SCHMITT INDUSTRIES INC
Form 10-Q
October 08, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: August 31, 2010

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, 2010

Common stock, no par value	2,894,802

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

SCHMITT INDUSTRIES, INC.

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	August 31, 2010	May 31, 2010
ASSETS		
Current assets		
Cash and cash equivalents	$ 3,468,222	$ 3,545,986
Accounts receivable, net of allowance of $21,800 and $23,387 at August 31, 2010 and May 31, 2010, respectively	1,299,423	1,144,420
Inventories	3,636,840	3,645,303
Prepaid expenses	202,430	192,167
Income taxes receivable	26,670	21,570
	8,633,585	8,549,446
Property and equipment		
Land	299,000	299,000
Buildings and improvements	1,564,880	1,564,880
Furniture, fixtures and equipment	1,076,588	1,059,496
Vehicles	90,452	90,452
	3,030,920	3,013,828
Less accumulated depreciation and amortization	(1,768,904)	(1,720,880)
	1,262,016	1,292,948
Other assets		
Intangible assets	1,466,454	1,509,711
TOTAL ASSETS	$ 11,362,055	$ 11,352,105
LIABILITIES & STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 611,310	$ 665,044
Accrued commissions	185,358	170,614
Accrued payroll liabilities	221,136	231,390
Other accrued liabilities	298,955	160,717
Total current liabilities	1,316,759	1,227,765
Long-term liabilities		3,591
Stockholders equity		
Common stock, no par value, 20,000,000 shares authorized, 2,894,802 shares issued and outstanding at both August 31, 2010 and May 31, 2010	9,749,090	9,739,391
Accumulated other comprehensive loss	(236,531)	(264,004)

Retained earnings	532,737	645,362
Total stockholders equity	10,045,296	10,120,749
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 11,362,055	$ 11,352,105

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

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE MONTHS ENDED AUGUST 31, 2010 AND 2009

(UNAUDITED)

	Three Months Ended August 31,	
	2010	2009
Net sales	$ 2,404,467	$ 1,223,234
Cost of sales	1,304,721	674,145
Gross profit	1,099,746	549,089
Operating expenses:		
General, administration and sales	1,107,450	960,707
Research and development	108,698	173,044
Total operating expenses	1,216,148	1,133,751
Operating loss	(116,402)	(584,662)
Other income (expense)	(5,322)	9,665
Loss before income taxes	(121,724)	(574,997)
Benefit for income taxes	(9,099)	
Net loss	$ (112,625)	$ (574,997)
Net loss per common share:		
Basic	$ (0.04)	$ (0.20)
Weighted average number of common shares, basic	2,894,802	2,870,160
Diluted	$ (0.04)	$ (0.20)
Weighted average number of common shares, diluted	2,894,802	2,870,160

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

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SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE MONTHS ENDED AUGUST 31, 2010 AND 2009

(UNAUDITED)

	Three Months Ended August 31,	
	2010	2009
Cash flows relating to operating activities		
Net loss	$ (112,625)	$ (574,997)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	87,587	87,693
Gain on disposal of property and equipment		(1,200)
Stock based compensation	9,699	24,312
(Increase) decrease in:		
Accounts receivable	(143,477)	191,186
Inventories	15,078	(85,740)
Prepaid expenses	(10,139)	64,086
Income taxes receivable	(5,100)	(980)
Increase (decrease) in:		
Accounts payable	(55,899)	(123,719)
Accrued liabilities and customer deposits	140,465	(48,948)
Net cash used in operating activities	(74,411)	(468,307)
Cash flows relating to investing activities		
Purchase of short-term investments		(1,000,000)
Purchase of property and equipment	(16,094)	(34,226)
Proceeds from sale of property and equipment		1,200
Net cash used in investing activities	(16,094)	(1,033,026)
Effect of foreign exchange translation on cash	12,741	(11,074)
Decrease in cash and cash equivalents	(77,764)	(1,512,407)
Cash and cash equivalents, beginning of period	3,545,986	4,174,335
Cash and cash equivalents, end of period	$ 3,468,222	$ 2,661,928
Supplemental Disclosure of Cash Flow Information		
Cash paid during the period for income taxes	$ 5,100	$ 980

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

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SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

AND COMPREHENSIVE INCOME

FOR THE THREE MONTHS ENDED AUGUST 31, 2010

(UNAUDITED)

	Shares	Amount	Accumulated other comprehensive loss	Retained earnings	Total	Total comprehensive loss
Balance, May 31, 2010	2,894,802	$ 9,739,391	$ (264,004)	$ 645,362	$ 10,120,749	
Stock-based compensation		9,699			9,699	
Net loss				(112,625)	(112,625)	$ (112,625)
Other comprehensive gain			27,473		27,473	27,473
Balance, August 31, 2010	2,894,802	$ 9,749,090	$ (236,531)	$ 532,737	$ 10,045,296	
Comprehensive loss, three months ended August 31, 2010						$ (85,152)

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

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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, 2010 and its results of operations and its cash flows for the periods presented. The consolidated balance sheet at May 31, 2010 has been derived from the Annual Report on Form 10-K for the fiscal year ended May 31, 2010. 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, 2010. 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, 2011.

Revenue Recognition

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

Financial Instruments

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

Recent Issued Accounting Pronouncements

In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force (ASU 2009-13), which provides amendments to the criteria in ASC Subtopic 605-25, Revenue Recognition Multiple-Element Arrangements, for separating consideration in multiple deliverable arrangements and expands the disclosures related to multiple deliverable arrangements. ASU 2009-13 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company adopted ASU 2009-13 on June 1, 2010. The Company s adoption of ASU 2009-13 is not expected to have a material impact on its consolidated financial statements.

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, 2010 and May 31, 2010, inventories consisted of:

	Aug. 31, 2010	May 31, 2010
Raw materials	$ 1,138,269	$ 1,070,902
Work-in-process	1,086,996	980,971
Finished goods	1,411,575	1,593,430
	$ 3,636,840	$ 3,645,303

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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, 2010) or LIBOR plus 2.0% (2.26% as of August 31, 2010). There were no outstanding balances on the line of credit at August 31, 2010 and May 31, 2010.

Note 4:

STOCK OPTIONS AND STOCK-BASED COMPENSATION

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

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

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

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

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

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

The Company has computed, to determine stock-based compensation expense recognized for those options granted during the three months ended August 31, 2010 and 2009, the value of all stock options granted using the Black-Scholes option pricing model. No stock options were issued during the three months ended August 31, 2010 and 2009.

At August 31, 2010, the Company had a total of 218,609 outstanding stock options (199,859 vested and exercisable and 18,750 non-vested) with a weighted average exercise price of $3.32. The Company estimates that a total of approximately $27,000 will be recorded as additional stock-based compensation expense during the remainder of the year ending May 31, 2011 for all options that were outstanding as of August 31, 2010, but which were not yet vested.

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Outstanding Options			Exercisable Options	
Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (yrs)	Number of Shares	Weighted Average Exercise Price
76,110	$ 1.20	1.5	76,110	$ 1.20
62,499	2.30	3.8	62,499	2.30
5,000	5.80	5.2	5,000	5.80
75,000	6.16	7.7	56,250	6.16
218,609	$ 3.32	4.4	199,859	$ 3.06

Options granted, exercised, and forfeited or canceled under the Company s stock option plan during the three months ended August 31, 2010 are summarized as follows:

	Three Months Ended August 31, 2010	
	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 - August 31, 2010	218,609	$ 3.32

Note 5:

EPS RECONCILIATION

	Three Months Ended August 31,	
	2010	2009
Weighted average shares (basic)	2,894,802	2,870,160
Effect of dilutive stock options		
Weighted average shares (diluted)	2,894,802	2,870,160

Basic earnings (loss) per share is computed using the weighted average number of common shares outstanding. Diluted earnings (loss) per share is computed using the weighted average number of common shares outstanding, adjusted for dilutive incremental shares attributed to outstanding options to purchase common stock. Common stock equivalents for stock options are computed using the treasury stock method. In periods in which a net loss is incurred, no common stock equivalents are included since they are antidilutive and as such all stock options outstanding are excluded from the computation of diluted net loss in those periods. 67,621 and 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, 2010 and 2009, respectively.

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Note 6:

INCOME TAXES

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

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

On June 1, 2007, the Company adopted the provisions of ACS Topic 740. Other long-term liabilities related to tax contingencies were $0 as of August 31, 2010 and May 31, 2010. Interest and penalties associated with uncertain tax positions are recognized as components of the Provision for income taxes. The liability for payment of interest and penalties was $0 as of August 31, 2010 and May 31, 2010.

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

Effective Tax Rate

The effective tax rate on consolidated net loss was 7.5% for the three months ended August 31, 2010. The effective tax rate on consolidated net loss differs from the federal statutory tax rate primarily due to the amount of income from foreign jurisdictions, changes in the deferred tax valuation allowance and certain expenses not being deductible for income tax reporting purposes offset by tax credits related to research and experimentation expenses. Management believes the effective tax rate for Fiscal 2011 will be approximately 6.0% due to the items noted above.

Note 7:

SEGMENTS OF BUSINESS

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

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Segment Information

	Three Months Ended August 31,			
	2010		2009	
	Balancer	Measurement	Balancer	Measurement
Gross sales	$ 1,693,973	$ 885,399	$ 1,018,261	$ 343,797
Intercompany sales	(166,556)	(8,349)	(136,139)	(2,685)
Net sales	$ 1,527,417	$ 877,050	$ 882,122	$ 341,112
Operating income (loss)	$ (53,812)	$ (62,590)	$ (345,208)	$ (239,454)
Depreciation expense	$ 31,438	$ 15,588	$ 39,090	$ 25,413
Amortization expense	$	$ 40,561	$	$ 23,190
Capital expenditures	$ 11,654	$ 4,440	$ 33,046	$ 1,180

Geographic Information-Net Sales by Geographic Area

	Three Months Ended August 31,	
	2010	2009
North American	$ 1,298,946	$ 593,593
European	236,767	271,285
Asia	782,321	341,932
Other markets	86,433	16,424
Total Net Sales	$ 2,404,467	$ 1,223,234

	Three Months Ended August 31,			
	2010		2009	
	United States	Europe	United States	Europe
Operating income (loss)	$ (87,345)	$ (29,057)	$ (590,323)	$ 5,661
Depreciation expense	$ 47,026	$	$ 64,503	$
Amortization expense	$ 40,561	$	$ 23,190	$
Capital expenditures	$ 16,094	$	$ 34,226	$

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

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Segment and Geographic Assets

	August 31, 2010	May 31, 2010
Segment assets to total assets		
Balancer	$ 4,618,429	$ 4,425,280
Measurement	3,248,735	3,359,269
Corporate assets	3,494,891	3,567,556
Total assets	$ 11,362,055	$ 11,352,105
Geographic assets to long-lived assets		
United States	$ 1,262,016	$ 1,292,948
Europe		
Total assets	$ 1,262,016	$ 1,292,948
Geographic assets to total assets		
United States	$ 10,883,253	$ 10,947,605
Europe	478,802	404,500
Total assets	$ 11,362,055	$ 11,352,105

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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. Through its wholly owned subsidiary, Schmitt Measurement Systems, Inc. (SMS), the Company designs, manufactures and markets precision laser-based surface measurement products for a wide variety of commercial applications in addition to the disk drive, silicon wafer and optics industries; laser-based distance measurement products for a wide variety of industrial applications; and ultrasonic measurement products that accurately measure the fill levels of large liquefied propane tanks and transmit that data via satellite to a secure web site (the Measurement segment). 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 on Form 10-K for the fiscal year ended May 31, 2010.

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

For the three months ended August 31, 2010, total sales increased $1.2 million, or 96.6%, to $2.4 million from $1.2 million in the three months ended August 31, 2009. Balancer segment sales focus throughout the world on end-users, rebuilders and original equipment manufacturers of grinding machines with the target geographic markets in North America, Asia and Europe. Balancer segment sales increased $645,000, or 73.2%, to $1.5 million for the three months ended August 31, 2010 compared to $882,000 for the three months ended August 31, 2009. The increase this quarter is due to higher volumes of shipments as the worldwide automotive and manufacturing industries have begun to recover from the previous low levels experienced due to the global economic downturn. The Measurement segment product line consists of both laser-based light-scatter, distance measurement and dimensional sizing products and ultrasonic measurement systems. Total Measurement segment sales increased $536,000, or 157.1%, to $877,000 for the three months ended August 31, 2010 compared to $341,000 for the three months ended August 31, 2009. The increase is primarily due to higher volumes of shipments of distance measurement and dimensional sizing laser-based measurement products and Lasercheck, a laser-based surface roughness measurement product, which did not exist in the prior year.

The Company has continued to closely monitor its expenses across the entire Company. Operating expenses have increased $82,000, or 7.3%, to $1.2 million for the three months ended August 31, 2010 from $1.1 million for the three months ended August 31, 2009. General, administration and sales expenses have increased $147,000, or 15.3%, to $1.1 million for the three

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months ended August 31, 2010 from $961,000 for the same period in the prior year. Research and development expenses have decreased $64,000, or 37.2%, to $109,000 for the three months ended August 31, 2010 from $173,000 for the three months ended August 31, 2009. Net loss was $113,000, or $0.04 per fully diluted share, for the three months ended August 31, 2010 as compared to net loss of $575,000, or $0.20 per fully diluted share, for the three months ended August 31, 2009.

Acquisition

On September 30, 2009, the Company entered into an Asset Purchase Agreement (the Agreement) with Optical Dimensions, a sole proprietorship, pursuant to which the Company acquired all of the assets and assumed certain liabilities of Optical Dimensions. As a result, the Company now owns and operates Optical Dimensions Lasercheck business, including its patented laser light scatter roughness measurement technology. The total purchase price for the acquisition was approximately $200,000 which includes the value of the shares issued and the cash paid. 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.

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, 2010.

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,			
	2010		2009	
Balancer sales	$ 1,527,417	63.5%	$ 882,122	72.1%
Measurement sales	877,050	36.5%	341,112	27.9%
Total sales	2,404,467	100.0%	1,223,234	100.0%
Cost of sales	1,304,721	54.3%	674,145	55.1%
Gross profit	1,099,746	45.7%	549,089	44.9%
Operating expenses:				
General, administration and sales	1,107,450	46.1%	960,707	78.5%
Research and development	108,698	4.5%	173,044	14.1%
Total operating expenses	1,216,148	50.6%	1,133,751	92.7%
Operating loss	(116,402)	-4.8%	(584,662)	-47.8%
Other income (expense)	(5,322)	-0.2%	9,665	0.8%
Loss before income taxes	(121,724)	-5.1%	(574,997)	-47.0%
Benefit for income taxes	(9,099)	-0.4%		0.0%
Net loss	$ (112,625)	-4.7%	$ (574,997)	-47.0%

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Sales - Sales in the Balancer segment increased $645,000, or 73.2%, to $1.5 million for the three months ended August 31, 2010 compared to $882,000 for the three months ended August 31, 2009. This increase is primarily due to higher unit sales volumes in Asia and North America offset by lower sales in Europe during the first quarter of Fiscal 2011. Sales in Asia increased $437,000, or 143.2%, for the three months ended August 31, 2010 as compared to the three months ended August 31, 2009. North American sales increased $260,000, or 76.9%, in the three months ended August 31, 2010 compared to the same period in the prior year. The increases in the Asian and North American markets are due primarily to higher volumes of shipments as the automotive and industrial markets in these markets have begun to recover from the previous low levels due to the global economic downturn. European sales decreased $68,000, or 29.7%, in the first quarter of Fiscal 2011 compared to the first quarter of Fiscal 2010. The decrease in the European market has been caused by the continuing weaknesses in the automotive, bearing and aircraft industries and its impact on the machine tool industry in this geography. Sales in other regions of the world increased $16,000 in the first quarter of Fiscal 2011 as compared to the same period in Fiscal 2010. The levels of demand in our geographic markets cannot be forecasted with any certainty given the recent weaknesses in the global economy.

Sales in the Measurement segment increased $536,000, or 157.1%, to $877,000 in the three months ended August 31, 2010 compared to $341,000 in the three months ended August 31, 2009. Sales of laser-based distance measurement and dimensional sizing products increased $454,000, or 165.2%, in the three months ended August 31, 2010 as compared to the same period in the prior year primarily due to the higher volume of shipments in the current fiscal year resulting from the recovery beginning in the commercial and industrial markets. Sales of laser-based surface measurement products in the three months ended August 31, 2010 as compared to the same period in the prior year increased $63,000, or 95.5%, primarily due to the September 30, 2009 acquisition of Optical Dimensions which resulted in sales of $59,000 during the first quarter of Fiscal 2011. During the first quarter of the current year, we started to ship our Xact ultrasonic measurement product which resulted in $20,000 of revenues. Given the recent volatility in these markets, 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, 2010 increased to 45.7% as compared to 44.9% for the three months ended August 31, 2009. These increases are due to changes in the product sales mix shifting toward higher margin products and the higher production volumes resulting in improved absorption of labor and overhead.

Operating expenses   Operating expenses increased $82,000, or 7.3%, to $1.2 million for the three months ended August 31, 2010 as compared to $1.1 million for the three months ended August 31, 2009. General, administrative and selling expenses increased $147,000, or 15.3%, for the three months ended August 31, 2010 as compared to the same period in the prior year primarily due to higher commissions related to the increase in sales. Research and development expenses decreased $64,000, or 37.2%, 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 and new product development related to existing product lines.

Other income   Other income consists of interest income, foreign currency exchange gain (loss) and other income (expense). Interest income was $1,000 and $5,000 for the three months ended August 31, 2010 and 2009, respectively. Interest income has decreased due to lower interest rates and decreased cash and investment balances. Foreign currency exchange gains (losses) were $(7,000) and $3,000 for the three months ended August 31, 2010 and 2009, respectively. The decrease in the gain (loss) 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 7.5% for the three months ended August 31, 2010. The Company s effective tax rate on consolidated net loss differs from the federal statutory tax rate primarily due to the amount of income from foreign jurisdictions, changes in the deferred tax valuation allowance and certain expenses not being deductible for income tax reporting purposes offset by tax credits related to research and experimentation expenses. Management believes the effective tax rate for Fiscal 2011 will be 6.0% due to the items noted above.

Net income   Net loss decreased $462,000 to a net loss of $113,000, or $0.04 per diluted share, for the three months ended August 31, 2010 as compared to net loss of $575,000, or $0.20 per diluted share, for the three months ended August 31, 2009. Net loss decreased due primarily to higher sales and related gross profit and lower research and development expenses offset by higher general, administrative and selling expenses during the three months ended August 31, 2010.

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LIQUIDITY AND CAPITAL RESOURCES

The Company s working capital remained relatively stable at $7.3 million as of August 31, 2010 and May 31, 2010. Cash and cash equivalents totaled $3.5 million at both August 31, 2010 and May 31, 2010, respectively.

Cash used in operating activities totaled $74,000 for the three months ended August 31, 2010 as compared to cash used in operating activities of $468,000 for the three months ended August 31, 2009. The decrease was primarily due to a decrease in net loss and accrued liabilities and customer deposits offset by an increase in accounts receivable and a decrease in accounts payable.

At August 31, 2010, the Company had accounts receivable of $1.3 million as compared to $1.1 million at May 31, 2010. The increase in accounts receivable of $155,000 was due to the increase in sales in the first quarter of Fiscal 2011. At August 31, 2010, total current liabilities increased $89,000 to $1.3 million as compared to $1.2 million at May 31, 2010. The increase was primarily due to the receipt of customer deposits related to future shipments.

During the three months ended August 31, 2010, net cash used in investing activities was $16,000, which consisted of additions to property and equipment. Additions to property and equipment consisted primarily of new manufacturing 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, 2010), or LIBOR plus 2.0% (2.26% as of August 31, 2010), and the agreement expires on March 1, 2011. There were no outstanding balances on the line of credit at August 31, 2010 and May 31, 2010.

We believe that our existing cash and cash equivalents 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 deteriorated significantly over the prior two fiscal years 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 past 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.

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The Company s primary markets are volatile and unpredictable

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

The 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.

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.

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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 other highly qualified technical and sales personnel as required can be attracted, assimilated and retained. There is also no guarantee that key employees will not leave and subsequently compete against the Company. The inability to attract and retain key personnel could adversely impact the business, financial condition and results of operations.

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

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

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 addition, the NASDAQ Capital Market, on which the Company s common stock is listed, has also adopted comprehensive rules and regulations relating to corporate governance. These laws, rules and regulations have increased the scope, complexity and cost of corporate governance, reporting and disclosure practices. The Company may be required to hire additional personnel and use outside legal, accounting and advisory services to address these laws, rules and regulations. The Company also expects these developments to make it more difficult and more expensive for the Company to obtain director and officer liability insurance in the future, and the Company may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Further, the Company s board members, Chief Executive Officer and Chief Financial Officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified board members and executive officers, which would adversely affect the Company.

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.

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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, 2010. 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, 2010. Also, there is no other long-term obligation whose interest rates are based on variable rates that may fluctuate over time based on economic changes in the environment. Therefore, at this time, the Company is not subject to interest rate risk on outstanding interest bearing obligations if market interest rates fluctuate and does not expect any change in the interest rates to have a material effect on the Company s results from operations.

Foreign Currency Risk

The Company markets and sells its products worldwide and international sales have accounted for and are expected to continue to account for a significant portion of future revenue. The Company operates a subsidiary in the United Kingdom and acquires certain materials and services from vendors transacted in foreign currencies. Therefore, the Company s business and financial condition is sensitive to currency exchange rates or any other restrictions imposed on their currencies. For the three months ended August 31, 2010 and 2009, results of operations included gains (losses) on foreign currency translation of $(7,000) and $3,000, respectively.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of August 31, 2010, 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). There are inherent limitations to the effectiveness of any system of disclosure controls and procedures including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives, and management necessarily is required to use its judgment in evaluating the cost-benefit relationship of possible controls and procedures. 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 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.

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, 2010 that has materially affected, or is reasonably likely to materially affect, such internal control over financial reporting.

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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 8, 2010 /s/ Wayne A. Case
Wayne A. Case, Chairman of the Board and Chief Executive Officer

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