

STARRETT L S CO  
Form 10-Q  
November 06, 2008

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 27, 2008

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 1-367

THE L. S. STARRETT COMPANY  
(Exact name of registrant as specified in its charter)

MASSACHUSETTS  
(State or other jurisdiction of incorporation or organization)

04-1866480  
(I.R.S. Employer Identification No.)

121 CRESCENT STREET, ATHOL, MASSACHUSETTS  
(Address of principal executive offices)

01331-1915  
(Zip Code)

Registrant's telephone number, including area code 978-249-3551

Former name, address and fiscal year, if changed since last report

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  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):

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Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Smaller Reporting Company

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

YES  NO

Common Shares October 31, 2008  
outstanding as of

Class A Common Shares 5,726,457

Class B Common Shares 888,440

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THE L. S. STARRETT COMPANY

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## Part I. Financial Information

## Item 1. Financial Statements

THE L. S. STARRETT COMPANY  
 Consolidated Statements of Operations  
 (in thousands of dollars except per share data)(unaudited)

	13 Weeks Ended	
	9/27/08	9/29/07
Net sales	\$ 67,985	\$ 59,550
Cost of goods sold	(46,792)	(40,996)
Selling and general expense	(17,498)	(14,703)
Other income (expense)	535	(266)
Earnings before income taxes	4,230	3,585
Income tax expense	1,607	1,255
Net earnings	\$ 2,623	\$ 2,330
Basic and diluted earnings per share	\$ 0.40	\$ 0.35
Average outstanding shares used in per share calculations (in thousands):		
Basic	6,618	6,596
Diluted	6,627	6,605
Dividends per share	\$ 0.12	\$ 0.10

See Notes to Consolidated Financial Statements

THE L. S. STARRETT COMPANY  
Consolidated Statements of Cash Flows  
(in thousands of dollars)(unaudited)

	13 Weeks Ended	
	9/27/08	9/29/07
Cash flows from operating activities:		
Net earnings	\$ 2,623	\$ 2,330
Non-cash items included:		
Depreciation	2,356	2,374
Amortization	312	295
Net long-term tax payable	101	-
Deferred taxes	77	447
Unrealized transaction (gains) losses	(24)	202
Retirement benefits	(510)	(821)
Cumulative effect of adopting FIN 48	-	(312)
Working capital changes:		
Receivables	(2,231)	(3,115)
Inventories	(4,364)	2,184
Other current assets	(617)	907
Other current liabilities	(195)	(73)
Prepaid pension cost and other	978	345
Net cash (used in) provided by operating activities	(1,494)	4,763
Cash flows from investing activities:		
Additions to plant and equipment	(2,968)	(2,397)
(Increase) decrease in investments	3,299	(760)
Purchase of Kinemetric Engineering	-	(2,060)
Net cash (used in) provided by investing activities	331	(5,217)
Cash flows from financing activities:		
Proceeds from short-term borrowings	4,036	2,216
Short-term debt repayments	(420)	(2,144)
Long-term debt repayments	(134)	(115)
Common stock issued	156	111
Treasury shares purchased	-	(317)
Dividends	(794)	(660)
Net cash (used in) provided by financing activities	2,844	(909)
Effect of exchange rate changes on cash	(514)	30
Net increase (decrease) in cash	1,167	(1,333)
Cash, beginning of period	6,515	7,708
Cash, end of period	\$ 7,682	\$ 6,375

See Notes to Consolidated Financial Statements

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THE L. S. STARRETT COMPANY  
Consolidated Balance Sheets  
(in thousands of dollars except share data)

	Sept. 27 2008 (unaudited)	June 28 2008
<b>ASSETS</b>		
Current assets:		
Cash	\$ 7,682	\$ 6,515
Investments	15,505	19,806
Accounts receivable (less allowance for doubtful accounts of \$798 and \$701)	40,781	39,627
Inventories:		
Raw materials and supplies	18,126	15,104
Goods in process and finished parts	17,764	16,653
Finished goods	28,867	29,400
	64,757	61,157
Current deferred income tax asset	5,835	5,996
Prepaid expenses, taxes and other current assets	6,132	5,535
Total current assets	140,692	138,636
Property, plant and equipment, at cost (less accumulated depreciation of \$131,708 and \$131,386)	61,045	60,945
Property held for sale	1,912	1,912
Intangible assets (less accumulated amortization of \$2,789 and \$2,477)	3,452	3,764
Goodwill	6,032	6,032
Pension asset	34,986	34,643
Other assets	1,101	1,877
Long-term taxes receivable	2,476	2,476
Total assets	\$ 251,696	\$ 250,285
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Notes payable and current maturities	\$ 7,742	\$ 4,121
Accounts payable and accrued expenses	18,011	18,041
Accrued salaries and wages	6,279	6,907
Total current liabilities	32,032	29,069
Long-term taxes payable	8,616	8,522
Deferred income taxes	6,289	6,312
Long-term debt	5,699	5,834
Postretirement benefit liability	13,292	13,775
Total liabilities	65,928	63,512
Stockholders' equity:		
Class A Common \$1 par (20,000,000 shrs. authorized) 5,733,012 outstanding on 9/27/08, 5,708,100 outstanding on 6/28/08	5,733	5,708
Class B Common \$1 par (10,000,000 shrs. authorized) 888,440 outstanding on 9/27/08,	888	906

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906,065 outstanding on 6/28/08		
Additional paid-in capital	49,777	49,613
Retained earnings reinvested and employed in the business	135,938	134,109
Accumulated other comprehensive loss	(6,568)	(3,563)
Total stockholders' equity	185,768	186,773
Total liabilities and stockholders' equity	\$ 251,696	\$ 250,285

See Notes to Consolidated Financial Statements

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THE L. S. STARRETT COMPANY  
Consolidated Statements of Stockholders' Equity  
For the Thirteen Weeks Ended September 27, 2008 and September 29, 2007  
(in thousands of dollars except per share data)  
(unaudited)

	Common Stock Out-standing (\$1 Par)		Addi- tional Paid-in Capital	Retained Earnings	Accumulated Other Com- prehensive Loss	Total
	Class A	Class B				
Balance June 30, 2007	\$ 5,632	\$ 963	\$ 49,282	\$ 127,023	\$ (5,786)	\$ 177,114
Comprehensive income (loss):						
Net earnings				2,330		2,330
Unrealized net gain (loss) on investments and swap agreement					(45)	(45)
Minimum pension liability, net					-	-
Translation gain, net					315	315
Total comprehensive income (loss)						2,600
Tax adjustment for FIN48				(312)		(312)
Dividends (\$.10 per share)				(660)		(660)
Treasury shares:						
Purchased	(20)		(297)			(317)
Issued	6		105			111
Issuance of stock under ESPP			11			11
Conversion	19	(19)				-
Balance September 29, 2007	\$ 5,637	\$ 944	\$ 49,101	\$ 128,381	\$ (5,516)	\$ 178,547
Balance June 28, 2008	\$ 5,708	\$ 906	\$ 49,613	\$ 134,109	\$ (3,563)	\$ 186,773
Comprehensive income (loss):						
Net earnings				2,623		2,623
Unrealized net gain (loss) on investments and swap agreement					39	39
Minimum pension liability, net					-	-
Translation loss, net					(3,044)	(3,044)
Total comprehensive income (loss)						(382)
Dividends (\$.12 per share)				(794)		(794)
Treasury shares:						
Purchased						
Issued	7		149			156
Issuance of stock under ESPP			15			15

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Conversion		18		(18)						-		
Balance September 27, 2008	\$	5,733	\$	888	\$	49,777	\$	135,938	\$	(6,568)	\$	185,768
<b>Cumulative Balance:</b>												
Translation loss									\$	(2,439)		
Unrealized loss on investments and swap agreements										(301)		
Amounts not recognized as a component of net periodic benefit cost										(3,828)		
									\$	(6,568)		

See Notes to Consolidated Financial Statements

THE L. S. STARRETT COMPANY  
Notes to Consolidated Financial Statements

In the opinion of management, the accompanying financial statements contain all adjustments, consisting of normal recurring adjustments, necessary to present fairly the financial position of the Company as of September 27, 2008 and June 28, 2008; the results of operations and cash flows for the thirteen weeks ended September 27, 2008 and September 29, 2007; and changes in stockholders' equity for the thirteen weeks ended September 27, 2008 and September 29, 2007.

The Company follows the same accounting policies in the preparation of interim statements as described in the Company's Annual Report filed on Form 10-K for the fiscal year ended June 28, 2008, and these financial statements should be read in conjunction with the Annual Report on Form 10-K. Note that signification foreign locations are reported on a one month lag.

Included in investments at September 27, 2008 is \$1.8 million of AAA rated Puerto Rico debt obligations that have maturities greater than one year but carry the benefit of possibly reducing repatriation taxes. These investments represent "core cash" and are part of the Company's overall cash management and liquidity program and, under Statement of Financial Accounting Standards (SFAS 115), are considered "available for sale." The investments themselves are highly liquid, carry no early redemption penalties, and are not designated for acquiring non-current assets. As of September 27, 2008, the Company had \$2.6 million of auction rate securities. Of this amount, \$.8 million, which was classified as long-term and included in Other Assets, has been redeemed for par value of \$1 million during October 2008 by the broker. The remaining \$1.7 million remains classified as investments based upon the broker's announced buyback at par which is expected to occur during November 2008. Cash and investments held in foreign locations amounted to \$18.0 million and \$18.8 million at September 27, 2008 and June 28, 2008. The other significant component of investments at September 27, 2008 is \$10.3 million of investments in certificate of deposit which are carried at cost.

Accounts payable and accrued expenses at September 27, 2008 and June 28, 2008 consisted primarily of accounts payable (\$7.8 million and \$9.0 million), accrued benefits (\$1.2 million and \$1.1 million) and accrued taxes other than income taxes (\$1.6 million and \$2.1 million).

Other income (expense) is comprised of the following (in thousands):

	Thirteen Weeks Ended September	
	2008	2007
Interest income	\$ 317	\$ 311
Interest expense and commitment fees	(182)	(255)
Realized and unrealized exchange gains (losses), net	430	(199)
Other	(30)	(123)
Other income (expense)	\$ 535	\$ (266)

The Company adopted FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes" ("FIN No. 48"), at the beginning of fiscal year 2008. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN No. 48 prescribes a two-step process to determine the amount of tax benefit to be recognized. First, the tax position must be evaluated to determine the likelihood that it will be sustained upon external examination. If the tax position is deemed "more-likely-than-not" to be sustained, the tax position is then assessed to determine the amount of benefit to recognize in the financial statements. The amount of the benefit that may be recognized is the largest amount that has a greater than 50 percent likelihood of being realized upon ultimate settlement. As a result of implementing FIN No. 48, the Company recognized a cumulative effect adjustment of \$.3 million to decrease the July 1, 2007 retained earnings

balance and increase long-term tax payable. Also in connection with this implementation the Company has reclassified \$1.8 million of unrecognized tax benefits into a long-term taxes receivable representing the corollary effect of transfer pricing competent authority adjustments.

The Company is subject to U.S. federal income tax and various state, local and international income taxes in numerous jurisdictions. The Company's domestic and international tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues and expenses. Additionally, the amount of income taxes paid is subject to the Company's interpretation of applicable tax laws in the jurisdictions in which it files.

The Company has substantially concluded all U.S. federal income tax matters for years through fiscal 2003. Currently, we do not have any income tax audits in progress in the numerous federal, state, local and international jurisdictions in which we operate. In international jurisdictions including Argentina, Australia, Brazil, Canada, China, UK, Germany, New Zealand, and Mexico, which comprise a significant portion of the Company's operations, the years that may be examined vary, with the earliest year being 2004 (except for Brazil, which has 1997-2006 still open for examination).

The Company recognizes interest expense related to income tax matters in income tax expense. The Company has accrued \$.1 million of interest as of June 28, 2008. The amount did not change significantly during the three months ended September 27, 2008.

The Company has identified no uncertain tax position for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next twelve months.

Net periodic benefit costs for the Company's defined benefit pension plans consist of the following (in thousands):

	Thirteen Weeks Ended September	
	2008	2007
Service cost	\$ 573	\$ 931
Interest cost	1,784	2,965
Expected return on plan assets	(2,636)	(4,227)
Amort. of transition obligation	-	-
Amort. of prior service cost	110	198
Amort. of unrecognized (gain) loss	(3)	(2)
	\$ (172)	\$ (135)

Net periodic costs for the Company's postretirement medical plan consists of the following (in thousands):

	Thirteen Weeks Ended September	
	2008	2007
Service cost	\$ 88	\$ 99
Interest cost	177	180
Amort. of prior service cost	(226)	(226)
Amort. of unrecognized loss	-	22
	\$ 39	\$ 75

Approximately 52% of all inventories are valued on the LIFO method. LIFO inventories were \$19.2 million and \$17.9 million at September 27, 2008 and June 28, 2008, respectively, such amounts being approximately \$29.3 million and \$27.5 million, respectively, less than if determined on a FIFO basis. The Company has not realized any material LIFO layer liquidation profits in the periods presented.

Long-term debt is comprised of the following (in thousands):

	Sept. 27, 2008	June 28, 2008
Reducing revolver	\$ 7,200	\$ 7,200
Capitalized lease obligations payable in Brazilian currency due 2009-2011, 13.3%-23.1%	1,426	1,569
	8,626	8,769

Less current portion	2,927	2,935
	\$ 5,699	\$ 5,834

Current notes payable primarily in Brazilian currency carry interest at up to 23%. The average rate for the current quarter was approximately 6.2%.

## RECENT ACCOUNTING PRONOUNCEMENTS

In March 2008, the FASB issued SFAS No. 161, “Disclosures About Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133” (“FAS 161”), which expands the disclosure requirements in FAS 133 about an entity’s derivative instruments and hedging activities. FAS 161 expands the disclosure provisions to apply to all entities with derivative instruments subject to FAS 133 and its related interpretations. The provisions also apply to related hedged items, bifurcated derivatives, and nonderivative instruments that are designated and qualify as hedging instruments. Entities with instruments subject to FAS 161 must provide more robust qualitative disclosures and expanded quantitative disclosures. Such disclosures, as well as existing FAS 133 required disclosures, generally will need to be presented for every annual and interim reporting period. FAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. The Company has not determined the impact, if any, of the adoption of FAS 161.

In April 2008, the FASB issued FSP SFAS No. 142-3, “Determination of the Useful Life of Intangible Assets” (“FAS 142-3”). FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FAS 142, “Goodwill and Other Intangible Assets” (“FAS 142”). The intent of FAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under FAS 142 and the period of expected cash flows used to measure the fair value of the asset under FAS 141(R) and other applicable accounting literature. FAS 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and must applied prospectively to intangible assets acquired after the effective date. The Company has not determined the impact, if any, of the adoption of FAS 142-3.

In May 2008, the FASB issued SFAS No. 162, “Hierarchy of Generally Accepted Accounting Principles” (“FAS 162”). This statement is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements of nongovernmental entities that are presented in conformity with GAAP. This statement will be effective 60 days following the U.S. Securities and Exchange Commission’s approval of the Public Company Accounting Oversight Board amendment to AU Section 411, “The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles.” The Company does not expect the adoption of FAS 162 to have a material impact on the Company’s financial reporting.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“FAS 157”). FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. FAS 157 applies under other accounting pronouncements that require or permit fair value measurements and accordingly, does not require any new fair value measurements. FAS 157 was initially effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In February 2008, the FASB issued FASB Staff Position (FSP) FAS 157-2. This FSP permits a delay in the effective date of FAS 157 to fiscal years beginning after November 15, 2008, for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). In October 2008, the FASB issued FSP FAS 157-3, “Determining the Fair Value of a Financial Asset when the Market for That Asset is Not Active,” which clarifies the application of FAS 157 for financial assets in a market that is not active. The Company has not determined the impact, if any, of the adoption of FAS 157 or FSP 157-3.

Item 2.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### RESULTS OF OPERATIONS

## Overview

The Company enjoyed strong financial results in the first quarter of fiscal 2009. Sales increased 14% and after tax earnings increased 18% over the same quarter of fiscal 2008. The Company had net income of \$2.6 million, an increase of 12.5%, or \$.40 per basic and diluted share, in the first quarter of fiscal 2009 (fiscal 2009 quarter) compared to a net income of \$2.3 million, or \$.35 per basic and diluted share, in the first quarter of fiscal 2008 (fiscal 2008 quarter). This represents an increase in net income of \$.3 million comprised of an increase in gross margin of \$2.6 million, an increase of other income of \$.8 million, offset by an increase of \$2.8 million in selling, general and administrative costs and an increase in income tax expense of \$.4 million. Both domestic and international markets contributed to this improved performance. These items are discussed in more detail below.



#### Net Sales

Net sales for the fiscal 2009 quarter increased 14% compared to the fiscal 2008 quarter. Foreign sales excluding North America increased \$8.3 million or 26.4% (24.1% in local currency), while North American sales increased \$.1 million or .4%. The increase in North American sales is attributed to stable U.S. industrial sector demand and increased penetration in Mexico and the acquisition of Kinematic Engineering.

Foreign sales were driven by strong sales in the Brazilian domestic market as a result of increased marketing efforts driving higher brand recognition, and the general expansion worldwide into newer markets, including Eastern Europe, the Middle East and China.

#### Earnings before income taxes

The fiscal 2009 quarter's pretax earnings of \$4.2 million represent an increase of pre-tax earnings of \$.6 million or 18.0% increase from the fiscal 2008 quarter's pre-tax earnings of \$3.6 million. Approximately \$2.6 million is at the gross margin line. The gross margin percentage remained unchanged at 31.2% from the fiscal 2008 quarter to the fiscal 2009 quarter. The stable gross margin is primarily a result of higher sales dollar volume, the impact of lean manufacturing initiatives, and cost reductions at the Evans Division offset by certain material cost increases that could not be fully passed on to customers. Effects of LIFO liquidations were not material in the fiscal 2009 quarter.

Selling and general expense increased \$2.8 million. As a percentage of sales, selling and general expenses increased from 24.7% in the fiscal 2008 quarter to 25.7% in the fiscal 2009 quarter. The increase in selling, general and administrative expense is primarily a result of higher commissions due to higher sales (\$.1 million), profit sharing and bonus (\$.4 million), increases in professional fees (\$.5 million), increases in computer maintenance and support (\$.1 million), the acquisition of Kinematic (\$.3 million), and expansion of sales offices and personnel in Mexico and China (\$.2 million).

The income increase in other income (expense) results primarily from a realization of exchange gains in the fiscal 2009 quarter versus exchange losses in the fiscal 2008 quarter.

#### Income taxes

The effective income tax rate is 38% in the fiscal 2009 quarter versus 35% for the fiscal 2008 quarter. Both rates reflect a combined federal, state and foreign rate adjusted for permanent book/tax differences, the most significant of which is the anticipated effect of the Brazilian dividend to be paid in the second quarter of fiscal 2009 and the dividend paid in the third quarter of fiscal 2008. The change in the effective rate percentage reflects the lesser impact of permanent book/tax differences and the Brazilian dividend on a larger income before tax in fiscal 2009.

No changes in valuation allowances relating to foreign NOL's, foreign tax credit carryforwards and certain state NOL's are anticipated for fiscal 2009 at this time. The Company continues to believe that it is more likely than not that it will be able to utilize its tax operating loss carryforward assets reflected on the balance sheet.

#### Net earnings per share

As a result of the above factors, the Company had basic and diluted net income of \$.40 per share in the fiscal 2009 quarter compared to basic and diluted net income per share of \$.35 in the fiscal 2008 quarter. The change in earnings per share is a 14% increase over first quarter 2008.

## LIQUIDITY AND CAPITAL RESOURCES

Cash flows (in thousands)

13 Weeks Ended  
9/27/08 9/29/07

Cash provided by (used in) operations	\$	(1,494)	\$	4,763
Cash provided by (used in) investing activities		331		(5,217)
Cash provided by (used in) financing activities		2,844		(909)

Cash used by operations in the fiscal 2009 quarter resulted primarily from increases in inventories and decreases in other current liabilities. This was offset by an improvement in net earnings and smaller increases in receivables compared to the fiscal 2008 quarter.

The Company's investing activities during the fiscal 2009 quarter consist of expenditures for plant and equipment offset by the sale of investments. The acquisition of Kinemetric Engineering was a significant investment in the fiscal 2008 quarter.

Cash flows related to financing activities are primarily the temporary use of the line of credit offset by the payment of dividends and repayment of debt.

#### Liquidity and credit arrangements

The Company believes it maintains sufficient liquidity and has the resources to fund its operations in the near term. In addition to its cash and investments, the Company maintains a \$10 million line of credit, of which, as of September 27, 2008, \$4.0 million was temporarily taken down for short-term working capital purposes and \$1.0 million was being utilized in the form of standby letters of credit for insurance purposes. As certain investments are redeemed during November 2008, it is expected that the line of credit takedown will be repaid. Although the credit line is not currently collateralized, it is possible, based on the Company's financial performance, that in the future the Company will have to provide collateral. The Company has a working capital ratio of 4.4 to one as of September 27, 2008 and 4.8 to one as of June 28, 2008.

#### STRATEGIC ACTIVITIES

Globalization has had a profound impact on product offerings and buying behaviors of industry and consumers in North America and around the world, forcing the Company to adapt to this new, highly competitive business environment. The Company continuously evaluates most all aspects of its business, aiming for new world-class ideas to set itself apart from its competition.

The strategic focus has shifted from manufacturing locations to global brand building through product portfolio and distribution channels management while reducing costs through lean manufacturing, plant consolidations, global sourcing and improved logistics.

The execution of these strategic initiatives has expanded the Company's manufacturing and distribution in developing economies which has increased its international sales revenues to approximately 50% of its consolidated sales.

On September 21, 2006, the Company sold its Alum Bank, PA level manufacturing plant and relocated the manufacturing to the Dominican Republic, where production began in fiscal 2005. The tape measure production of the Evans Rule Division facilities in Puerto Rico and Charleston, SC has been transferred to the Dominican Republic. The Company vacated and plans to sell its Evans Rule facility in North Charleston, SC. The Company's goal is to achieve labor savings and maintain margins while satisfying the demands of its customers for lower prices. The Company has closed three warehouses, the most recent being the Glendale, AZ facility, which was sold in fiscal 2008. Also during fiscal 2006, the Company began a lean manufacturing initiative in its Athol, MA facility, which has reduced costs over time. This initiative has continued through fiscal 2007 and 2008 and will continue into fiscal 2009.

The Tru-Stone acquisition in April 2006 represented a strategic acquisition for the Company in that it provides an enhancement of the Company's granite surface plate capabilities. Profit margins for the Company's standard plate business have improved as the Company's existing granite surface plate facility was consolidated into Tru-Stone, where average gross margins have been higher. Along the same lines, the Kinemetric Engineering acquisition in July 2007 represented another strategic acquisition in the field of precision video-based metrology which, when combined with the Company's existing optical projection line, has provided a very comprehensive product offering.

#### OFF-BALANCE SHEET ARRANGEMENTS

The Company does not have any material off-balance sheet arrangements as defined under the Securities and Exchange Commission rules.

#### INFLATION

The Company has experienced modest inflation relative to its material cost, much of which cannot be passed on to the customer through increased prices.

## CRITICAL ACCOUNTING POLICIES

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect the amounts reported in the consolidated financial statements and accompanying notes. The second footnote to the Company's Consolidated Financial Statements included in the Annual Report on Form 10-K for the fiscal year ended June 28, 2008 describes the significant accounting policies and methods used in the preparation of the consolidated financial statements.

Judgments, assumptions, and estimates are used for, but not limited to, the allowance for doubtful accounts receivable and returned goods; inventory allowances; income tax reserves; employee turnover, discount, and return rates used to calculate pension obligations; investments; and normal expense accruals for such things as workers' compensation and employee medical expenses.

Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results may differ from those estimates, and such differences may be material to the Company's Consolidated Financial Statements. The following sections describe the Company's critical accounting policies.

Sales of merchandise and freight billed to customers are recognized when title passes and all substantial risks of ownership change, which generally occurs either upon shipment or upon delivery based upon contractual terms. Sales are net of provision for cash discounts, returns, customer discounts (such as volume or trade discounts), cooperative advertising and other sales related discounts. Outbound shipping costs absorbed by the Company and inbound freight included in material purchases are included in the cost of sales.

The allowance for doubtful accounts and sales returns of \$1.1 million and \$1.2 million as of September 27, 2008 and June 28, 2008, respectively, is based on the Company's assessment of the collectibility of specific customer accounts, the aging of the Company's accounts receivable and trends in product returns. While the Company believes that the allowance for doubtful accounts and sales returns is adequate, if there is a deterioration of a major customer's credit worthiness, actual defaults are higher than the Company's previous experience, or actual future returns do not reflect historical trends, the estimates of the recoverability of the amounts due the Company, the Company could be adversely affected.

Inventory purchases and commitments are based upon future demand forecasts. If there is a sudden and significant decrease in demand for the Company's products or there is a higher risk of inventory obsolescence because of rapidly changing technology and requirements, the Company may be required to increase the inventory reserve and, as a result, gross profit margin could be adversely affected.

The Company generally values property, plant and equipment (PP&E) at historical cost less accumulated depreciation. Impairment losses are recorded when indicators of impairment, such as plant closures, are present and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount. The Company continually reviews for such impairment and believes that PP&E is being carried at its appropriate value.

The Company assesses the fair value of its goodwill, generally based upon a discounted cash flow methodology. The discounted cash flows are estimated utilizing various assumptions regarding future revenue and expenses, working capital, terminal value, and market discount rates. If the carrying amount of the goodwill is greater than the fair value, goodwill impairment may be present. An impairment charge is recognized to the extent the recorded goodwill exceeds the implied fair value of goodwill.

Accounting for income taxes requires estimates of future tax liabilities. Due to temporary differences in the timing of recognition of items included in income for accounting and tax purposes, deferred tax assets or liabilities are recorded to reflect the impact arising from these differences on future tax payments. With respect to recorded tax assets, the Company assesses the likelihood that the asset will be realized. If realization is in doubt because of uncertainty regarding future profitability or enacted tax rates, the Company provides a valuation allowance related to the asset. Should any significant changes in the tax law or the estimate of the necessary valuation allowance occur, the Company would record the impact of the change, which could have a material effect on the Company's financial position or results of operations.

Pension and postretirement medical costs and obligations are dependent on assumptions used by the Company's actuaries in calculating such amounts. These assumptions include discount rates, healthcare cost trends, inflation,

salary growth, long-term return on plan assets, employment turnover rates, retirement rates, mortality rates and other factors. These assumptions are made based on a combination of external market factors, actual historical experience, long-term trend analysis, and an analysis of the assumptions being used by other companies with similar plans. Actual results that differ from our assumptions are accumulated and amortized over future periods. Significant differences in actual experience or significant changes in assumptions would affect the Company's pension and other postretirement benefit costs and obligations.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Market risk is the potential change in a financial instrument's value caused by fluctuations in interest and currency exchange rates, and equity and commodity prices. The Company's operating activities expose it to risks that are continually monitored, evaluated, and managed. Proper management of these risks helps reduce the likelihood of earnings volatility. At September 27, 2008, the Company was party to an interest rate swap agreement, which is more fully described in the fiscal 2008 Annual Report on Form 10-K. The Company does not enter into long-term supply contracts with either fixed prices or quantities. The Company does not engage in regular hedging activities to minimize the impact of foreign currency fluctuations. Net foreign monetary assets are approximately \$6.6 million.

A 10% change in interest rates would not have a significant impact on the aggregate net fair value of the Company's interest rate sensitive financial instruments (primarily variable rate investments of \$13.7 million and debt of \$7.2 million at September 27, 2008) or the cash flows or future earnings associated with those financial instruments. A 10% change in interest rates would impact the fair value of the Company's fixed rate investments of approximately \$1.8 million by \$11,000.

Item 4. CONTROLS AND PROCEDURES

The Company's management, under the supervision and with the participation of the Company's President and Chief Executive Officer and Chief Financial Officer, has evaluated the Company's disclosure controls and procedures as of September 27, 2008, and they have concluded that the Company's disclosure controls and procedures were effective as of such date. All information required to be filed in this report was recorded, processed, summarized and reported within the time period required by the rules and regulations of the Securities and Exchange Commission, and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. There have been no other changes in internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

SAFE HARBOR STATEMENT  
UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Quarterly Report on Form 10-Q contains forward-looking statements about the Company's business, competition, sales, expenditures, foreign operations, plans for reorganization, interest rate sensitivity, debt service, liquidity and capital resources, and other operating and capital requirements. In addition, forward-looking statements may be included in future Company documents and in oral statements by Company representatives to security analysts and investors. The Company is subject to risks that could cause actual events to vary materially from such forward-looking statements, including the following risk factors:

Risks Related to Reorganization: The Company continues to evaluate plans to consolidate and reorganize some of its manufacturing and distribution operations. There can be no assurance that the Company will be successful in these

efforts or that any consolidation or reorganization will result in revenue increases or cost savings to the Company. The implementation of these reorganization measures may disrupt the Company's manufacturing and distribution activities, could adversely affect operations, and could result in asset impairment charges and other costs that will be recognized if and when reorganization or restructuring plans are implemented or obligations are incurred. This has occurred with the Company's move to the Dominican Republic from South Carolina. Indeed, the relocation, restructuring and closure of our Evans Division's Charleston, South Carolina facility and start up of that Division's Dominican Republic operations was a factor contributing to the Company's fiscal 2006 loss. If the Company is unable to maintain consistent profitability, additional steps will have to be taken, including further plant consolidations and workforce and dividend reductions.



**Risks Related to Technology:** Although the Company's strategy includes investment in research and development of new and innovative products to meet technology advances, there can be no assurance that the Company will be successful in competing against new technologies developed by competitors.

**Risks Related to Foreign Operations:** Approximately 50% of the Company's sales and 40% of net assets relate to foreign operations. Foreign operations are subject to special risks that can materially affect the sales, profits, cash flows, and financial position of the Company, including taxes and other restrictions on distributions and payments, currency exchange rate fluctuations, political and economic instability, inflation, minimum capital requirements, and exchange controls. In particular, the Company's Brazilian operations, which constitute over half of the Company's revenues from foreign operations, can be very volatile, changing from year to year due to the political situation and economy. As a result, the future performance of the Brazilian operations may be difficult to forecast.

**Risks Related to Industrial Manufacturing Sector:** The market for most of the Company's products is subject to economic conditions affecting the industrial manufacturing sector, including the level of capital spending by industrial companies and the general movement of manufacturing to low cost foreign countries where the Company does not have a substantial market presence. Accordingly, economic weakness in the industrial manufacturing sector may, and in some cases has, resulted in decreased demand for certain of the Company's products, which adversely affects sales and performance. In the event that demand for any of Company's products declines significantly, the Company could be required to recognize certain costs as well as asset impairment charges on long-lived assets related to those products.

**Risks Related to Competition:** The Company's business is subject to direct and indirect competition from both domestic and foreign firms. In particular, low cost foreign sources have created severe competitive pricing pressures. Under certain circumstances, including significant changes in U.S. and foreign currency relationships, such pricing pressures tend to reduce unit sales and/or adversely affect the Company's margins.

**Risks Related to Customer Concentration:** Sears sales and unit volume has decreased significantly during fiscal 2008 and 2007. This situation is problematic and if the Sears brands (i.e., Craftsman) the Company supports are no longer viable, this would have a negative effect on the Company's financial performance. The further loss or reduction in orders by Sears or any of the Company's remaining large customers, including reductions due to market, economic or competitive conditions could adversely affect business and results of operations. Moreover, the Company's major customers have, and may continue to, place pressure on the Company to reduce its prices. This pricing pressure may affect the Company's margins and revenues and could adversely affect business and results of operations.

**Risks Related to Insurance Coverage:** The Company carries liability, property damage, workers' compensation, medical, and other insurance coverages that management considers adequate for the protection of its assets and operations. There can be no assurance, however, that the coverage limits of such policies will be adequate to cover all claims and losses. Such uncovered claims and losses could have a material adverse effect on the Company. Depending on the risk, deductibles can be as high as 5% of the loss or \$500,000.

**Risks Related to Raw Material and Energy Costs:** Steel is the principal raw material used in the manufacture of the Company's products. The price of steel has historically fluctuated on a cyclical basis and has often depended on a variety of factors over which the Company has no control. During fiscal 2007, the cost of steel rose approximately 7%. Because of competitive pressures, the Company generally has not been able to pass on these increases to its customers, resulting in reduction to the gross margins. The cost of producing the Company's products is also sensitive to the price of energy. The selling prices of the Company's products have not always increased in response to raw material, energy or other cost increases, and the Company is unable to determine to what extent, if any, it will be able to pass future cost increases through to its customers. The Company's inability to pass increased costs through to its customers could materially and adversely affect its financial condition or results of operations.

Risks Related to Stock Market Performance: Although the Company's domestic defined benefit pension plan is overfunded, a significant (over 30%) drop in the stock market, even if short in duration, could cause the plan to become temporarily underfunded and require the temporary reclassification of prepaid pension cost on the balance sheet from an asset to a contra equity account, thus reducing stockholders' equity and book value per share. There would also be a similar risk for the Company's UK plan, which was underfunded during fiscal 2006 and 2007. In fact, there has been a significant drop in the stock market for the first few months of fiscal 2009 resulting in a drop in the overfunding status from \$37.4 million at June 28, 2008 to approximately \$10 million at October 31, 2008.

**Risks Related to Acquisitions:** Acquisitions, such as our acquisition of Tru-Stone in fiscal 2006 and Kinemetric Engineering in July 2007, involve special risks, including, the potential assumption of unanticipated liabilities and contingencies, difficulty in assimilating the operations and personnel of the acquired businesses, disruption of the Company's existing business, dissipation of the Company's limited management resources, and impairment of relationships with employees and customers of the acquired business as a result of changes in ownership and management. While the Company believes that strategic acquisitions can improve its competitiveness and profitability, these activities could have an adverse effect on the Company's business, financial condition and operating results.

**Risks Related to Investor Expectations.** The Company's operating results have fluctuated from quarter to quarter in the past, and the Company expects that they will continue to do so in the future. The Company's earnings may not continue to grow at rates similar to the growth rates achieved in recent years and may fall short of either a prior quarter or investors' expectations. If the Company fails to meet the expectations of securities analysts or investors, the Company's share price may decline.

**Risks Related to Information Systems.** The efficient operation of the Company's business is dependent on its information systems, including its ability to operate them effectively and to successfully implement new technologies, systems, controls and adequate disaster recovery systems. In addition, the Company must protect the confidentiality of data of its business, employees, customers and other third parties. The failure of the Company's information systems to perform as designed or its failure to implement and operate them effectively could disrupt the Company's business or subject it to liability and thereby harm its profitability.

**Risks Related to Litigation and Changes in Laws, Regulations and Accounting Rules.** Various aspects of the Company's operations are subject to federal, state, local or foreign laws, rules and regulations, any of which may change from time to time. Generally accepted accounting principles may change from time to time, as well. In addition, the Company is regularly involved in various litigation matters that arise in the ordinary course of business. Litigation, regulatory developments and changes in accounting rules and principles could adversely affect the Company's business operations and financial performance.

Item 6. Exhibits

31a Certification of Chief Executive Officer Pursuant to Rules 13a-15(e)/15(d)-15(e) and 13a-15(f)/15(d)-15(f), filed herewith.

31b Certification of Chief Financial Officer Pursuant to Rules 13a-15(e)/15(d)-15(e) and 13a-15(f)/15(d)-15(f), filed herewith.

32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Rule 13a-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code), filed herewith.

SIGNATURES

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

THE L. S. STARRETT COMPANY  
(Registrant)

Date November 6, 2008

R. J. Hylek  
R. J. Hylek (Treasurer and Chief Financial  
Officer)

Date November 6, 2008

R. J. Simkevich  
R. J. Simkevich (Corporate Controller)

