meet our cash requirements for the foreseeable future. We do not have any significant commitments nor are we aware of any significant events or conditions that are likely to have a material impact on our liquidity or capital resources.

QUARTERLY FINANCIAL DATA

In thousands, except per share information (unaudited)

2013 Quarter Ended	August 31	November 30	February 28	May 31
Sales	$ 3,681	$ 2,702	$ 2,796	$ 3,273
Gross profit	$ 1,874	$ 1,542	$ 1,358	$ 1,321
Net income (loss)	$ 120	$ (105)	$ (191)	$ (364)
Net income (loss) per share, basic	$ .04	$ (.03)	$ (.06)	$ (.12)
Net income (loss) per share, diluted	$ .04	$ (.03)	$ (.06)	$ (.12)

2014 Quarter Ended	August 31	November 30	February 28	May 31
Sales	$ 2,899	$ 3,143	$ 3,066	$ 3,026
Gross profit	$ 1,331	$ 1,468	$ 1,458	$ 1,369
Net loss	$ (147)	$ (163)	$ (72)	$ (158)
Net loss per share, basic	$ (.05)	$ (.05)	$ (.02)	$ (.05)
Net loss per share, diluted	$ (.05)	$ (.05)	$ (.02)	$ (.05)

Item 7A. Quantitative and Qualitative Disclosures about Market Risk
Interest Rate Risk

The Company did not have any derivative financial instruments as of May 31, 2014. However, the Company could be exposed to interest rate risk at any time in the future and, therefore, employs established policies and procedures to manage its exposure to changes in the market risk of its cash equivalents.

The Company s interest income and expense are most sensitive to changes in the general level of U.S. and European interest rates. In this regard, changes in U.S. and European interest rates affect the interest earned on the Company s interest bearing cash equivalents and short term investments. The Company has a variable rate line of credit facility with a bank, but there is no outstanding balance as of May 31, 2014. Also, there is no other long-term obligation whose interest rates are based on variable rates that may fluctuate over time based on economic changes in the environment. Therefore, at this time, the Company is not subject to interest rate risk on outstanding interest bearing obligations if market interest rates fluctuate and does not expect any change in the interest rates to have a material effect on the Company s results from operations.

Foreign Currency Risk

The Company markets and sells its products worldwide and international sales have accounted for and are expected to continue to account for a significant portion of future revenue. The Company operates a subsidiary in the United Kingdom and acquires certain materials and services from vendors transacted in foreign currencies. Therefore, the Company s business and financial condition is sensitive to currency exchange rates or any other restrictions imposed on their currencies. For Fiscal 2014, 2013 and 2012, results of operations included gains (losses) on foreign currency translation of $(23,375), $12,884 and $17,565, respectively. The foreign exchange gains or losses in Fiscal 2014, 2013 and 2012 are primarily attributable to Company s United Kingdom subsidiary, Schmitt Europe, Ltd.

Item 8. Financial Statements and Supplementary Data

SCHMITT INDUSTRIES, INC.

CONSOLIDATED BALANCE SHEETS

	May 31, 2014	May 31, 2013
ASSETS		
Current assets		
Cash and cash equivalents	$ 1,510,565	$ 1,909,071
Accounts receivable, net	2,235,194	1,980,685
Inventories	4,789,822	5,054,087
Prepaid expenses	152,237	219,492
Income taxes receivable	1,339	48,095
	8,689,157	9,211,430
Property and equipment, net	1,191,591	1,334,890
Other assets		
Intangible assets, net	943,643	1,078,278
TOTAL ASSETS	$ 10,824,391	$ 11,624,598
LIABILITIES & STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 512,219	$ 918,094
Accrued commissions	204,772	273,307
Accrued payroll liabilities	127,035	131,772
Other accrued liabilities	366,848	286,307
Income taxes payable	210	0
Total current liabilities	1,211,084	1,609,480
Commitments and contingencies (Note 5)		
Stockholders equity		
Common stock, no par value, 20,000,000 shares authorized, 2,995,910 shares issued and outstanding at May 31, 2014 and 2,990,910 shares issued and outstanding at May 31, 2013	10,438,750	10,369,524
Accumulated other comprehensive loss	(263,337)	(331,924)
Accumulated deficit	(562,106)	(22,482)
Total stockholders equity	9,613,307	10,015,118
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 10,824,391	$ 11,624,598

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

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

	Year Ended May 31,		
	2014	2013	2012
Net sales	$ 12,134,506	$ 12,452,252	$ 14,437,022
Cost of sales	6,508,360	6,357,452	8,094,386
Gross profit	5,626,146	6,094,800	6,342,636
Operating expenses:			
General, administration and sales	5,663,121	6,083,611	5,967,359
Research and development	475,430	573,461	317,993
Total operating expenses	6,138,551	6,657,072	6,285,352
Operating income (loss)	(512,405)	(562,272)	57,284
Other income (expense)	(17,887)	14,106	37,260
Income (loss) before income taxes	(530,292)	(548,166)	94,544
Provision (benefit) for income taxes	9,332	(8,284)	17,123
Net income (loss)	$ (539,624)	$ (539,882)	$ 77,421
Net income (loss) per common share, basic	$ (0.18)	$ (0.18)	$ 0.03
Weighted average number of common shares, basic	2,995,910	2,990,910	2,930,314
Net income (loss) per common share, diluted	$ (0.18)	$ (0.18)	$ 0.03
Weighted average number of common shares, diluted	2,995,910	2,990,910	2,944,081
Comprehensive loss			
Net income (loss)	$ (539,624)	$ (539,882)	$ 77,421
Foreign currency translation adjustment	68,587	(18,629)	(86,714)
Total comprehensive loss	$ (471,037)	$ (558,511)	$ (9,293)

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

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended May 31,		
	2014	2013	2012
Cash flows relating to operating activities			
Net income (loss)	$ (539,624)	$ (539,882)	$ 77,421
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	328,293	347,715	344,553
(Gain) loss on disposal of property and equipment	(13,667)	0	(18,014)
Stock based compensation	57,726	89,888	199,396
Tax benefit related to stock options	0	0	(1,134)
(Increase) decrease in:			
Accounts receivable	(224,309)	510,531	(686,578)
Inventories	292,594	(1,082,931)	159,002
Prepaid expenses	69,201	(33,509)	(20,529)
Income taxes receivable	46,756	(40,315)	(7,780)
Increase (decrease) in:			
Accounts payable	(411,954)	149,574	(66,729)
Accrued liabilities and customer deposits	2,398	(80,183)	185,863
Income taxes payable	210	0	(2,073)
Net cash provided by (used in) operating activities	(392,376)	(679,112)	163,398
Cash flows relating to investing activities			
Purchase of property and equipment	(56,192)	(175,835)	(277,045)
Proceeds from sale of property and equipment	19,500	0	47,180
Decrease (increase) in other long term assets	0	291	1,745
Net cash used in investing activities	(36,692)	(175,544)	(228,120)
Cash flows relating to financing activities			
Common stock issued on exercise of stock options	11,500	0	136,330
Increase in line of credit	400,000	0	0
Payments on line of credit	(400,000)	0	0
Excess tax benefit from stock-based compensation	0	0	1,134
Net cash provided by financing activities	11,500	0	137,464
Effect of foreign exchange translation on cash	19,062	(13,090)	(56,431)
Increase (decrease) in cash and cash equivalents	(398,506)	(867,746)	16,311
Cash and cash equivalents, beginning of period	1,909,071	2,776,817	2,760,506
Cash and cash equivalents, end of period	$ 1,510,565	$ 1,909,071	$ 2,776,817

Supplemental disclosure of cash flow information			
Cash paid during the year for income taxes	$ 8,989	$ 39,635	$ 19,476
Cash paid during the year for interest	$ 9,159	$ 0	$ 0

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

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

	Shares	Amount	Accumulated other comprehensive loss	Retained earnings	Total
Balance, May 31, 2011	2,895,635	$ 9,943,910	$ (226,581)	$ 439,979	$ 10,157,308
Stock options exercised net of related tax benefit of $1,134	95,275	136,330	0	0	136,330
Stock based compensation	0	199,396	0	0	199,396
Net income	0	0	0	77,421	77,421
Other comprehensive loss	0	0	(86,714)	0	(86,714)
Balance, May 31, 2012	2,990,910	10,279,636	(313,295)	517,400	10,483,741
Stock based compensation	0	89,888	0	0	89,888
Net loss	0	0	0	(539,882)	(539,882)
Other comprehensive loss	0	0	(18,629)	0	(18,629)
Balance, May 31, 2013	2,990,910	10,369,524	(331,924)	(22,482)	10,015,118
Stock options exercised net of related tax benefit of $0	5,000	11,500	0	0	11,500
Stock based compensation	0	57,726	0	0	57,726
Net loss	0	0	0	(539,624)	(539,624)
Other comprehensive income	0	0	68,587	0	68,587
Balance, May 31, 2014	2,995,910	$ 10,438,750	$ (263,337)	$ (562,106)	$ 9,613,307

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

Schmitt Industries, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED MAY 31, 2014, 2013 AND 2012

NOTE 1

THE COMPANY

Schmitt Industries, Inc. (the Company) designs, manufactures, and sells high precision test and measurement products for two main business segments: the Balancer Segment and the Measurement Segment. The Company designs, manufactures, and sells computer-controlled vibration detection, balancing and process control systems for the worldwide machine tool industry, particularly for grinding machines (the Balancer Segment). Through its wholly owned subsidiary, Schmitt Measurement Systems, Inc., the Company designs, manufactures and sells laser and white light sensors for distance, dimensional and area measurement products for a variety of scientific applications, and ultrasonic measurement products that accurately measure the liquid levels of propane tanks and transmit that data via satellite to a secure web site for display (the Measurement Segment).

NOTE 2

SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

These consolidated financial statements include those of the Company and its wholly owned subsidiaries: Schmitt Measurement Systems, Inc. (SMS), Schmitt Europe, Ltd. (SEL) and Schmitt Industries (Canada) Limited. All significant intercompany accounts and transactions have been eliminated in the preparation of the consolidated financial statements.

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. The Company estimates customer product returns based on historical return patterns and reduces sales and cost of sales accordingly.

Cash Equivalents

The Company generally invests excess cash in money market funds and investment grade highly liquid securities. The Company considers securities that are highly liquid, readily convertible into cash and have original maturities of less than three months when purchased to be cash equivalents. The Company s cash consists of demand deposits in large financial institutions. At times, balances may exceed federally insured limits.

Accounts Receivable

The Company maintains credit limits for all customers based upon several factors, including but not limited to financial condition and stability, payment history, published credit reports and use of credit references. Management performs various analyses to evaluate accounts receivable balances to ensure recorded amounts reflect estimated net realizable value. This review includes using accounts receivable agings, other operating trends and relevant business conditions, including general economic factors, as they relate to each of the Company s domestic and international customers. If these analyses lead management to the conclusion that potential significant accounts are uncollectible, a reserve is provided. The allowance for doubtful accounts was $63,297 and $30,576 as of May 31, 2014 and 2013, respectively.

Schmitt Industries, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED MAY 31, 2014, 2013 AND 2012

Inventories

Inventories are 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 May 31 inventories consisted of:

	2014	2013
Raw materials	$ 1,888,985	$ 2,225,295
Work-in-process	994,009	1,132,534
Finished goods	1,906,828	1,696,258
	$ 4,789,822	$ 5,054,087

Property and Equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over estimated useful lives of three to seven years for furniture, fixtures, and equipment; three years for vehicles; and twenty-five years for buildings and improvements. Expenditures for maintenance and repairs are charged to expense as incurred. As of May 31 property and equipment consisted of:

	2014	2013
Land	$ 299,000	$ 299,000
Buildings and improvements	1,805,951	1,805,951
Furniture, fixtures and equipment	1,370,131	1,312,028
Vehicles	86,838	121,835
	3,561,920	3,538,814
Less accumulated depreciation	(2,370,329)	(2,203,924)
	$ 1,191,591	$ 1,334,890

Intangible Assets

Amortizable intangible assets, which include purchased technology and patents, are amortized over their estimated useful lives ranging from five to seventeen years. As of May 31, 2014 and 2013, amortizable intangible assets were

$2,200,883, and accumulated amortization was $1,257,240 and $1,122,604, respectively. Amortization expense for each of the following years ending May 31 is expected to be as follows:

Year ending May 31,	
2015	$ 119,233
2016	111,531
2017	111,531
2018	104,583
2019	104,583
Thereafter	392,182
	$ 943,643

Intangible and other long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. Recoverability is determined by comparing the forecasted future net cash flows from the operations to which the assets relate, based on management s best estimates using the appropriate assumptions and projections at the time, to the carrying amount of the assets. If the carrying value is determined to be in excess of future operating cash flows, the asset is considered impaired and a loss is recognized equal to the amount by which the carrying amount exceeds the estimated fair value of the assets. As of May 31, 2014, no impairment existed.

Schmitt Industries, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED MAY 31, 2014, 2013 AND 2012

Foreign Currency

Financial statements for the Company s subsidiaries outside the United States are translated into U.S. dollars at year-end exchange rates for assets and liabilities and weighted average exchange rates for income and expenses. The resulting translation adjustments are included as a separate component of stockholders equity titled Accumulated Other Comprehensive Loss. Transaction gains and losses are included in net income (loss).

Advertising

Advertising costs included in general, administration and sales, are expensed when the advertising first takes place. Advertising expense was $45,155, $82,289 and $98,093 for the years ended May 31, 2014, 2013 and 2012, respectively.

Research and Development Costs

Research and development costs, predominately internal labor costs and costs of materials, are charged to expense when incurred.

Warranty Reserve

Warranty costs are estimated and charged to operations to cover a defined warranty period. The estimated warranty cost is based on the history of warranty claims for each particular product type. For new product types without a warranty history, preliminary estimates are based on historical information for similar product types. The warranty reserve accruals, included in other accrued liabilities, are reviewed periodically and updated based on warranty trends.

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. The Company requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options based on estimated fair values.

Stock-based compensation recognized during the period is based on the value of the portion 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.

Income Taxes

The Company applies the asset and liability method in recording income taxes, under which deferred income tax assets and liabilities are determined, based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using currently enacted tax rates and laws. Additionally, deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the deferred tax asset will not be realized. Management continues to review the level of the valuation allowance on a quarterly basis.

There can be no assurance that the Company s future operations will produce sufficient earnings so that the deferred tax asset can be fully utilized. The Company currently maintains a full valuation allowance against net deferred tax assets.

Schmitt Industries, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED MAY 31, 2014, 2013 AND 2012

Earnings (Loss) Per Share

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. 7,636, 13,002 and 0 potentially dilutive common shares from outstanding stock options have been excluded from diluted earnings (loss) per share for the years ended May 31, 2014, 2013 and 2012, respectively.

Concentration of Credit Risk

Financial instruments that potentially expose the Company to concentration of credit risk are trade accounts receivable. Credit terms generally include a discount of 1.5% if the invoice is paid within ten days, with the net amount payable in 30 days.

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) approximates fair value because of their short-term maturities.

Shipping and Handling Charges

The Company incurs costs related to shipping and handling of its manufactured products. These costs are expensed as incurred as a component of cost of sales. Shipping and handling charges related to the receipt of raw materials are also incurred, which are recorded as a cost of the related inventory.

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

NOTE 3

LINE OF CREDIT

The Company has a $2 million bank line of credit secured by U.S. accounts receivable, inventories, general intangibles and a depository account. The line of credit is subject to certain covenant requirements if draws on the line

are executed. Interest is payable at the bank s prime rate (3.25% as of May 31, 2014) or LIBOR plus 2.0%, (2.15% as of May 31, 2014). The line expires September 1, 2014. The outstanding balance on the line of credit was $0 of May 31, 2014 and 2013.

NOTE 4

INCOME TAXES

The provision for income taxes is as follows:

	Year ended May 31,		
	2014	2013	2012
Current	$ 9,332	$ (8,284)	$ 17,123
Deferred	(155,252)	(283,447)	(6,753)
Change in valuation allowance	155,252	283,447	6,753
Total provision for income taxes	$ 9,332	$ (8,284)	$ 17,123

Schmitt Industries, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED MAY 31, 2014, 2013 AND 2012

Deferred tax assets are comprised of the following components:

	2014	2013
Basis difference of assets	$ 346,939	$ 311,441
Inventory related items	269,916	271,790
Other reserves and liabilities	80,513	81,482
Net operating loss carryforward	880,373	752,372
General business and other credit carryforward	437,786	443,190
Other deferred items, net	1,994	1,994
Gross deferred tax assets	2,017,521	1,862,269
Deferred tax asset valuation allowance	(2,017,521)	(1,862,269)
Net deferred tax asset	$ 0	$ 0

Deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the deferred tax asset will not be realized. The Company has recorded a substantial deferred tax asset related to temporary differences between book and tax bases of assets and liabilities. During the years ended May 31, 2014, 2013 and 2012, the Company increased its valuation allowance $155,252, $283,447, and $6,753 respectively, as a result of the increase in the Company s deferred tax assets. The Company has provided a full valuation allowance against all of its deferred tax assets as the recent losses have been given more weight than projected future income when determining the need for a valuation allowance.

The Company has federal net operating loss carryforwards of approximately $1.9 million which expire in 2030, 2033 and 2034 along with the federal general business and other credit carryforwards. The Company has state net operating loss carryforwards of approximately $2.5 million which expire in 2024, 2025, 2028 and 2029.

The provision for income taxes differs from the amount of income taxes determined by applying the U.S. statutory federal tax rate to pre-tax loss due to the following:

	Year ended May 31,		
	2014	2013	2012
Statutory federal tax rate	(34.0)%	(34.0)%	34.0%
State taxes, net of federal benefit	(4.4)	(4.4)	4.4
Change in deferred tax valuation allowance	29.3	51.7	7.1
Stock-based compensation	4.2	6.3	71.7
R&E tax credits	1.5	(17.7)	(42.3)
Effect of foreign income tax rates	1.8	1.9	3.2

Permanent and other differences	3.4	(5.3)	(60.0)
Effective tax rate	1.8%	(1.5)%	18.1%

Each year the Company files income tax returns in the various federal, 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, derecognition, classification, accounting for interest and penalties, accounting in interim periods, disclosure, and transition. The liability for unrecognized tax benefits was $0 as of May 31, 2014 and 2013.

Schmitt Industries, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEARS ENDED MAY 31, 2014, 2013 AND 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 May 31, 2014 and 2013.

Several tax years are subject to examination by major tax jurisdictions. In the United States, federal tax years for Fiscal 2011 and after are subject to examination. In the United Kingdom, tax years for Fiscal 2012 and after are subject to examination. In Canada, tax years for Fiscal 2005 and after are subject to examination.

NOTE 5

COMMITMENTS AND CONTINGENCIES

The Company entered into a 5-year lease of manufacturing equipment in May 2014. The lease is classified as a capital lease and the asset, valued at $38,890, is included in the furniture, fixtures and equipment amount in Note 2 Property and Equipment as of May 31, 2014.

The future minimum lease payments under the capital lease for each of the years ending May 31 are as follows:

Year ending May 31,	
2015	$ 9,019
2016	9,019
2017	9,019
2018	9,019
2019	9,019
Thereafter	3,887
Total minimum lease payments	48,982
Less: amount representing interest	(10,092)
Present value of minimum lease payments [1]	$ 38,890

(1) Reflected in other accrued liabilities on the balance sheet as of May 31, 2014.

The Company leases certain facilities and equipment to support operations under non-cancelable operating leases and other contractual obligations. Total lease expense under operating leases for the years ended May 31, 2014, 2013 and 2012 amounted to $58,517, $56,721 and $75,005, respectively.

The future minimum commitments under operating leases for each of the years ending May 31 are as follows:

Year ending May 31,	
2015	$ 40,633
2016	40,633
2017	32,886
2018	0
2019	0
Thereafter	0

In a transaction related to the acquisition of Schmitt Measurement Systems, Inc., formerly TMA Technologies, Inc. (TMA), the Company established a royalty pool and vested in each shareholder and debt holder of the acquired company an interest in the royalty pool equal to the amount invested or loaned including interest payable through March 1995. The royalty pool is funded at 5% of net sales (defined as gross sales less returns, allowances and sales commissions) of the Company s surface measurement products and future derivative products developed by Schmitt Industries, Inc., which utilize these technologies. As part of the royalty pool agreement, each former shareholder and debt holder released TMA from any claims with regard to the acquisition except their rights to future royalties. Royalty expense applicable to the years ended May 31, 2014, 2013 and 2012 amounted to $30,386, $28,797 and $40,840, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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In a transaction related to the acquisition of Xtero Datacom Inc., a British Columbia corporation (Xtero), former Xtero shareholders were eligible to receive shares of stock that were exchangeable for shares of Schmitt common stock on a one-for-one basis based on 50% of the after-tax earnings derived from Xtero products during a five-year earn-out program that ended on May 31, 2013. This additional consideration would have increased the value of the intangible asset recorded in connection with the acquisition. No additional shares of stock were issued to former Xtero shareholders during the five-year earn-out program.

NOTE 6

SEGMENT INFORMATION

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

	Year Ended May 31,					
	2014		2013		2012	
	Balancer	Measurement	Balancer	Measurement	Balancer	Measurement
Gross sales	$ 8,675,628	$ 4,472,945	$ 8,546,010	$ 4,796,620	$ 10,194,525	$ 5,231,238
Intercompany sales	(954,417)	(59,650)	(831,888)	(58,490)	(929,517)	(59,224)
Net sales	$ 7,721,211	$ 4,413,295	$ 7,714,122	$ 4,738,130	$ 9,265,008	$ 5,172,014
Operating income (loss)	$ (316,863)	$ (195,542)	$ (63,622)	$ (498,650)	$ 422,528	$ (365,244)
Depreciation expense	$ 137,808	$ 55,849	$ 142,288	$ 70,794	$ 142,576	$ 67,342
Amortization expense	$ 0	$ 134,636	$ 0	$ 134,633	$ 0	$ 134,635
Capital expenditures	$ 56,192	$ 0	$ 80,492	$ 95,343	$ 129,148	$ 147,897

Geographic Information

	Year Ended May 31,		
	2014	2013	2012
North America	$ 7,474,067	$ 8,413,970	$ 9,074,152
Europe			