SCHMITT INDUSTRIES INC
Form 10-Q
October 09, 2009
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: August 31, 2009

Or

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

For the transition period from: ______ To: ______

Commission File Number: 000-23996

SCHMITT INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

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

2765 NW Nicolai Street, Portland, Oregon 97210-1818

(Address of principal executive offices) (Zip Code)

(503) 227-7908

(Registrant s telephone number, including area code)

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

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

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

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

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

The number of shares of each class of common stock outstanding as of September 30, 2009

Common stock, no par value	2,894,802

Table of Contents

SCHMITT INDUSTRIES, INC.

INDEX TO FORM 10-Q

		Page
Part I - FINANCIAL INFORMATION		
Item 1.	Financial Statements:	
	Consolidated Balance Sheets: August 31, 2009 and May 31, 2009 (unaudited)	3
	Consolidated Statements of Operations: For the Three Months Ended August 31, 2009 and 2008 (unaudited)	4
	Consolidated Statements of Cash Flows: For the Three Months Ended August 31, 2009 and 2008 (unaudited)	5
	Consolidated Statement of Changes in Stockholders Equity and Comprehensive Income: For the Three Months Ended August 31, 2009 (unaudited)	6
	Notes to Consolidated Interim Financial Statements	7
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	13
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	18
Item 4.	Controls and Procedures	19
Part II - OTHER INFORMATION		
Item 6.	Exhibits	20
Signatures		
Certifications		

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

SCHMITT INDUSTRIES, INC.

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	August 31, 2009	May 31, 2009
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,661,928	$ 4,174,335
Short-term investments	1,000,000	
Accounts receivable, net of allowance of $38,578 and $38,233 at August 31, 2009 and May 31, 2009, respectively	921,855	1,110,850
Inventories	3,953,782	3,866,971
Prepaid expenses	99,603	171,178
Income taxes receivable	330,908	330,134
	8,968,076	9,653,468
Property and equipment		
Land	299,000	299,000
Buildings and improvements	1,564,880	1,564,880
Furniture, fixtures and equipment	1,023,280	1,037,346
Vehicles	90,452	90,452
	2,977,612	2,991,678
Less accumulated depreciation and amortization	(1,568,456)	(1,563,840)
	1,409,156	1,427,838
Other assets		
Intangible assets	1,515,494	1,542,694
TOTAL ASSETS	$ 11,892,726	$ 12,624,000
LIABILITIES & STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 212,597	$ 335,609
Accrued commissions	127,055	172,755
Accrued payroll liabilities	223,378	228,887
Other accrued liabilities	166,986	168,325
Total current liabilities	730,016	905,576
Long-term liabilities	3,993	
Stockholders equity		
Common stock, no par value, 20,000,000 shares authorized, 2,870,160 shares issued and outstanding at both August 31, 2009 and May 31, 2009	9,569,990	9,545,678

Accumulated other comprehensive loss	(192,651)	(183,629)
Retained earnings	1,781,378	2,356,375
Total stockholders equity	11,158,717	11,718,424
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 11,892,726	$ 12,624,000

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

Table of Contents

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE MONTHS ENDED AUGUST 31, 2009 AND 2008

(UNAUDITED)

	Three Months Ended August 31,	
	2009	2008
Net sales	$ 1,223,234	$ 3,193,385
Cost of sales	674,145	1,536,005
Gross profit	549,089	1,657,380
Operating expenses:		
General, administration and sales	960,707	1,322,918
Research and development	173,044	247,219
Total operating expenses	1,133,751	1,570,137
Operating income (loss)	(584,662)	87,243
Other income	9,665	20,231
Income (loss) before income taxes	(574,997)	107,474
Provision for income taxes		73,927
Net income (loss)	$ (574,997)	$ 33,547
Net income (loss) per common share:		
Basic	$ (0.20)	$ 0.01
Weighted average number of common shares, basic	2,870,160	2,870,160
Diluted	$ (0.20)	$ 0.01
Weighted average number of common shares, diluted	2,870,160	2,966,182

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

Table of Contents

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE MONTHS ENDED AUGUST 31, 2009 AND 2008

(UNAUDITED)

	Three Months Ended August 31, 2009	Three Months Ended August 31, 2008
Cash flows relating to operating activities		
Net income (loss)	$ (574,997)	$ 33,547
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	87,693	98,922
Gain on disposal of property and equipment	(1,200)	
Stock based compensation	24,312	79,695
(Increase) decrease in:		
Accounts receivable	191,186	250,213
Inventories	(85,740)	(85,323)
Prepaid expenses	64,086	32,846
Income taxes receivable	(980)	
Increase (decrease) in:		
Accounts payable	(123,719)	13,821
Accrued liabilities and customer deposits	(48,948)	(179,803)
Income taxes payable		5,118
Net cash provided by (used in) operating activities	(468,307)	249,036
Cash flows relating to investing activities		
Purchase of short-term investments	(1,000,000)	(1,008,794)
Maturities of short-term investments		1,000,000
Purchase of property and equipment	(34,226)	(92,674)
Proceeds from sale of property and equipment	1,200	
Net cash used in investing activities	(1,033,026)	(101,468)
Effect of foreign exchange translation on cash	(11,074)	(41,058)
Increase (decrease) in cash and cash equivalents	(1,512,407)	106,510
Cash and cash equivalents, beginning of period	4,174,335	3,020,131
Cash and cash equivalents, end of period	$ 2,661,928	$ 3,126,641
Supplemental Disclosure of Cash Flow Information		
Cash paid during the period for income taxes	$ 980	$ 68,809

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

Table of Contents

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

AND COMPREHENSIVE INCOME

FOR THE THREE MONTHS ENDED AUGUST 31, 2009

(UNAUDITED)

	Shares	Amount	Accumulated other comprehensive loss	Retained earnings	Total	Total comprehensive loss
Balance, May 31, 2009	2,870,160	$ 9,545,678	$ (183,629)	$ 2,356,375	$ 11,718,424	
Stock based compensation		24,312			24,312	
Net loss				(574,997)	(574,997)	$ (574,997)
Other comprehensive loss			(9,022)		(9,022)	(9,022)
Balance, August 31, 2009	2,870,160	$ 9,569,990	$ (192,651)	$ 1,781,378	$ 11,158,717	
Comprehensive loss, three months ended August 31, 2009						$ (584,019)

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

6

Table of Contents

SCHMITT INDUSTRIES, INC.

NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS

Note 1:

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial information included herein has been prepared by Schmitt Industries, Inc. (the Company or Schmitt) and its wholly owned subsidiaries. In the opinion of management, the accompanying unaudited Consolidated Financial Statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission and contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly its financial position as of August 31, 2009 and its results of operations and its cash flows for the periods presented. The consolidated balance sheet at May 31, 2009 has been derived from the Annual Report on Form 10-K for the fiscal year ended May 31, 2009. The accompanying unaudited financial statements and related notes should be read in conjunction with the audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended May 31, 2009. Operating results for the interim periods presented are not necessarily indicative of the results that may be experienced for the fiscal year ending May 31, 2010.

The Company has performed a review for subsequent events through the date of the filing of these financial statements with the Securities and Exchange Commission on October 9, 2009.

Revenue Recognition and Accounts Receivable

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 Staff Accounting Bulletin No. 104, Revenue Recognition, issued by the Securities and Exchange Commission in December 2003. For sales to all customers, including manufacturer representatives, distributors or their third-party customers, these criteria are met at the time product is shipped. When other significant obligations remain after products are delivered, revenue is recognized only after such obligations are fulfilled. In addition, judgments are required in evaluating the credit worthiness of our customers. Credit is not extended to customers and revenue is not recognized until we have determined that collectability is reasonably assured.

Financial Instruments

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

Recent Issued Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS 141(R)), which replaces SFAS No 141. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS is to be applied prospectively to business combinations for which the acquisition date is after May 31, 2009.

In May 2009, the FASB issued SFAS No 165, Subsequent Events (SFAS 165). SFAS 165 is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for selecting that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. SFAS 165 is effective for interim or annual financial periods ending after June 15, 2009. The Company has adopted SFAS 165.

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a Replacement of FASB Statement No. 162, which establishes the FASB

Table of Contents

Accounting Standards Codification (the Codification) as the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of this Statement, the Codification will supersede all then-existing non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the codification will become non-authoritative. This Statement is effective for financial statements issued for interim and annual periods after September 15, 2009.

Note 2:

INVENTORY

Inventory is valued at the lower of cost or market with cost determined on the average cost basis. Costs included in inventories consist of materials, labor and manufacturing overhead, which are related to the purchase or production of inventories. Write-downs, when required, are made to reduce excess inventories to their net realizable values. Such estimates are based on assumptions regarding future demand and market conditions. If actual conditions become less favorable than the assumptions used, an additional inventory write-down may be required. As of August 31, 2009 and May 31, 2009, inventories consisted of:

	Aug. 31, 2009	May 31, 2009
Raw materials	$ 1,521,233	$ 1,525,618
Work-in-process	738,141	730,609
Finished goods	1,694,408	1,610,744
	$ 3,953,782	$ 3,866,971

Note 3:

LINE OF CREDIT

In February 2009, the Company renewed its $1.0 million bank line of credit secured by U.S. accounts receivable, inventories and general intangibles that expires on March 1, 2011. Interest is payable at the bank s prime rate (3.25% as of August 31, 2009) or LIBOR plus 2.0% (2.26% as of August 31, 2009). There were no outstanding balances on the line of credit at August 31, 2009 and May 31, 2009.

Note 4:

STOCK OPTIONS AND STOCK-BASED COMPENSATION

Stock-based compensation includes expense charges for all stock-based awards to employees and directors granted under the Company s stock option plan. Stock-based compensation recognized during the period is based on the 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. Stock-based compensation recognized in the Company s Consolidated Financial Statements for the three months ended August 31, 2009 has been recognized in accordance with FAS123R. The Company uses the Black-Scholes option pricing model as its method of valuation for stock-based awards. The Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results. These variables include, but are not limited to:

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

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

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

Expected Dividend Yield. The Company has never paid any cash dividends on its common stock and does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero.

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

The Company has computed, to determine stock-based compensation expense recognized for those options granted during the three months ended August 31, 2009 and 2008, the value of all stock options granted using the Black-Scholes option pricing model using the following assumptions:

	Three Months Ended August 31,	
	2009	**2008**
Risk-free interest rate		4.0%
Expected life		4.8 years
Expected volatility		54.4%

At August 31, 2009, the Company had a total of 218,609 outstanding stock options (181,109 vested and exercisable and 37,500 non-vested) with a weighted average exercise price of $3.32. The Company estimates that a total of approximately $69,000 will be recorded as additional stock-based compensation expense during the remainder of the year ending May 31, 2010 for all options that were outstanding as of August 31, 2009, but which were not yet vested.

Outstanding Options			**Exercisable Options**	
Number of Shares	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life (yrs)**	**Number of Shares**	**Weighted Average Exercise Price**
76,110	$ 1.20	2.5	76,110	$ 1.20
62,499	2.30	4.8	62,499	2.30
5,000	5.80	6.2	5,000	5.80
75,000	6.16	8.7	37,500	6.16
218,609	$ 3.32	5.4	181,109	$ 2.73

Options granted, exercised, and forfeited or canceled under the Company s stock option plan during the three months ended August 31, 2009 are summarized as follows:

	Three Months Ended August 31, 2009	
	Number of Shares	**Weighted Average Exercise Price**
Options outstanding - beginning of period	218,609	$ 3.32
Options granted		
Options exercised		
Options forfeited/canceled		
Options outstanding - February 28, 2009	218,609	$ 3.32

Note 5:

EPS RECONCILIATION

	Three Months Ended August 31,	
	2009	**2008**
Weighted average shares (basic)	2,870,160	2,870,160
Effect of dilutive stock options		96,022
Weighted average shares (diluted)	2,870,160	2,966,182

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. 85,531 potentially dilutive common shares from outstanding stock options have been excluded from diluted earnings (loss) per share for the three months ended August 31, 2009.

Note 6:

INCOME TAXES

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

FIN 48

Each year the Company files income tax returns in the various national, state and local income taxing jurisdictions in which it operates. These tax returns are subject to examination and possible challenge by the taxing authorities. Positions challenged by the taxing authorities may be settled or appealed by the Company. As a result, there is an uncertainty in income taxes recognized in the Company s financial statements in accordance with SFAS No. 109. The Company applies FIN 48, which clarifies the application of SFAS 109 by defining criteria that an individual income tax position must meet for any part of the benefit of that position to be recognized in an enterprise s financial statements and provides guidance on measurement, de-recognition, classification, accounting for interest and penalties, accounting in interim periods, disclosure, and transition.

On June 1, 2007, the Company adopted the provisions of FIN 48. At June 1, 2007, the gross amount of unrecognized tax benefits was approximately $586,000, which included approximately $150,000 of net unrecognized tax benefits that, if recognized, would reduce the Company s effective income tax rate. During the third quarter of Fiscal 2009, the Company completed an examination of its federal tax returns for the years ended May 31, 2005 through 2007. The Company recognized tax benefits of approximately $150,000 during the three and nine months ended February 28, 2009. Other long-term liabilities related to tax contingencies were $0 as of August 31, 2009 and May 31, 2009.

Interest and penalties associated with uncertain tax positions are recognized as components of the Provision for income taxes. The Company s accrual for interest and penalties was $96,500 upon adoption of FIN 48. The liability for payment of interest and penalties was $0 as of August 31, 2009 and May 31, 2009. The liability for payment of interest and penalties decreased to $0 during the three and nine months ended February 28, 2009 due to the completion of the federal examination.

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

Table of Contents

Effective Tax Rate

Our effective tax rate on consolidated net loss was 0.0% for the three months ended August 31, 2009. Our effective tax rate on consolidated net loss differs 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 purposes offset by tax credits related to research and experimentation expenses. One of the items not deductible for income tax reporting is stock based compensation Management believes the effective tax rate for Fiscal 2010 will be approximately 0.0% due to the items noted above.

Note 7:

SEGMENTS OF BUSINESS

The Company has two reportable business segments: the design and assembly of dynamic balancing systems 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: North America, Europe and Asia.

Segment Information

	Three Months Ended August 31,			
	2009		2008	
	Balancer	Measurement	Balancer	Measurement
Gross sales	$ 1,018,261	$ 343,797	$ 2,495,021	$ 904,195
Intercompany sales	(136,139)	(2,685)	(193,099)	(12,732)
Net sales	$ 882,122	$ 341,112	$ 2,301,922	$ 891,463
Operating income (loss)	$ (345,208)	$ (239,454)	$ 180,953	$ (93,710)
Depreciation expense	$ 39,090	$ 25,413	$ 33,045	$ 12,132
Amortization expense	$	$ 23,190	$	$ 53,745
Capital expenditures	$ 33,046	$ 1,180	$ 78,254	$ 14,420

Geographic Information-Net Sales by Geographic Area

	Three Months Ended August 31,	
Geographic Sales	2009	2008
North American	$ 593,593	$ 1,666,858
European	271,285	485,529
Asia	341,932	939,915
Other markets	16,424	101,083
Total Net Sales	$ 1,223,234	$ 3,193,385

Three Months Ended August 31,			
2009		2008	
United States	Europe	United States	Europe

Operating income (loss)	$ (590,323)	$ 5,661	$ (18,907)	$ 106,150
Depreciation expense	$ 64,503	$	$ 45,020	$ 157
Amortization expense	$ 23,190	$	$ 53,745	$
Capital expenditures	$ 34,226	$	$ 92,674	$

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

Table of Contents

Segment and Geographic Assets

	August 31, 2009	May 31, 2009
Segment assets to total assets		
Balancer	$ 4,546,270	$ 4,674,279
Measurement	3,353,620	3,445,253
Corporate assets	3,992,836	4,504,468
Total assets	$ 11,892,726	$ 12,624,000
Geographic assets to long-lived assets		
United States	$ 1,409,156	$ 1,427,838
Europe		
Total assets	$ 1,409,156	$ 1,427,838
Geographic assets to total assets		
United States	$ 11,389,299	$ 12,042,035
Europe	503,427	581,965
Total assets	$ 11,892,726	$ 12,624,000

Note 8:

SUBSEQUENT EVENT

On September 30, 2009, the Company closed an Asset Purchase Agreement (the Agreement) with Optical Dimensions, a sole proprietorship (Optical) pursuant to which the Company acquired all of the assets and assumed certain liabilities of Optical. The Company will own and operate Optical s business, including its patented laser light scatter roughness measurement technology. The Agreement provided that the Company pay cash of $100,000 and issue 24,642 shares of common stock of the Company. The number of shares issued was equal to $100,000 in value based on the average closing price of the Company s common stock, as reported on the NASDAQ National Market, over the five-day period immediately prior to closing. The purchase price allocation has not yet been completed due to the timing of the closing.

Table of Contents

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

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

RESULTS OF OPERATIONS

Overview

Schmitt Industries, Inc. designs, manufactures and markets computer controlled vibration detection and balancing equipment (the Balancer Segment) primarily to the machine tool industry, and, through its wholly owned subsidiary, Schmitt Measurement Systems, Inc. (SMS), precision laser-based surface measurement products laser-based distance measurement products and ultrasonic measurement systems (the Measurement segment) for a variety of industrial applications worldwide. The Company also sells and markets its products in Europe through its wholly owned subsidiary, Schmitt Europe Ltd. (SEL), located in the United Kingdom. The Company is organized into two operating segments: the Balancer segment and the Measurement segment. The accompanying unaudited financial information should be read in conjunction with our Annual Report filed with the Securities and Exchange Commission (SEC) on Form 10-K for the fiscal year ended May 31, 2009.

For the three months ended August 31, 2009, total sales decreased $2.0 million, or 61.7%, to $1.2 million from $3.2 million in the three months ended August 31, 2008. Balancer segment sales primarily come from end-users, rebuilders and original equipment manufacturers of grinding machines with the target geographic markets of North America, Asia and Europe. Balancer segment sales decreased $1.4 million, or 61.7%, to $882,000 for the three months ended August 31, 2009 compared to $2.3 million for the three months ended August 31, 2008. The Measurement segment product line consists of both laser-based light-scatter and distance measurement and dimensional sizing products. Total Measurement segment sales decreased $550,000, or 61.7%, to $341,000 for the three months ended August 31, 2009 compared to $891,000 for the three months ended August 31, 2008.

In response to the significant decreases in revenues during the past year, the Company has been reducing its expenses across the entire Company. Operating expenses have decreased $436,000, or 27.8%, to $1.1 million for the three months ended August 31, 2009 from $1.6 million for the three months ended August 31, 2008. General, administration and sales expenses have decreased $362,000, or 27.4%, to $961,000 for the three months ended August 31, 2009 from $1.3 million for the same period in the prior year. Research and development expenses have decreased $74,000, or 30.0%, to $173,000 for the three months ended August 31, 2009 from $247,000 for the three months ended August 31, 2008. Net loss was $575,000, or $0.20 per fully diluted share, for the three months ended August 31, 2009 as compared to net income of $34,000, or $0.01 per fully diluted share, for the three months ended August 31, 2008.

Table of Contents

Critical Accounting Policies

There were no material changes in our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended May 31, 2009.

Recently Issued Accounting Pronouncements:

Refer to Note 1 of the Notes to Consolidated Interim Financial Statements for discussion of recently issued accounting pronouncements.

Discussion of Operating Results

	Three Months Ended August 31,			
	2009		2008	
Balancer sales	$ 882,122	0.72	$ 2,301,922	72.1%
Measurement sales	341,112	0.28	891,463	27.9%
Total sales	1,223,234	1.00	3,193,385	100.0%
Cost of sales	674,145	0.55	1,536,005	48.1%
Gross profit	549,089	0.45	1,657,380	51.9%
Operating expenses:				
General, administration and sales	960,707	0.79	1,322,918	41.4%
Research and development	173,044	0.14	247,219	7.7%
Total operating expenses	1,133,751	0.93	1,570,137	49.2%
Operating income (loss)	(584,662)	(0.48)	87,243	2.7%
Other income	9,665	0.01	20,231	0.6%
Income (loss) before income taxes	(574,997)	(0.47)	107,474	3.4%
Provision for income taxes		0.00	73,927	2.3%
Net income (loss)	$ (574,997)	(0.47)	$ 33,547	1.1%

Sales Sales in the Balancer segment decreased $1.4 million, or 61.7%, to $882,000 for the three months ended August 31, 2009 compared to $2.3 million for the three months ended August 31, 2008. This decrease is primarily due to lower unit sales volumes in Asia, North America and Europe during the first quarter of Fiscal 2010. Sales in Asia decreased $585,000, or 65.7%, for the three months ended August 31, 2009 as compared to the three months ended August 31, 2008. North American sales decreased $584,000, or 63.3%, in the three months ended August 31, 2009 compared to the same period in the prior year. European sales decreased $199,000, or 46.4%, in the first quarter of Fiscal 2010 compared to the first quarter of Fiscal 2009. Sales in other regions of the world decreased $52,000 in the first quarter of Fiscal 2010 as compared to the same period in Fiscal 2009. As with the North American market, the duration of the strength or weakness in demand in Asia and Europe cannot be forecasted with any certainty given the weaknesses in the global economy.

Sales in the Measurement segment decreased $550,000, or 61.7%, to $341,000 in the three months ended August 31, 2009 compared to $891,000 in the three months ended August 31, 2008. Sales of laser-based dimensional sizing products decreased $467,000, or 63.0%, in the three months ended August 31, 2009 as compared to the same period in the prior year primarily due to the lower volume of shipments in the current fiscal year. Sales of laser-based surface measurement products in the three months ended August 31, 2009 as compared to the same period in the prior year decreased $84,000, or 56.0%, as sales to disk drive and silicon wafer manufacturers decreased. These industries have undergone significant technological change and consolidation as manufacturers merged or exited the markets resulting in a redeployment of equipment rather than the making of additional investments in capital equipment, and future sales of laser-based surface measurement products cannot be forecasted with any certainty.

Gross margin Gross margin for the three months ended August 31, 2009 decreased to 44.9% as compared to 51.9% for the three months ended August 31, 2008. These decreases were due to changes in the product sales mix shifting toward lower margin products. Balancer margins were also negatively impacted as a result of higher sales in foreign markets as a large portion of those sales are made through distributors who receive favorable pricing.

Operating expenses Operating expenses decreased $436,000, or 27.8%, to $1.1 million for the three months ended August 31, 2009 as compared to $1.6 million for the three months ended August 31, 2008. General, administrative and selling expenses decreased $362,000, or 27.4%, for the three months ended August 31, 2009 as compared to the same period in the prior year primarily due to lower commissions related to the decrease in sales, lower personnel costs resulting from both salary reductions and mandatory furloughs and lower stock based compensation. Research and development expenses decreased $74,000, or 30.0%, as compared to the same period in the prior year primarily due to lower material costs associated with new product development associated with technologies acquired from Xtero and new product development related to existing product lines and lower personnel costs associated with salary reductions.

Other income Other income consists of interest income, foreign currency exchange gain (loss) and other income (expense). Interest income was $5,000 and $30,000 for the three months ended August 31, 2009 and 2008, respectively. Interest income has decreased due to lower interest rates and decreased cash and investment balances. Foreign currency exchange gains (losses) were $3,000 and $(10,000) for the three months ended August 31, 2009 and 2008, respectively. The increase in the gains is primarily due to the strengthening of foreign currencies against the US dollar during the current period.

Income tax provision The Company s effective tax rate on consolidated net loss was 0.0% for the three months ended August 31, 2009. The Company s effective tax rate on consolidated net loss differs 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 purposes offset by tax credits related to research and experimentation expenses. One of the items not deductible for income tax reporting is stock based compensation. Management believes the effective tax rate for Fiscal 2010 will be 0.0% due to the items noted above.

Net income Net income decreased $609,000 to a net loss of $575,000, or $0.20 per diluted share, for the three months ended August 31, 2009 as compared to net income of $34,000, or $0.01 per diluted share, for the three months ended August 31, 2008. Net income decreased due primarily to lower sales and related gross profit offset by lower general, administrative and selling expenses, lower research and development expenses and a lower effective tax rate during the three months ended August 31, 2009 and 2008.

LIQUIDITY AND CAPITAL RESOURCES

The Company s working capital decreased $510,000 to $8.2 million as of August 31, 2009 compared to $8.7 million as of May 31, 2009. Cash, cash equivalents and short term investments totaled $3.7 million and $4.2 million as of August 31, 2009 and May 31, 2009, respectively. As of August 31, 2009, the Company had $2.7 million in cash and cash equivalents on hand compared to $4.2 million at May 31, 2009. The Company had $1.0 million and $0 in short-term investments as of August 31, 2009 and May 31, 2009, respectively. The Company invested in $1.0 million of certificates of deposit during the first quarter of Fiscal 2010.

Cash used in operating activities totaled $468,000 for the three months ended August 31, 2009 as compared to cash provided by operating activities of $249,000 for the three months ended August 31, 2008. The decrease was primarily due to decreases in net income, accounts payable and other accrued liabilities and an increase in inventories offset by decreases in accounts receivable and prepaid expenses and increases in depreciation and amortization and stock based compensation.

At August 31, 2009, the Company had accounts receivable of $922,000 as compared to $1.1 million at May 31, 2009. The decrease in accounts receivable of $189,000 was due to the decrease in sales in the first quarter of Fiscal 2010. At August 31, 2009, total current liabilities decreased $176,000 to $730,000 as compared to $906,000 at May 31, 2009. The decrease was primarily due to the timing of payments and decreases in the levels of inventories purchased as compared to the prior year.

Table of Contents

During the three months ended August 31, 2009, net cash used in investing activities was $1.0 million, which consisted of net purchases of short-term investments of $1.0 million offset by additions to property and equipment of $34,000. Additions to property and equipment consisted primarily of new manufacturing and office equipment.

The Company has a $1.0 million bank line of credit agreement secured by U.S. accounts receivable, inventories and general intangibles. Interest is payable at the bank s prime rate (3.25% as of August 31, 2009), or LIBOR plus 2.0% (2.26% as of August 31, 2009), and the agreement expires on March 1, 2011. There were no outstanding balances on the line of credit at August 31, 2009 and May 31, 2009.

We believe that our existing cash, cash equivalents 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.

Business Risks

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 Item 2 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 known or unknown 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.

The general economic conditions and the global financial crisis 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 manufacturing sector, and their impact on levels of capital investment, which have recently deteriorated significantly and may remain 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, customers and suppliers access to credit, unemployment and other macroeconomic factors affecting commercial and industrial spending behavior.

The recent distress in the financial markets and global economy has resulted in reduced liquidity and a tightening of credit markets. 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 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 introduction of the Xact tank monitoring system may not become commercially viable and satisfy expected demand

On May 13, 2009, the Company announced the introduction of the Xact tank monitoring system for measuring fill levels of industrial liquefied propane tanks and communicating that data via satellite to a secure web site. Although the initial acquisition and further development of the Xact product has negatively impacted current operating results, the product should allow the Company to enter new measurement markets and is expected to add sales and profits to the Company in future years. However, the introduction of the Xact product may not be successful, anticipated market demand for the product may not materialize and additional product or market opportunities may not be identified and developed and brought to market in a timely and cost-effective manner, each of which could continue to negatively impact future operating results and result in large and immediate write-offs of recorded intangible asset balances.

Table of Contents

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

The failure to develop new technologies, or react to changes in existing technologies, could materially delay development of new products, which 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.

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.

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 companies 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, research and development and marketing resources. 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.

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.

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 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.

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.

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 that key technical and sales personnel can be retained or that

Table of Contents

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 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.

Changes in securities laws and regulations have increased and will 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 will continue to increase Company expenses as the Company devotes resources to ensure compliance with all applicable laws and regulations. In particular, the Company will incur significant additional administrative expense and a diversion of management s time in Fiscal 2010 to implement Section 404 of the Sarbanes-Oxley Act which requires management to report on, and the Company s independent registered public accounting firm to ultimately attest to, our internal control over financial reporting. The Company may also incur additional fees necessary for them to provide their attestation. 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 reduce 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.

The Company faces risks from international sales and currency fluctuations

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. 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 staffing and managing international operations; political and economic instability; general economic conditions; and fluctuations in 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.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Risk

The Company did not have any derivative financial instruments as of August 31, 2009. 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 marketable securities.

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 was no outstanding balance as of August 31, 2009. 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.

Table of Contents

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 the three months ended August 31, 2009 and 2008, results of operations included gains (losses) on foreign currency translation of $3,000 and $(10,000), respectively.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of August 31, 2009, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and the Company s Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures, as such term is defined in Rule 13a-15(e). Based on the evaluation, the Company s Chief Executive Officer and Chief Financial Officer have concluded that the Company s disclosure controls and procedures are not effective to ensure that information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. Management determined the controls around the preparation and review of income tax accounts did not operate effectively. These deficiencies, if left unremediated, could result in the failure to prevent or detect a material misstatement in the Company s consolidated financial statements.

Changes in Internal Control Over Financial Reporting

There has been no change in the Company s internal control over financial reporting that occurred during the Company s fiscal quarter ended August 31, 2009 that has materially affected, or is reasonably likely to materially affect, such internal control over financial reporting.

Table of Contents

PART II - OTHER INFORMATION

Item 6. Exhibits

Exhibit	Description
3.1	Second Restated Articles of Incorporation of Schmitt Industries, Inc. (the Company). Incorporated by reference to Exhibit 3(i) to the Company s Annual Report on Form 10-K for the fiscal year ended May 31, 1998.
3.2	Second Restated Bylaws of the Company. Incorporated by reference to Exhibit 3(ii) to the Company s Annual Report on Form 10-K for the fiscal year ended May 31, 1998.
4.1	See exhibits 3.1 and 3.2 for provisions of the Articles of Incorporation and Bylaws defining the rights of security holders.
31.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

SCHMITT INDUSTRIES, INC.
(Registrant)

Date: October 9, 2009

/s/ WAYNE A. CASE
Wayne A. Case,

Chairman of the Board and Chief Executive Officer

20