SCHMITT INDUSTRIES INC
Form 10-Q
January 05, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: November 30, 2006

Or

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

For the transition period from: To:

Commission File Number: 000-23996

SCHMITT INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

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

2765 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 o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

The number of shares of each class of common stock outstanding as of December 31, 2006

Common stock, no par value	2,652,128

SCHMITT INDUSTRIES, INC.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

SCHMITT INDUSTRIES, INC.

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	November 30, 2006	May 31, 2006
ASSETS		
Current assets		
Cash and cash equivalents	$ 1,440,330	$ 1,552,072
Short-term investments	3,477,747	1,985,940
Accounts receivable, net of allowance of $13,989 and $52,186 at November 30, 2006 and May 31, 2006, respectively	1,595,533	1,983,090
Inventories	3,316,751	3,241,590
Prepaid expenses	52,852	77,626
Deferred tax asset	111,090	116,080
	9,994,303	8,956,398
Property and equipment		
Land	299,000	299,000
Buildings and improvements	1,290,539	1,275,922
Furniture, fixtures and equipment	787,717	1,180,648
Vehicles	96,849	96,849
	2,474,105	2,852,419
Less accumulated depreciation and amortization	(1,312,602)	(1,643,047)
	1,161,503	1,209,372
Other assets		
Long-term deferred tax asset	366,400	552,380
Other assets	191,101	208,405
	557,501	760,785
Total assets	$ 11,713,307	$ 10,926,555
LIABILITIES & STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 583,152	$ 403,490
Accrued commissions	254,943	250,835
Accrued payroll liabilities	87,132	138,801
Other accrued liabilities	175,566	237,149
Income taxes payable	2,830	60,237
Current portion of long-term obligations	10,350	15,204
Total current liabilities	1,113,973	1,105,716
Long-term obligations	1,614	6,408
Stockholders equity		
Common stock, no par value, 20,000,000 shares authorized, 2,652,128 and 2,625,045 shares issued and outstanding at November 30, 2006 and May 31, 2006, respectively	8,043,674	7,946,976
Accumulated other comprehensive loss	(128,237)	(220,051)
Retained earnings	2,682,283	2,087,506
Total stockholders equity	10,597,720	9,814,431
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 11,713,307	$ 10,926,555

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

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SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE AND SIX MONTHS ENDED NOVEMBER 30, 2006 AND 2005

(UNAUDITED)

	Three Months Ended November 30, 2006	2005	Six Months Ended November 30, 2006	2005
Net sales	$ 2,929,696	$ 2,605,807	$ 6,002,248	$ 5,270,484
Cost of sales	1,287,764	1,100,179	2,762,025	2,336,747
Gross profit	1,641,932	1,505,628	3,240,223	2,933,737
Operating expenses:				
General, administration and sales	1,295,480	1,271,486	2,407,242	2,293,160
Research and development	18,240	19,131	39,449	33,639
Total operating expenses	1,313,720	1,290,617	2,446,691	2,326,799
Operating income	328,212	215,011	793,532	606,938
Other income (expense)	45,973	(2,423)	86,245	(453)
Income before income taxes	374,185	212,588	879,777	606,485
Provision for income taxes	50,000	(181,957)	285,000	(30,957)
Net income	$ 324,185	$ 394,545	$ 594,777	$ 637,442
Net income per common share:				
Basic	$ 0.12	$ 0.15	$ 0.23	$ 0.25
Diluted	$ 0.12	$ 0.14	$ 0.22	$ 0.23

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

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX MONTHS ENDED NOVEMBER 30, 2006 AND 2005

(UNAUDITED)

	Six Months Ended November 30, 2006	2005
Cash flows relating to operating activities		
Net income	$ 594,777	$ 637,442
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	104,463	106,333
Stock based compensation	26,918	
Deferred taxes	190,970	(216,900)
Tax benefit related to stock options	8,739	76,141
Loss on disposal of property and equipment	7,220	
(Increase) decrease in:		
Accounts receivable	387,557	452,257
Inventories	(75,161)	26,632
Prepaid expenses	24,774	60,047
Increase (decrease) in:		
Accounts payable	179,662	(86,597)
Accrued liabilities and customer deposits	(109,144)	(65,944)
Income taxes payable	(57,407)	14,152
Net cash provided by operating activities	1,283,368	1,003,563
Cash flows relating to investing activities		
Purchase of short-term investments	(4,491,807)	
Maturities of short-term investments	3,000,000	
Purchase of property and equipment	(46,510)	(97,091)
Disposals of property and equipment		
Net cash used in investing activities	(1,538,317)	(97,091)
Cash flows relating to financing activities		
Repayments on long-term obligations	(9,648)	(22,324)
Common stock issued on exercise of stock options	61,041	84,442
Net cash provided by financing activities	51,393	62,118
Effect of foreign exchange translation on cash	91,814	(4,002)
Increase (decrease) in cash and cash equivalents	(111,742)	964,588
Cash and cash equivalents, beginning of period	1,552,072	1,176,959
Cash and cash equivalents, end of period	$ 1,440,330	$ 2,141,547
Supplemental Disclosure of Cash Flow Information		
Cash paid during the period for interest	$ 206	$ 333
Cash paid during the period for income taxes	$ 143,028	$ 95,650

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

SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

FOR THE SIX MONTHS ENDED NOVEMBER 30, 2006

(UNAUDITED)

	Shares	Amount	Accumulated other comprehensive loss	Retained earnings	Total	Total comprehensive income
Balance, May 31, 2006	2,625,045	$ 7,946,976	$ (220,051)	$ 2,087,506	$ 9,814,431	
Stock options exercised and related tax benefit of $8,739	27,083	69,780			69,780	
Stock-based compensation		26,918			26,918	
Net income				594,777	594,777	$ 594,777
Other comprehensive income			91,814		91,814	91,814
Balance, November 30, 2006	2,652,128	$ 8,043,674	$ (128,237)	$ 2,682,283	$ 10,597,720	
Comprehensive income, six months ended November 30, 2006						$ 686,591

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: Basis of Presentation

The consolidated financial information included herein has been prepared by Schmitt Industries, Inc. (the Company) and its wholly owned subsidiaries. In the opinion of management, the accompanying unaudited Consolidated Financial Statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission and contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly its financial position as of November 30, 2006 and its results of operations and its cash flows for the six months ended November 30, 2006 and 2005. The consolidated balance sheet at May 31, 2006 has been derived from the Annual Report on Form 10-K for the fiscal year ended May 31, 2006. 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, 2006. 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, 2007. Certain amounts in prior periods financial statements have been reclassified to conform to the current periods presentation. These reclassifications did not affect consolidated net income.

Note 2: Revenue Recognition

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectibility is probable. 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.

Note 3: Recent Accounting Pronouncements

The FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) in June 2006. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in our financial statements in accordance with SFAS No. 109, Accounting for Income Taxes . The provisions of FIN 48 are effective for our fiscal year beginning June 1, 2007. We are currently evaluating the impact of the provisions of FIN 48.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, which addresses how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in current-year financial statements. SAB No. 108 requires companies to quantify misstatements using both the balance sheet and income statement approaches and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. SAB No. 108 is effective for our fiscal year ending May 31, 2007. We believe that the implementation of SAB No. 108 will not have any effect on our financial position or results of operations.

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. On June 1, 2006, the Company adopted SFAS No. 123(R), Share-Based Payment (Revised 2004) , which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options based on estimated fair values. SFAS 123(R) supersedes previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), for periods beginning in fiscal 2007. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 relating to application of SFAS 123(R). The Company has applied the provisions of SAB 107 in our adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of June 1, 2006, the first day of our 2007 fiscal year. In accordance with the modified prospective transition method, the Company s Consolidated Financial Statements for periods prior to the first quarter of fiscal 2007 have not been restated to reflect this change. Stock-based compensation recognized during the period is based on the value of the portion of the stock-based award that will vest during the period, adjusted for expected forfeitures. The compensation cost for awards granted prior to May 31, 2006 is based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 while awards granted on or after June 1, 2006 follow the provisions of SFAS 123(R) to determine the grant date fair value and compensation cost. Compensation cost for all stock-based awards is recognized using the straight-line method. Stock-based compensation recognized in the Company s Consolidated Financial Statements for the first quarter of fiscal 2007 includes compensation cost for stock-based awards granted prior to, but not fully vested as of, May 31, 2006. There were no stock-based awards granted subsequent to May 31, 2006.

Upon adoption of SFAS 123(R), the Company continued to use the Black-Scholes option pricing model as its method of valuation for stock-based awards. The Company s determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R) and SAB 107, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results. These variables include, but are not limited to:

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

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

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

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

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

The Company has computed, to determine stock-based compensation expense recognized for the three and six months ended November 30, 2006 and for pro forma disclosure purposes for the three and six months ended November 30, 2005, the value of all stock options granted using the Black-Scholes option pricing model as prescribed by SFAS No. 123(R) using the following assumptions:

Risk-free interest rate	3.8-4.45%
Expected life	4.0-4.7 years
Expected volatility	95-102%

Stock-Based Compensation Under FAS 123(R)

The following table summarizes stock-based compensation expense related to stock-based awards under SFAS 123(R) for the three and six months ended November 30, 2006 and what certain operating results would have been without the effects of applying SFAS No. 123(R).

	Three Months Ended November 30, 2006		**Six Months Ended November 30, 2006**	
	As reported	**Pro Forma without effects of applying SFAS No. 123(R)**	**As reported**	**Pro Forma without effects of applying SFAS No. 123(R)**
General, administration and sales	$ 1,295,480	$ 1,308,939	$ 2,407,242	$ 2,434,160
Income before income taxes	$ 374,185	$ 387,644	$ 879,777	$ 906,695
Net income	$ 324,185	$ 332,476	$ 594,777	$ 611,358
Cash flow from operating activities			$ 1,283,368	$ 1,283,368
Cash flow from financing activities			$ 51,393	$ 51,393
Basic earnings per share	$ 0.12	$ 0.13	$ 0.23	$ 0.24
Diluted earnings per share	$ 0.12	$ 0.12	$ 0.22	$ 0.23

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At November 30, 2006 the Company had a total of 188,162 outstanding stock options (171,538 vested and exercisable and 16,624 non-vested) with a weighted average exercise price of $2.53. The Company estimates that a total of approximately $63,976 will be recorded as additional stock-based compensation expense over the period beginning with the quarter ending February 28, 2007 through the fiscal year ending May 31, 2009, for all options which are outstanding as of November 30, 2006, but which were not yet vested.

Outstanding Options			Exercisable Options	
Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (yrs)	Number of Shares	Weighted Average Exercise Price
80,413	$ 1.20	5.3	80,413	$ 1.20
76,249	2.30	7.5	73,750	2.30
5,000	5.80	8.9	3,750	5.80
26,500	6.58	8.8	13,625	6.58
188,162	$ 2.53	6.8	171,538	$ 2.20

Options granted, exercised, canceled and expired under the Company s stock option plan during the three and six months ended November 30, 2006 are summarized as follows:

	Three Months Ended November 30, 2006		Six Months Ended November 30, 2006	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding - beginning of period	197,371	$ 2.51	216,496	$ 2.52
Options granted				
Options exercised	(9,209)	2.24	(27,084)	2.25
Options forfeited/cancelled		0	(1,250)	6.58
Options outstanding November 30, 2006	188,162	$ 2.53	188,162	$ 2.53

Pro Forma Information under SFAS 123 and APB 25

Prior to June 1, 2006, the Company elected to follow the accounting provisions of APB 25 for stock-based compensation and to furnish the pro forma disclosures required under SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. No stock-based employee compensation cost was reflected in net income because all options granted under the Company s stock option plan had an exercise price equal to the market value of the underlying common stock on the date of the grant.

The following table illustrates the effect on the Company s net income and basic and diluted net income per share for the three and six months ended November 30, 2005 had compensation cost for the plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS 123.

	Three Months Ended November 30, 2005	Six Months Ended November 30, 2005
Net income, as reported	$ 394,545	$ 637,442
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(4,188)	(9,624)
Pro forma net income	$ 390,357	$ 627,818
Earnings per share basic		
As reported	$ 0.15	$ 0.25
Pro forma	$ 0.15	$ 0.24
Earnings per share diluted		
As reported	$ 0.14	$ 0.23
Pro forma	$ 0.14	$ 0.23

Note 5: EPS Reconciliation

	Three Months Ended November 30		Six Months Ended November 30	
	2006	2005	2006	2005
Weighted average shares (basic)	2,647,245	2,607,948	2,642,468	2,595,500
Effect of dilutive stock options	193,045	145,153	198,020	155,228
Weighted average shares (diluted)	2,840,290	2,753,101	2,840,488	2,750,728

Basic earnings per share are computed using the weighted average number of shares outstanding. Diluted earnings per share are computed using the weighted average number of shares outstanding, adjusted for dilutive incremental shares attributed to outstanding options to purchase common stock.

Note 6: Deferred Tax Assets

The Company applies the asset and liability method in recording income taxes, under which deferred income tax assets and liabilities are determined, based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using currently enacted tax rates and laws. Deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the deferred tax asset will not be realized. The Company has recorded a substantial deferred tax asset related to the expected realization of net operating loss carryforwards for federal income tax purposes and other temporary differences between book and tax bases of assets and liabilities. Due to the uncertainty of utilization of the Company s net operating losses and in consideration of other factors, management recorded a valuation allowance on the deferred tax asset at May 31, 2003.

During Fiscal 2005 and 2006, management concluded future operations would produce sufficient earnings so that portions of this asset could be used in future periods to reduce federal and state tax liabilities and the allowance was reduced to reflect the amount of the deferred tax asset management believes can be utilized in future periods. Our effective tax rate on consolidated net income was 32.4% and (5.1%) in the first six months of fiscal 2007 and 2006, respectively. Our effective tax rate on consolidated net income differs from the federal statutory tax rate in the first six months of fiscal 2007 primarily due to the Company not recording any tax expense on net income reported by the Company s wholly owned subsidiary, Schmitt Europe Ltd. (SEL), located in the United Kingdom. The net effective tax benefit on consolidated net income in the first six months of fiscal 2006 is primarily due to a reduction in the valuation allowance of $281,000 at November 30, 2005. Management believes the effective tax rate on consolidated net income in future periods will reflect a normal combined state and federal rate, net of the effect from net income or losses reported by SEL.

Note 7: Segments of Business

Segment Information

	Three Months Ended November 30, 2006 Balancer	2006 Measurement	2005 Balancer	2005 Measurement
Gross sales	$ 2,032,250	$ 1,140,549	$ 1,940,344	$ 846,577
Intercompany sales	(156,545)	(86,558)	(140,722)	(40,392)
Net sales	$ 1,875,705	$ 1,053,991	$ 1,799,622	$ 806,185
Operating income	$ 179,383	$ 148,829	$ 28,797	$ 186,214
Intercompany rent expense (income)	$ (7,500)	$ 7,500	$ (7,500)	$ 7,500
Depreciation expense	$ 35,798	$ 7,349	$ 33,337	$ 9,179
Amortization expense	$	$ 8,652	$	$ 8,650
Capital expenditures	$ 20,199	$ 18,610	$ 1,062	$ 45,941

	Six Months Ended November 30, 2006 Balancer	2006 Measurement	2005 Balancer	2005 Measurement
Gross sales	$ 4,245,719	$ 2,137,694	$ 3,984,246	$ 1,603,911
Intercompany sales	(286,084)	(95,081)	(273,070)	(44,603)
Net sales	$ 3,959,635	$ 2,042,613	$ 3,711,176	$ 1,559,308
Operating income	$ 284,795	$ 508,737	$ 323,608	$ 283,330
Intercompany rent expense (income)	$ (7,500)	$ 7,500	$ (7,500)	$ 7,500
Depreciation expense	$ 72,434	$ 14,725	$ 70,478	$ 18,554
Amortization expense	$	$ 17,304	$	$ 17,301
Capital expenditures	$ 27,900	$ 18,610	$ 36,394	$ 60,697

Geographic Information

\ Geographic Sales	Three Months Ended November 30, 2006	2005	Six Months Ended November 30, 2006	2005
North American				
United States	$ 1,421,349	$ 1,279,205	$ 2,963,227	$ 2,774,547
Canada and Mexico	14,712	17,198	121,191	54,264
North American total	1,436,061	1,296,403	3,084,418	2,828,811
European				
Germany	82,461	80,412	144,527	161,367
Intercompany				(174)
Germany total	82,461	80,412	144,527	161,193
United Kingdom	351,056	255,180	588,700	483,394
Intercompany	(243,103)	(181,114)	(381,165)	(313,967)
United Kingdom total	107,953	74,066	207,535	169,427
Other European	575,252	247,010	786,432	414,638
Total European	765,666	401,488	1,138,494	745,258
Asia	585,466	610,973	1,336,470	1,158,366
Other markets	142,503	296,943	442,866	538,049
Total Net Sales	$ 2,929,696	$ 2,605,807	$ 6,002,248	$ 5,270,484

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

Long-term Assets

	November 30, 2006	May 31, 2006
Segment:		
Balancer	$ 1,249,514	$ 1,483,166
Measurement	469,490	486,991
Geographic:		
United States	$ 1,704,252	$ 1,949,390
Europe	14,752	20,767

Note 8: Related Party Transactions

Effective June 1, 2004, the Company entered into a contract to provide consulting services to PulverDryer USA, Inc., (PulverDryer) pursuant to which PulverDryer paid the Company $8,000 a month from June 2004 through October 2004. PulverDryer also buys certain products from the Company at normal prevailing rates. The Company and PulverDryer extended the contract from November 1, 2004 forward at that same monthly fee of $8,000. Product sales to PulverDryer during the three months ended November 30, 2006 and 2005 totaled $7,945 and $9,462, respectively. Product sales to PulverDryer during the six months ended November 30, 2006 and 2005 totaled $19,523 and $72,568, respectively.

In connection with the contract, the Board authorized Wayne Case, the Company s Chief Executive Officer, to provide advisory services to PulverDryer, and permitted Mr. Case to receive as compensation the total consulting fees paid by PulverDryer from June 2004 through October 2004. Effective November 1, 2004, Mr. Case receives 40% of the ongoing consulting fee from PulverDryer, which percentage was determined by the Compensation Committee. Mr. Case also serves on the board of directors of PulverDryer.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations:

Schmitt Industries, Inc. designs, assembles and markets computer controlled 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 measurement systems (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 accompanying unaudited financial information should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended May 31, 2006. Certain amounts in prior periods financial information have been reclassified to conform to the current periods presentation. These reclassifications did not affect consolidated net income.

RESULTS OF OPERATIONS

Overview

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. Combined Balancer sales increased 6.7% for the six months ended November 30, 2006 compared to the six months ended November 30, 2005. Balancer sales for the three months ended November 30, 2006 increased 4.2% compared to the same fiscal quarter ended November 30, 2005. Continued improved economic conditions in the worldwide automotive, bearing and aircraft industries and its impact on the machine tool industry are the reason for increased Balancer orders. While machine tool industry customers are optimistic regarding short term demand for grinding machines, they remain uncertain as to the strength and duration of current business conditions in North America for their products which incorporate the Balancer segment product line. North American sales were essentially the same (increased 0.2%) in the three months ended November 30, 2006 compared to the three months ended November 30, 2005. Market demand in Asia for the Balancer segment products remains strong with that region showing a 16% increase for the three months ended November 30, 2006 compared to the three months ended November 30, 2005. The European market continues to rebound as total Balancer sales into that geographic market increased 55.4% during the three months ended November 30, 2006 compared to the three months ended November 30, 2005. Sales in all Other markets decreased to $131,623 in the three months ended November 30, 2006 compared to $282,899 for the three months ended November 30, 2005, a 53.5% decrease. The large percentage decrease was predominately a result of decreases in the Japanese and South American markets. As with the North American market, the duration of the stronger demand in Asia and European markets cannot be forecasted with any certainty.

The Measurement segment product line consists of both laser light-scatter and dimensional sizing products. Combined Measurement sales increased 31% for the six months ended November 30, 2006 compared to the six months ended November 30, 2005. Measurement sales for the three months ended November 30, 2006 increased 30.7% when compared to the same fiscal quarter ended November 30, 2005. The increased sales volume is primarily due to the delivery of a CASI Scatterometer during the current fiscal quarter. As noted below sales can be very cyclical in the Measurement segment. The business operations and prospects for these two product lines are summarized as follows:

Laser light-scatter products for disk drive and silicon wafer manufacturers The primary target markets for Measurement products have been disk drive and silicon wafer manufacturers and companies and organizations involved in research efforts. Certain segments of these targeted industries have seen consolidation into very large international manufacturers. Sales totaled $738,046 for the six months ended November 30, 2006 compared to the $622,968 for the six months ended November 30, 2005. Management and the sales staff monitor industry publications and public financial information in order to judge the potential demand for products by the targeted industries. Over the past year, this information has indicated improving demand for and sales of the products of those industries. Sales to customers in these industries can be very cyclical and therefore the impact of this recovery on sales to the Company s laser light-scatter products is unknown at this time.

Laser light-scatter products for research organizations The Company continues to receive inquiries for these products and provide quotes to interested parties. The Company completed the delivery of a CASI Scatterometer in the current fiscal quarter, the first delivery of a new CASI Scatterometer since fiscal 2004.

Dimensional sizing products   These products are marketed and sold into a wide array of industries. Sales totaled $1,083,430 for the six months ended November 30, 2006 compared to the $936,340 for the six months ended November 30, 2005. In Fiscal 2004 Management built a sales distribution network covering all fifty states. As a result of this action, the Company experienced increasing interest and sales in these products. Since relocation of operations related to these products to Portland was completed as of August 31, 2003, sales of these products have increased. Sales of these products can be cyclical and therefore the duration of the continued demand cannot be forecasted with any certainty.

Critical Accounting Policies

Revenue Recognition   The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectibility is probable. 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.

Cash Equivalents and Short Term Investments   The Company generally invests excess cash in money market funds and investment grade highly liquid securities. The Company considers securities that are highly liquid, readily convertible into cash and have original maturities of less than three months when purchased to be cash equivalents. At November 30, 2006, short-term investments are classified as available-for-sale. The carrying amounts of cash equivalents and short term investments are stated at cost, which approximate fair market value because of their short maturities. There were no related unrealized holding gains or losses at November 30, 2006.

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

Inventories   These assets are stated at the lower of cost or market on an average cost basis. Each fiscal quarter, management utilizes various analyses based on sales forecasts, historical sales and inventory levels to ensure the current carrying value of inventory accurately reflects current and expected requirements within a reasonable timeframe.

Deferred Tax Assets   The Company applies the asset and liability method in recording income taxes, under which deferred income tax assets and liabilities are determined, based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using currently enacted tax rates and laws. Additionally, deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the deferred tax asset will not be realized. In Fiscal 2005 and 2006, management concluded future operations would produce sufficient earnings so that a portion of this asset could be used in future periods to reduce federal and state tax liabilities. Management continues to review the level of the valuation allowance on a quarterly basis. There can be no assurance that the Company s future operations will produce sufficient earnings so that the deferred tax asset can be fully utilized.

Intangible Assets   There is a periodic review of intangible and other long-lived assets for impairment. This review consists of the analysis of events or changes in circumstances that would indicate the carrying amount of the asset may not be recoverable. Recoverability is determined by comparing the forecasted future net cash flows from the operations to which the assets relate, based on management s best estimates using the appropriate assumptions and projections at the time, to the carrying amount of the assets. If the carrying value is determined to be in excess of future operating cash flows, the asset is considered impaired and a loss is recognized equal to the amount by which the carrying amount exceeds the estimated fair value of the assets. As of November 30, 2006, management does not believe impairment, as defined above, exists.

Recently issued accounting pronouncements:

The FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) in June 2006. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in our financial statements in accordance with SFAS No. 109, Accounting for Income Taxes . The provisions of FIN 48 are effective for our fiscal year beginning June 1, 2007. We are currently evaluating the impact of the provisions of FIN 48.

Discussion of operating results:

Three months ended November 30, 2006 and 2005:

Three months ended November 30, 2006			
Consolidated		Balancer	Measurement
Dollars	%	Dollars	