

SCHMITT INDUSTRIES INC  
Form 10-K  
August 05, 2016

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

(Mark One)

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

For the fiscal year ended: May 31, 2016

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**  
(State or other jurisdiction of

incorporation or organization)

**93-1151989**  
(IRS Employer

Identification Number)

**2765 N.W. Nicolai Street**

**Portland, Oregon 97210**

(Address of principal executive offices) (Zip Code)

**(503) 227-7908**

(Registrant's telephone number, including area code)

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

Title of each class  
**Common Stock - no par value**

Name of each exchange on which registered  
**The NASDAQ Stock Market LLC**

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

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**None**

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

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

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of November 30, 2015, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$4,557,800 based upon the closing price of \$2.71 reported for such date on the NASDAQ Capital Market. For purposes of this disclosure, shares of Common Stock held by persons who hold more than 10% of the outstanding shares of Common Stock and shares held by officers and directors of the registrant, have been excluded because such persons may be deemed to be affiliates. This determination is not necessarily conclusive for other purposes.

As of July 31, 2016, the registrant had 2,995,910 outstanding shares of Common Stock.

## Documents Incorporated by Reference

Portions of the registrant's definitive Proxy Statement for its 2016 Annual Meeting of Shareholders are incorporated by reference into Part III hereof.

**PART I**

**Item 1. Business**

*Forward-Looking Statements*

*This Annual Report on Form 10-K (the Report ), including Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 regarding future events and the future results of Schmitt Industries, Inc. and its consolidated subsidiaries (the Company ) that are based on management s current expectations, estimates, projections and assumptions about the Company s business. Words such as expects, anticipates, intends, plans, believes, sees, estimates and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements due to numerous factors, including, but not limited to, those discussed in the Risk Factors section in Item 1A, Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7 and elsewhere in this Report as well as those discussed from time to time in the Company s other Securities and Exchange Commission filings and reports. In addition, such statements could be affected by general industry and market conditions. Such forward-looking statements speak only as of the date of this Report or, in the case of any document incorporated by reference, the date of that document, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Report. If we update or correct one or more forward-looking statements, investors and others should not conclude that we will make additional updates or corrections with respect to other forward-looking statements.*

**Introduction**

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

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

**Balancer Segment**

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

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

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

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

The SB-5500 also offers two process control cards that fit inside the control panel to provide enhanced control of the grinding process: the ExactControl card and the ExactDress card. The ExactControl process control card offers multi-functional grinding process control capability by detecting and analyzing either the AE signal pattern or the machine power fluctuations and then using one of seven process control strategies to adjust and optimize the grinding process based on that signal data, resulting in improved part quality and reduced operating costs. Software control strategies include ExactDisplay (graphically displays the measurement signal), ExactGap (displays and evaluates the measurement signal against a predetermined signal threshold to automatically determine when the grinding wheel touches the work piece and to shorten the time between grinding work pieces), ExactTime (displays and evaluates the time interval of a measurement signal that is above a predetermined signal threshold to monitor the minimum or maximum processing time, ExactIntegral (displays and evaluates the area under a measurement signal curve to optimize the grinding process for the particular work piece), and ExactDress (displays and evaluates the measurement signal and compares it to a standard threshold to optimize the grinding wheel dress process).

The ExactDress control strategy is also available in a separate process control card as part of the AEMS system to automatically monitor and control the grinding wheel dressing process. The AE signal pattern of a wheel dress is displayed and compared to a stored master AE signal pattern and indicates when the dressing process has been successfully completed. Monitoring for AE levels during wheel dressing permits the operator or CNC control to determine if the wheel is being dressed fully across its width, control the aggressiveness of the process and maintain the quality of the dressed wheel to conserve wheel material.

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

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

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

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

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

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

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

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

For the years ended May 31, 2016, May 31, 2015 and May 31, 2014 (Fiscal 2016, 2015 and 2014), net sales of the Company's balancing products totaled \$6,962,746, \$7,850,236 and \$7,721,211, respectively. Net sales of balancing products accounted for 60%, 60% and 64% of the Company's total sales in Fiscal 2016, 2015 and 2014, respectively. See Note 5 to Consolidated Financial Statements.

### ***Competition***

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

### **Measurement Segment**

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

### ***Laser and White Light Sensors***

These products include lasers utilizing both triangulation and time-of-flight methods of measurement, and confocal chromatic white light sensors that are used in a wide range of industrial applications including manufacturing, lumber production, steel casting, glass and paper production, medical imaging, crane control and micron-level part and surface inspection and are sold under the Acuity brand. Presently, there are 12 products offered under the Acuity brand: The AccuRange (AR)1000, AR2000, AR2500 and AR3000 distance measurement sensors, the AR700, AR500 and AR200 series of triangulating laser displacement sensors, the AR CCS Prima and the AR CCS Initial chromatic confocal sensors, the AccuProfile (AP) 400 and AP820 and the Aquity (AQ) 6 2D laser line scanners. The Company designs, manufactures and sells the AR200 and AR700 and distributes the AR500, AR1000, AR2000, AR2500, AR3000, AR CCS Prima, AR CCS Initial, AP400, AP820 and the AQ6, primarily into North America.

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

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

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

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

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

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

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

The AP820 is a two-dimensional laser line scanner that measures surface height profiles by projecting a beam of visible laser light that creates a line on a targeted surface. The AP820 is a highly accurate sensor for industrial surface dimensional and measurement applications. The scanner quickly and accurately generates low-noise 2D or 3D profile scans of objects, surfaces or scenes. The sensor automatically adjusts laser power and detector exposure to compensate for varying surface conditions. Typical scanner applications include weld gap tracking and weld bead profiling, positional control of objects and surfaces, tire profiling, wheel profiling, surface profiling, 3D profile generation and dimensional measurement.

The new AQ6 laser line sensor offers higher speed and higher resolution, with models from 0.3 megapixels to over 12 megapixels. The AQ6 uses the latest in new high density CMOS camera design with new Gigabit Ethernet communications and the newly released GeniCam high speed vision protocols. This allows the customer to increase the resolution on the target and reduce the amount of sensors needed for larger parts. The new outputs also will allow for a faster and less expensive integration of the sensor into the customer's application. Applications include pipe and tube manufacturers, large laser line applications for flaw detection, and high accuracy scans of difficult targets. The AQ6 also lends itself to custom OEM applications with laser lines of over 80 inches in length. Currently there are 9 models available.

### ***Surface Roughness Measurement Products***

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

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

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

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

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

### ***Laser Light-Scatter Surface Measurement Products***

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

The MicroScan system is a portable device consisting of a hand-held control unit, an interchangeable measurement head and a separate charging unit. To perform a measurement, the operator places the measurement



head on the objective area and presses a button. Each measurement takes less than five seconds with results displayed and stored in system memory. The MicroScan can store 700 measurements in 255 files and provides the capability to program pass/fail criteria. Software is available for control, analysis and file conversion. From a single measurement, a user can determine RMS surface roughness, reflectance and scatter light levels (BRDF) on either flat or curved surfaces and under any lighting conditions.

### ***Competition***

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

The market for distance measurement and dimensional sizing products is extremely competitive, characterized by rapidly changing technology. The Company believes the principal elements of competition include quality of ongoing technical support and maintenance coupled with responsiveness to customer needs, as well as price, product quality, reliability and performance. The differences between the Company's sensors and competitive products include pushbutton selection of output signals in certain models and sensors that can be programmed using serial commands through a PC computer.

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

### ***Remote Tank Monitoring Products***

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

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

***Tank Sensor***

The Xact ultrasonic sensor incorporates patented technology and is externally mounted to the bottom of the tank. The sensor produces a small electrical pulse, or a ping, that travels through the tank's steel shell, which is reflected off the bottom surface of the liquid stored in the tank in the form of an echo that is detected by the sensor. The time of flight between the ping and the echo, which is measured in milliseconds, is then calculated to determine, based upon additional data regarding tank size and shape, the volume of liquid the tank contains. This information is then remotely transmitted via a satellite radio transmitter. For smaller tanks that are difficult to access or where the precise accuracy provided by the ultrasonic sensor is not as important, Xact also offers a sensor that is affixed to the dial of a preinstalled float gauge (known as a gauge reader). The gauge reader detects the fill level that is reported by the gauge and transmits that data by satellite in the same manner as the ultrasonic sensor. Float gauges have a typical accuracy range of +/- 8% to 12%.

***Satellite Radio Transmitter***

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

***Xact Website***

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

***Benefits***

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

***Customers***

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

**Competition**

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

In Fiscal 2016, 2015 and 2014, net sales of Measurement products totaled \$4,722,607, \$5,218,855 and \$4,413,295, respectively, and accounted for 40%, 40% and 36% of the Company's total sales in Fiscal 2016, 2015 and 2014, respectively. See Note 5 to Consolidated Financial Statements.

**Sales by Geographic Area**

In Fiscal 2016, 2015 and 2014, the Company recorded net sales of its products in the United States, its country of domicile, of \$6,931,278, \$7,174,257 and \$6,704,239, respectively. Net sales in the last three fiscal years by geographic areas were:

	North America	Europe	Asia	Others
Fiscal 2016	\$ 7,749,753	\$ 1,435,280	\$ 2,288,550	\$ 211,770
Fiscal 2015	\$ 8,165,269	\$ 1,194,186	\$ 3,388,757	\$ 320,879
Fiscal 2014	\$ 7,474,067	\$ 1,773,928	\$ 2,693,767	\$ 192,744

**Business and Marketing Strategy**

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

**Balancer Segment Products**

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

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

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

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

### **Measurement Segment Products**

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

### **Backlog**

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

### **Manufacturing**

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

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

The Company's Quality Control Program first received full ISO 9001 certification in 1996. In 2005, the Company received its certification to the newer ISO 9001:2000 requirements and in 2011 and 2014 received its recertification.

### **Proprietary Technology**

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

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

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

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

#### **Product Development**

The Company maintains an ongoing research and development program to expand the product lines and capabilities of its business segments. The goal of this program is to expand the product base in historic markets and to enter new market areas so as to reduce reliance on historic market segments. During Fiscal 2016, 2015 and 2014, the Company's research and development expense totaled \$287,672, \$378,305 and \$475,430, respectively.

#### **Employees**

As of July 31, 2016, the Company employed 54 individuals worldwide on a full-time basis. There were no part-time or temporary employees. None of the Company's employees are covered by a collective bargaining agreement.

#### **Item 1A. RISK FACTORS**

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

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

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

Past distress in the global financial markets and global economy resulted in reduced liquidity and a tightening of credit markets. If these conditions were to reoccur, the Company could experience several potential adverse

effects, including the inability of customers to obtain credit to finance purchases of the Company's products, the insolvency of customers resulting in reduced sales and bad debts, and the insolvency of key suppliers resulting in product development and production delays.

*The Company's primary markets are volatile and unpredictable*

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

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

The Xact Tank Monitoring System measures the fill levels of tanks holding propane, diesel and other tank-based liquids and communicates that data via satellite to a secure web site. The Company's efforts to continue to accelerate the growth of Xact in its two primary markets of North America and Latin America may not be successful, anticipated market demand for the products may not materialize, and additional products or market opportunities may not be identified, developed and brought to market in a timely and cost-effective manner. All of this could continue to negatively impact future operating results and result in large and immediate write-offs of recorded intangible asset balances.

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

The failure to develop new products or enhance existing products or react to changes in existing technologies could result in decreased revenues and a loss of market share to competitors. Financial performance depends on the ability to design, develop, manufacture, assemble, test, market and support new products and enhancements on a timely and cost-effective basis. New product opportunities may not be identified and developed and brought to market in a timely and cost-effective manner. Products or technologies developed by other companies may render products or technologies obsolete or noncompetitive, or a fundamental shift in technologies in the product markets could have a material adverse effect on the Company's competitive position within historic industries.

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

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

*The Company may experience increased pricing pressure*

We have experienced and continue to experience pricing pressure in the sale of our products, from both competitors and customers. Pricing pressures typically have become more intense during cyclical downturns

when competitors seek to maintain or increase market share, reduce inventory or introduce more technologically advanced products or lower cost products. In addition, we may agree to pricing concessions or extended payment terms with our customers in connection with volume orders or to reduce cost of ownership in highly competitive applications. Our business, financial condition, margins or results of operations may be materially and adversely affected by competitive pressure and intense price-based competition.

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

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

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

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

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

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

*The Company's existing cash may not be sufficient and the Company may not be able to obtain financing to fund operations or future growth*

The Company had a cash balance of \$988,686 as of May 31, 2016, compared to \$1,795,654 as of May 31, 2015, and has no bank line of credit facility. The Company believes that its existing cash and investments combined with the cash from operating activities will be sufficient to meet its cash requirements for the near term. However, if sales weaken and the Company is unable to reduce its operating costs in a timely manner or access additional financing, the Company may have to continue to reduce its cash balance, which could significantly impact the liquidity or operations of the Company, and may have to explore other financing alternatives to raise cash.

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

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

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

Sales to customers outside the U.S. accounted for 40.7% of total sales in Fiscal 2016. We expect that sales to customers outside the U.S. will continue to represent a significant percentage of sales in the future. We currently have a sales and service office in Coventry, England and a sales office in Shanghai, China. We may need to increase our foreign operations in the future. Our international sales, purchases and operations are subject to risks inherent in conducting business abroad, many of which are outside of our control, including periodic local or geographical economic downturns, fluctuations in the relative values of currencies, difficulties in protecting intellectual property, shipping delays and disruptions, local labor disputes, unexpected changes in trading policies, regulatory requirements, tariffs and duties and difficulties in managing a global presence, including staffing, collecting accounts receivable, and managing distributors and sales representatives.

*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. In a referendum held in the United Kingdom ( UK ) on June 23, 2016, a majority of those voting voted for the UK to leave the European Union ( EU ) (commonly referred to as Brexit ). The terms of the UK 's future relationship with the EU will be negotiated over time. In the meantime, there are immediate uncertainties that face U.S. companies with operations in the UK and the EU, of which Schmitt is one of those companies. Specifically, currency fluctuations will impact sales, costs and earnings. At one point shortly after the Brexit vote, the British pound fell more than 10% to the lowest level since 1985. Currencies could remain volatile for the foreseeable future. No assurances can be given that these factors will not have a material adverse effect on future international sales and operations and, consequently, on business, financial condition and results of operations.

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

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

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

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

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

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



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

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

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

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

*The Company may experience uncertainties resulting from conflict minerals regulation*

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

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

The Company's design and assembly facilities and executive offices are located in Portland, Oregon in three company-owned buildings totaling approximately 40,500 square feet. SEL occupies a 1,080-square foot facility in Coventry, England pursuant to a three-year lease, which will expire in March 2017. The current basic monthly rent amount is £1,002 (\$1,496 as of May 31, 2016).

**Item 3. Legal Proceedings**

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

**Item 4. Mine Safety Disclosures**

None.

## PART II

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

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

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

<i>Year Ended May 31, 2015</i>	<b>High</b>	<b>Low</b>
First Quarter	\$ 3.06	\$ 2.65
Second Quarter	\$ 3.20	\$ 2.70
Third Quarter	\$ 2.99	\$ 2.65
Fourth Quarter	\$ 2.80	\$ 2.62
<i>Year Ended May 31, 2016</i>	<b>High</b>	<b>Low</b>
First Quarter	\$ 2.92	\$ 2.63
Second Quarter	\$ 3.16	\$ 2.56
Third Quarter	\$ 2.70	\$ 2.08
Fourth Quarter	\$ 2.49	\$ 2.11

As of July 31, 2016, there were 2,995,910 shares of Common Stock outstanding held by approximately 66 holders of record. The number of holders does not include individual participants in security position listings; the Company believes that there are more than 700 individual holders of shares of Common Stock.

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

This table shows information about equity awards under the Company's equity compensation plans at May 31, 2016:

Plan Category	Number of Securities remaining available for future issuance under equity compensation plans (excluding securities in column a)		
	Number of Securities to be issued upon exercise of outstanding options (a)	Weighted-average exercise price of outstanding options (b)	Number of Securities remaining available for future issuance under equity compensation plans (excluding securities in column a) (c)
Equity compensation plans approved by security holders	147,500	\$ 3.11	247,500
Equity compensation plans not approved by security holders	0	0	0
	147,500	\$ 3.11	247,500

**Recent Sales of Unregistered Securities**

None.

**Issuer Purchases of Equity Securities**

None.



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

<b>Year Ended</b>	5/31/2016	5/31/2015	5/31/2014	5/31/2013	5/31/2012
Net sales	\$ 11,685	\$ 13,069	\$ 12,135	\$ 12,452	\$ 14,437
Net income (loss)	\$ (1,515)	\$ (94)	\$ (540)	\$ (540)	\$ 77
Net income (loss) per common share, basic	\$ (0.51)	\$ (0.03)	\$ (0.18)	\$ (0.18)	\$ 0.03
Weighted average number of common shares, basic	2,996	2,996	2,996	2,991	2,930
Net income (loss) per common share, diluted	\$ (0.51)	\$ (0.03)	\$ (0.18)	\$ (0.18)	\$ 0.03
Weighted average number of common shares, diluted	2,996	2,996	2,996	2,991	2,944
Stockholders' equity	\$ 8,004	\$ 9,489	\$ 9,613	\$ 10,015	\$ 10,484
Total assets	\$ 9,635	\$ 11,104	\$ 10,824	\$ 11,625	\$ 12,026
Long-term debt (including current portion)	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0

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

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

For the fiscal year ended May 31, 2016 (Fiscal 2016), total sales decreased \$1,383,738, or 10.6%, to \$11,685,353 from \$13,069,091 in the fiscal year ended May 31, 2015 (Fiscal 2015).

The focus of Balancer segment sales throughout the world is on end-users, rebuilders and original equipment manufacturers of grinding machines with the target geographic markets of North America, Asia, and Europe. Balancer sales decreased \$887,490, or 11.3%, to \$6,962,746 in Fiscal 2016 compared to \$7,850,236 in Fiscal 2015. Sales to customers in Europe increased \$173,359, or 16.0%, to \$1,259,868 in Fiscal 2016 compared to \$1,086,509 in Fiscal 2015. Sales to customers in the rest of the world decreased \$1,060,849, or 15.7%, from Fiscal 2015 to Fiscal 2016 with sales into China and other parts of Asia accounting for 77% of the decrease.

The Measurement segment product lines consist of the SMS and Lasercheck laser-based surface microroughness measurement systems, the Acuity laser-based distance measurement and dimensional sizing laser sensors, and the Xact ultrasonic-based remote tank monitoring products. Total Measurement segment sales decreased \$496,248, or 9.5%, to \$4,722,607 for Fiscal 2016 as compared to \$5,218,855 for Fiscal 2015. The overall decrease in sales in the Measurement segment is primarily attributed to decreased sales in our SMS product line of \$886,468, or 71.7%, which had sales of two CASI machines included in its Fiscal 2015 results which were not repeated in Fiscal 2016. This decrease was, in part, offset by increased sales in our Acuity product line. Acuity posted sales of \$2,401,465 in Fiscal 2016 as compared to \$1,991,596 in Fiscal 2015, an increase of \$409,869, or 20.6%.

Operating expenses increased \$98,613, or 1.6%, to \$6,303,769 in Fiscal 2016 from \$6,205,156 in Fiscal 2015. General, administrative and sales expenses increased \$189,246, or 3.2%, in Fiscal 2016 to \$6,016,097 as compared to \$5,826,851 in the prior fiscal year. This increase was offset by a decrease in spending of \$90,633, or 24.0%, for research and development expenses in Fiscal 2016 as compared to the same period in the prior year.

Net loss was \$1,515,189, or \$(0.51) per fully diluted share, for the year ended May 31, 2016 as compared to net loss of \$93,669, or \$(0.03) per fully diluted share, for the year ended May 31, 2015.

### **Critical Accounting Policies**

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

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

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

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

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

**Recently issued accounting pronouncements**

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

**Discussion of Operating Results**

	2016		Year Ended May 31, 2015		2014	
Balancer sales	\$ 6,962,746	59.6%	\$ 7,850,236	60.1%	\$ 7,721,211	63.6%
Measurement sales	4,722,607	40.4%	5,218,855	39.9%	4,413,295	36.4%
<b>Total sales</b>	<b>11,685,353</b>	<b>100.0%</b>	<b>13,069,091</b>	<b>100.0%</b>	<b>12,134,506</b>	<b>100.0%</b>
Cost of sales	6,818,058	58.3%	6,928,394	53.0%	6,508,360	53.6%
<b>Gross profit</b>	<b>4,867,295</b>	<b>41.7%</b>	<b>6,140,697</b>	<b>47.0%</b>	<b>5,626,146</b>	<b>46.4%</b>
Operating expenses:						
General, administration and sales	6,016,097	51.5%	5,826,851	44.6%	5,663,121	46.7%
Research and development	287,672	2.5%	378,305	2.9%	475,430	3.9%
<b>Total operating expenses</b>	<b>6,303,769</b>	<b>53.9%</b>	<b>6,205,156</b>	<b>47.5%</b>	<b>6,138,551</b>	<b>50.6%</b>
Operating loss	(1,436,474)	(12.3%)	(64,459)	(0.5%)	(512,405)	(4.2%)
Other expense	(58,713)	(0.5%)	(19,123)	(0.1%)	(17,887)	(0.1%)
Loss before income taxes	(1,495,187)	(12.8%)	(83,582)	(0.6%)	(530,292)	(4.4%)
Provision for income taxes	20,002	0.2%	10,087	0.1%	9,332	0.1%
<b>Net loss</b>	<b>\$ (1,515,189)</b>	<b>(13.0%)</b>	<b>\$ (93,669)</b>	<b>(0.7%)</b>	<b>\$ (539,624)</b>	<b>(4.4%)</b>

**Sales** Sales in the Balancer segment decreased \$887,490, or 11.3%, to \$6,962,746 for Fiscal 2016 compared to \$7,850,236 for Fiscal 2015. While sales in the overall Balancing segment declined in Fiscal 2016, sales to customers in Europe increased \$173,359, or 16.0%, to \$1,259,868 in Fiscal 2016 compared to \$1,086,509 in Fiscal 2015. This increase is the direct result of the targeted market strategy we have been pursuing in that geographic area. Sales to customers in the rest of the world decreased \$1,060,849, or 15.7%, from Fiscal 2015 to Fiscal 2016, with sales into China and other parts of Asia accounting for \$819,666, or 77%, of the decrease. Sales into China decreased \$555,076, or 31.6%, during Fiscal 2016 as compared to Fiscal 2015 and sales into other parts of Asia decreased \$264,590, or 21.7%, during Fiscal 2016 as compared to Fiscal 2015. North American sales decreased \$90,869, or 2.6%, during the year ended May 31, 2016 and compared to the prior fiscal year. The economic circumstances in China, in the other Asia markets and in the North American market appear to be significantly contributing to the decline in sales experienced in Fiscal 2016. The levels of demand for our Balancer products in any of these geographic markets cannot be forecasted with any certainty given current economic trends and the historical volatility experienced in these markets.

Sales in the Measurement segment decreased \$496,248, or 9.5%, to \$4,722,607 in Fiscal 2016 compared to \$5,218,855 in Fiscal 2015. The overall decrease in sales in the Measurement segment is primarily attributed to decreased sales in our SMS product line of \$886,468, or 71.7%, which had sales of two CASI machines included in its Fiscal 2015 results which were not repeated in Fiscal 2016. This decrease was, in part, offset by increased sales in our Acuity product line. Acuity posted sales of \$2,401,465 in Fiscal 2016 as compared to \$1,991,596 in Fiscal 2015, an increase of \$409,869, or 20.6%. In addition, sales of Xact remote tank monitoring products and the related monitoring revenues increased \$75,332, or 4.4%, to \$1,771,271 in Fiscal 2016 as compared to \$1,695,939 in Fiscal 2015, and sales of Lasercheck laser-based surface measurement products decreased \$94,981, or 32.2%, to \$200,177 in Fiscal 2016 as compared to \$295,158 in Fiscal 2015. Future sales of laser-based or ultrasonic measurement products cannot be forecasted with any certainty given the historical volatility experienced in this market.

Sales in the Balancer segment increased \$129,025, or 1.7%, to \$7,850,236 for Fiscal 2015 compared to \$7,721,211 for Fiscal 2014. This increase was primarily attributed to stronger sales in Asia and other regions of the world, offset by lower shipments into North America and Europe. Sales into Asia increased \$574,923, or 24.0%, and sales into other regions of the world increased \$126,352, or 117.0%, during Fiscal 2015 as compared to Fiscal 2014. North American sales decreased \$530,905, or 13.0%, in Fiscal 2015 compared to Fiscal 2014. While sales into Europe decreased \$41,345, or 3.7%, in Fiscal 2015 compared to Fiscal 2014, sales into Germany and other European countries increased \$137,923, or 18.9% in Fiscal 2015 compared to the prior year. The increases in sales into Asia and other regions of the world were due to an increase in demand for the Company's SBS products, while the increase in sales into Germany and other European countries is in response to the targeted market strategy we have in those areas. The decline in sales in North America reflected fluctuations in demand in the markets we serve. The levels of demand for our Balancer products in any of these geographic markets cannot be forecasted with any certainty given current economic trends and the historical volatility experienced in this market.

Sales in the Measurement segment increased \$805,560, or 18.3%, to \$5,218,855 in Fiscal 2015 compared to \$4,413,295 in Fiscal 2014. Sales of Acuity laser-based distance measurement and dimensional-sizing products decreased \$499,937, or 20.1%, primarily due to a reduction in the markets we serve. Sales of Xact remote tank monitoring products increased \$723,595, or 74.4%, to \$1,695,939 during Fiscal 2015 due to an increase in product shipments and increasing monitoring revenues associated with unit sales. Sales of SMS and Lasercheck laser-based surface measurement products increased \$581,902, or 61.3%, primarily due to an increase in demand for these products. Future sales of laser-based or ultrasonic measurement products cannot be forecasted with any certainty given the historical volatility experienced in this market.

**Gross margin** Gross margin in Fiscal 2016 decreased to 41.7% compared to 47.0% in Fiscal 2015. Gross margin in Fiscal 2015 increased to 47.0% compared to 46.4% in Fiscal 2014. The variances in gross margin between the periods presented was primarily influenced by shifts in the product sales mix from higher to lower margin product line sales.

**Operating expenses** Operating expenses increased \$98,613, or 1.6%, to \$6,303,769 for Fiscal 2016 compared to \$6,205,156 for Fiscal 2015. General, administrative and sales expenses increased \$189,246, or 3.2%, to \$6,016,097 in Fiscal 2015 compared to \$5,826,851 in the prior year. This increase was a result of increases in sales commissions, salaries and related payroll expense in the early part of Fiscal 2016 and increases in general office and utilities costs for Fiscal 2016, offset by decreases in depreciation expense. This increase in general, administrative and sales expenses was offset by a decrease in spending of \$90,633, or 24.0%, for research and development in Fiscal 2016 as compared to Fiscal 2015.

Operating expenses increased \$66,605, or 1.1%, to \$6,205,156 for Fiscal 2015 compared to \$6,138,551 for Fiscal 2014. General, administrative and sales expenses increased \$163,730, or 2.9%, to \$5,826,851 in Fiscal 2015 compared to \$5,663,121 in the prior year. Increases in personnel costs and commissions expense were offset by decreases in professional fees, depreciation expense and other general office expenses. Research and development expenses decreased \$97,125, or 20.4%, to \$378,305 in Fiscal 2015 compared to \$475,430 in Fiscal 2014. The decrease in research and development expense was primarily due to the timing of completion of some of the development projects occurring within our existing product lines, with new projects starting during the fourth quarter of Fiscal 2015.

**Other income (expense)** Other income (expense) consists of interest income, interest expense, foreign currency exchange gain (loss) and other income (expense). Interest income was \$1,338, \$191 and \$1,558 in Fiscal 2016, 2015 and 2014, respectively. Fluctuations in interest income are impacted by the levels of our average cash and investment balances and changes in interest rates. Interest expense was \$2,988, \$3,452 and \$9,158 in Fiscal 2016, 2015 and 2014, respectively. Fiscal 2016 and 2015 interest expense is related to the capital lease of a piece of manufacturing equipment. Fiscal 2014 interest expense was related to the interest charges on the outstanding balances on our line of credit. Foreign currency exchange loss was \$57,406, \$33,411 and \$23,375 in Fiscal 2016,



2015 and 2014, respectively. The foreign currency exchange loss fluctuated with the strength of foreign currencies against the U.S. dollar during the respective periods. In Fiscal 2016, 2015 and 2014, other income included gains in the amounts of \$299, \$17,500 and \$13,667, respectively, which were the result of sales of certain fixed assets.

**Income tax provision** The effective tax rate in Fiscal 2016 was 1.3%. The effective tax rate on consolidated net loss in Fiscal 2016 differed from the federal statutory tax rate primarily due to changes in the deferred tax valuation allowance. The effective tax rate in Fiscal 2015 was 12.1%. The effective tax rate on consolidated net loss in Fiscal 2015 differed from the federal statutory tax rate primarily due to changes in the deferred tax valuation allowance and certain expenses not being deductible for income tax reporting, offset by tax credits related to research and experimentation expenses. The effective tax rate in Fiscal 2014 was 1.8%. The effective tax rate on consolidated net loss in Fiscal 2014 differed from the federal statutory tax rate primarily due to changes in the deferred tax valuation allowance and certain expenses not being deductible for income tax reporting, offset by tax credits related to research and experimentation expenses.

**Net income (loss)** Net loss was \$1,515,189, or \$(0.51) per fully diluted share, for the year ended May 31, 2016 as compared to net loss of \$93,669, or \$(0.03) per fully diluted share, for the year ended May 31, 2015. Net loss for Fiscal 2016 was primarily the result of the decline in sales to our customers in China, other Asia markets and North America within the Balancer segment, lower sales in the SMS product line and higher operating expenses. Net loss was \$93,669, or \$(0.03) per fully diluted share, for the year ended May 31, 2015 as compared to net loss of \$539,624, or \$(0.18) per fully diluted share for the year ended May 31, 2014. Net loss for Fiscal 2015 reflected increased sales and a higher gross margin percentage, which was partially offset by an increase in operating expenses.

## LIQUIDITY AND CAPITAL RESOURCES

The Company's working capital decreased \$1,227,608 to \$6,325,707 as of May 31, 2016 compared to \$7,553,315 as of May 31, 2015. Cash and cash equivalents decreased \$806,968 from \$1,795,654 as of May 31, 2015 to \$988,686 as of May 31, 2016.

Cash used in operating activities was \$819,808 in Fiscal 2016, as compared to cash provided by operating activities of \$390,146 in Fiscal 2015 and cash used in operations of \$392,376 in Fiscal 2014. The amount of cash used in or provided by operating activities was primarily impacted by the amount of the net loss in each of the fiscal years, the timing of collections of accounts receivable, shifts in the level of inventories, and the timing of payments of accounts payable.

At May 31, 2016, accounts receivable decreased \$561,344 to \$2,099,082 compared to \$2,660,426 as of May 31, 2015. The decrease in accounts receivable was due to the decrease in sales in the second half of Fiscal 2016 and the timing of collections. Inventories increased \$170,410 to \$4,727,977 as of May 31, 2016 compared to \$4,557,567 as of May 31, 2015 as a result of lower level of sales occurring during Fiscal 2016. At May 31, 2016, total current liabilities increased \$15,369 to \$1,630,700 as compared to \$1,615,331 at May 31, 2015.

During Fiscal 2016, net cash provided by investing activities of \$11,430 consisted primarily of the proceeds from the disposition of some office equipment, offset by the purchase of computer equipment. During Fiscal 2015, net cash used in investing activities of \$49,127 consisted primarily of the addition of a new vehicle and new manufacturing and computer equipment, offset by the proceeds from the disposition of one of the Company's vehicles. During Fiscal 2014, net cash used in investing activities of \$36,692 consisted primarily of additions to property and equipment of new manufacturing and computer equipment, offset by proceeds from the disposition of one of the Company's vehicles.

We believe that our existing cash and investments combined with the cash we anticipate to generate from operating activities and financing available from other sources will be sufficient to meet our cash requirements

for the foreseeable future. We do not have any significant commitments nor are we aware of any significant events or conditions that are likely to have a material impact on our liquidity or capital resources.

## QUARTERLY FINANCIAL DATA

*In thousands, except per share information (unaudited)*

	August 31	November 30	February 29	May 31
<b>2016 Quarter Ended</b>				
Net sales	\$ 3,104	\$ 3,074	\$ 2,528	\$ 2,979
Gross profit	\$ 1,442	\$ 1,276	\$ 1,063	\$ 1,085
Net loss	\$ (195)	\$ (404)	\$ (451)	\$ (465)
Net loss per share, basic	\$ (0.07)	\$ (0.13)	\$ (0.15)	\$ (0.16)
Net loss per share, diluted	\$ (0.07)	\$ (0.13)	\$ (0.15)	\$ (0.16)
	August 31	November 30	February 28	May 31
<b>2015 Quarter Ended</b>				
Net sales	\$ 3,049	\$ 3,152	\$ 3,011	\$ 3,858
Gross profit	\$ 1,464	\$ 1,554	\$ 1,350	\$ 1,773
Net income (loss)	\$ 52	\$ (70)	\$ (168)	\$ 93
Net income (loss) per share, basic	\$ 0.02	\$ (0.02)	\$ (0.06)	\$ 0.03
Net income (loss) per share, diluted	\$ 0.02	\$ (0.02)	\$ (0.06)	\$ 0.03

## Item 7A. Quantitative and Qualitative Disclosures about Market Risk

### Interest Rate Risk

The Company did not have any derivative financial instruments as of May 31, 2016. However, the Company could be exposed to interest rate risk at any time in the future and, therefore, employs established policies and procedures to manage its exposure to changes in the market risk of its cash equivalents.

The Company's interest income and expense are most sensitive to changes in the general level of U.S. interest rates. In this regard, changes in the U.S. interest rates affect the interest earned on the Company's interest bearing cash equivalents and short term investments. During FY2014, the Company allowed its variable rate line of credit facility with a bank to expire, and as such there was no outstanding balance as of May 31, 2016. Also, there is no other long-term obligation whose interest rates are based on variable rates that may fluctuate over time based on economic changes in the environment. Therefore, at this time, the Company is not subject to interest rate risk on outstanding interest bearing obligations if market interest rates fluctuate and does not expect any change in the interest rates to have a material effect on the Company's results from operations.

### Foreign Currency Risk

The Company markets and sells its products worldwide and international sales have accounted for and are expected to continue to account for a significant portion of future revenue. The Company operates a subsidiary in the United Kingdom and acquires certain materials and services from vendors transacted in foreign currencies. Therefore, the Company's business and financial condition is sensitive to currency exchange rates or any other restrictions imposed on their currencies. For Fiscal 2016, 2015 and 2014, results of operations included losses on foreign currency translation of \$57,406, \$33,411 and \$23,375, respectively. The foreign exchange gains or losses in Fiscal 2016, 2015 and 2014 are primarily attributable to Company's United Kingdom subsidiary, Schmitt Europe, Ltd.

**Item 8. Financial Statements and Supplementary Data**

SCHMITT INDUSTRIES, INC.

**CONSOLIDATED BALANCE SHEETS**

	May 31, 2016	May 31, 2015
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 988,686	\$ 1,795,654
Accounts receivable, net	2,099,082	2,660,426
Inventories	4,727,977	4,557,567
Prepaid expenses	132,230	153,970
Income taxes receivable	8,432	1,029
	7,956,407	9,168,646
<b>Property and equipment, net</b>	<b>965,452</b>	<b>1,110,878</b>
<b>Other assets</b>		
Intangible assets, net	712,881	824,411
<b>TOTAL ASSETS</b>	<b>\$ 9,634,740</b>	<b>\$ 11,103,935</b>
<b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 877,167	\$ 834,002
Accrued commissions	273,147	284,944
Accrued payroll liabilities	148,823	140,872
Other accrued liabilities	331,563	355,513
<b>Total current liabilities</b>	<b>1,630,700</b>	<b>1,615,331</b>
<b>Commitments and contingencies (Note 5)</b>		
<b>Stockholders equity</b>		
Common stock, no par value, 20,000,000 shares authorized, 2,995,910 shares issued and outstanding at May 31, 2016 and May 31, 2015	10,569,522	10,511,324
Accumulated other comprehensive loss	(394,518)	(366,945)
Accumulated deficit	(2,170,964)	(655,775)
<b>Total stockholders equity</b>	<b>8,004,040</b>	<b>9,488,604</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 9,634,740</b>	<b>\$ 11,103,935</b>

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

## SCHMITT INDUSTRIES, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

	Year Ended May 31,		
	2016	2015	2014
<b>Net sales</b>	\$ 11,685,353	\$ 13,069,091	\$ 12,134,506
Cost of sales	6,818,058	6,928,394	6,508,360
<b>Gross profit</b>	4,867,295	6,140,697	5,626,146
Operating expenses:			
General, administration and sales	6,016,097	5,826,851	5,663,121
Research and development	287,672	378,305	475,430
Total operating expenses	6,303,769	6,205,156	6,138,551
<b>Operating loss</b>	(1,436,474)	(64,459)	(512,405)
Other expense	(58,713)	(19,123)	(17,887)
<b>Loss before income taxes</b>	(1,495,187)	(83,582)	(530,292)
Provision for income taxes	20,002	10,087	9,332
<b>Net loss</b>	\$ (1,515,189)	\$ (93,669)	\$ (539,624)
<b>Net loss per common share, basic</b>	\$ (0.51)	\$ (0.03)	\$ (0.18)
<b>Weighted average number of common shares, basic</b>	2,995,910	2,995,910	2,995,910
<b>Net loss per common share, diluted</b>	\$ (0.51)	\$ (0.03)	\$ (0.18)
<b>Weighted average number of common shares, diluted</b>	2,995,910	2,995,910	2,995,910
<b>Comprehensive loss</b>			
Net loss	\$ (1,515,189)	\$ (93,669)	\$ (539,624)
Foreign currency translation adjustment	(27,573)	(103,608)	68,587
<b>Total comprehensive loss</b>	\$ (1,542,762)	\$ (197,277)	\$ (471,037)

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

## SCHMITT INDUSTRIES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended May 31,		
	2016	2015	2014
<b>Cash flows relating to operating activities</b>			
Net loss	\$ (1,515,189)	\$ (93,669)	\$ (539,624)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	245,824	266,572	328,293
Gain on disposal of property and equipment	(299)	(17,500)	(13,667)
Stock based compensation	58,198	72,574	57,726
(Increase) decrease in:			
Accounts receivable	548,650	(455,905)	(224,309)
Inventories	(192,509)	205,399	292,594
Prepaid expenses	20,737	(3,701)	69,201
Income taxes receivable	(7,403)	310	46,756
Increase (decrease) in:			
Accounts payable	46,787	326,899	(411,954)
Accrued liabilities and customer deposits	(24,604)	89,377	2,398
Income taxes payable	0	(210)	210
Net cash provided by (used in) operating activities	(819,808)	390,146	(392,376)
<b>Cash flows relating to investing activities</b>			
Purchase of property and equipment	(3,520)	(66,627)	(56,192)
Proceeds from sale of property and equipment	14,950	17,500	19,500
Net cash provided by (used in) investing activities	11,430	(49,127)	(36,692)
<b>Cash flows relating to financing activities</b>			
Common stock issued on exercise of stock options	0	0	11,500
Increase in line of credit	0	0	400,000
Payments on line of credit	0	0	(400,000)
Net cash provided by financing activities	0	0	11,500
<b>Effect of foreign exchange translation on cash</b>	1,410	(55,930)	19,062
<b>Increase (decrease) in cash and cash equivalents</b>	(806,968)	285,089	(398,506)
<b>Cash and cash equivalents, beginning of period</b>	1,795,654	1,510,565	1,909,071
<b>Cash and cash equivalents, end of period</b>	\$ 988,686	\$ 1,795,654	\$ 1,510,565
<b>Supplemental disclosure of cash flow information</b>			
Cash paid during the year for income taxes	\$ 27,496	\$ 9,978	\$ 8,989
Cash paid during the year for interest	\$ 2,988	\$ 3,452	\$ 9,159

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

## SCHMITT INDUSTRIES, INC.

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

	Shares	Amount	Accumulated other comprehensive loss	Retained earnings	Total
<b>Balance, May 31, 2013</b>	2,990,910	\$ 10,369,524	\$ (331,924)	\$ (22,482)	\$ 10,015,118
Stock options exercised net of related tax benefit of \$0	5,000	11,500	0	0	11,500
Stock based compensation	0	57,726	0	0	57,726
Net loss	0	0	0	(539,624)	(539,624)
Other comprehensive income	0	0	68,587	0	68,587
<b>Balance, May 31, 2014</b>	2,995,910	10,438,750	(263,337)	(562,106)	9,613,307
Stock based compensation	0	72,574	0	0	72,574
Net loss	0	0	0	(93,669)	(93,669)
Other comprehensive income	0	0	(103,608)	0	(103,608)
<b>Balance, May 31, 2015</b>	2,995,910	10,511,324	(366,945)	(655,775)	9,488,604
Stock based compensation	0	58,198	0	0	58,198
Net loss	0	0	0	(1,515,189)	(1,515,189)
Other comprehensive loss	0	0	(27,573)	0	(27,573)
<b>Balance, May 31, 2016</b>	2,995,910	\$ 10,569,522	\$ (394,518)	\$ (2,170,964)	\$ 8,004,040

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

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**Schmitt Industries, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014**

**NOTE 1**

**THE COMPANY**

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

**NOTE 2**

**SIGNIFICANT ACCOUNTING POLICIES**

**Principles of Consolidation**

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

**Revenue Recognition**

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

**Cash and Cash Equivalents**

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

**Accounts Receivable**

The Company maintains credit limits for all customers based upon several factors, including but not limited to financial condition and stability, payment history, published credit reports and use of credit references. Management performs various analyses to evaluate accounts receivable balances to ensure recorded amounts reflect estimated net realizable value. This review includes using accounts receivable agings, other

## Schmitt Industries, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014

operating trends and relevant business conditions, including general economic factors, as they relate to each of the Company's domestic and international customers. If these analyses lead management to the conclusion that potential significant accounts are uncollectible, a reserve is provided. The allowance for doubtful accounts was \$42,387 and \$56,370 as of May 31, 2016 and 2015, respectively.

**Inventories**

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

	2016	2015
Raw materials	\$ 2,030,655	\$ 1,845,037
Work-in-process	1,059,864	836,346
Finished goods	1,637,458	1,876,184
	\$ 4,727,977	\$ 4,557,567

**Property and Equipment**

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

	2016	2015
Land	\$ 299,000	\$ 299,000
Buildings and improvements	1,814,524	1,814,524
Furniture, fixtures and equipment	1,344,343	1,381,691
Vehicles	96,587	96,587
	3,554,454	3,591,802
Less accumulated depreciation	(2,589,002)	(2,480,924)
	\$ 965,452	\$ 1,110,878



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**Schmitt Industries, Inc.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014****Intangible Assets**

Amortizable intangible assets, which include purchased technology and patents, are amortized over their estimated useful lives ranging from five to seventeen years. As of May 31, 2016 and 2015, amortizable intangible assets were \$2,200,883, and accumulated amortization was \$1,488,002 and \$1,376,472, respectively. Amortization expense for each of the following years ending May 31 is expected to be as follows:

Year ending May 31,	
2017	111,531
2018	104,583
2019	104,583
2020	104,583
2021	104,583
Thereafter	183,018
	<b>\$ 712,881</b>

Intangible and other long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. Recoverability is determined by comparing the forecasted future net cash flows from the operations to which the assets relate, based on management's best estimates using the appropriate assumptions and projections at the time, to the carrying amount of the assets. If the carrying value is determined to be in excess of future operating cash flows, the asset is considered impaired and a loss is recognized equal to the amount by which the carrying amount exceeds the estimated fair value of the assets. As of May 31, 2016, no impairment existed.

**Foreign Currency**

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

**Advertising**

Advertising costs included in general, administration and sales, are expensed when the advertising first takes place. Advertising expense was \$27,762, \$33,451 and \$45,155 for the years ended May 31, 2016, 2015 and 2014, respectively.

**Research and Development Costs**

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

**Warranty Reserve**

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



**Schmitt Industries, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014**

**Stock-Based Compensation**

Stock-based compensation includes expense charges for all stock-based awards to employees and directors granted under the Company's stock option plan. The Company requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options based on estimated fair values.

Stock-based compensation recognized during the period is based on the value of the portion of the stock-based award that will vest during the period, adjusted for expected forfeitures. Compensation cost for all stock-based awards is recognized using the straight-line method.

**Income Taxes**

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

**Earnings (Loss) Per Share**

Basic earnings (loss) per share is computed using the weighted average number of common shares outstanding. Diluted earnings (loss) per share is computed using the weighted average number of common shares outstanding, adjusted for dilutive incremental shares attributed to outstanding options to purchase common stock. Common stock equivalents for stock options are computed using the treasury stock method. In periods in which a net loss is incurred, no common stock equivalents are included since they are antidilutive and as such all stock options outstanding are excluded from the computation of diluted net loss in those periods. 118, 3,375 and 7,636 potentially dilutive common shares from outstanding stock options have been excluded from diluted earnings (loss) per share for the years ended May 31, 2016, 2015 and 2014, respectively.

**Concentration of Credit Risk**

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

**Financial Instruments**

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

**Shipping and Handling Charges**

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

## Schmitt Industries, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014

**Use of Estimates**

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

**Recent accounting pronouncements**

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers (Topic 606). ASU 2014-09 affects any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (e.g., insurance contracts or lease contracts). ASU 2014-09 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016.

In August 2015, the FASB issued ASU 2015-14, which defers the effective date of ASU 2014-09 by one year. The new guidance is effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption is permitted as of the date of the original effective date, for interim and annual reporting periods beginning after December 15, 2016.

The Company is currently evaluating the provisions of ASU 2015-14 and ASU 2014-09.

**NOTE 3****INCOME TAXES**

The provision for income taxes is as follows:

	Year ended May 31,		
	2016	2015	2014
Current	\$ 20,002	\$ 10,087	\$ 9,332
Deferred	(533,357)	3,558	(155,252)
Change in valuation allowance	533,357	(3,558)	155,252
Total provision for income taxes	\$ 20,002	\$ 10,087	\$ 9,332

Deferred tax assets are comprised of the following components:

	2016	2015
Basis difference of assets	\$ 321,511	\$ 336,196
Inventory related items	276,887	260,152
Other reserves and liabilities	119,460	111,694
Net operating loss carryforward	1,369,399	850,655
General business and other credit carryforward	454,246	454,060
Other deferred items, net	12,933	8,322

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Gross deferred tax assets	2,554,436	2,021,079
Deferred tax asset valuation allowance	(2,554,436)	(2,021,079)
Net deferred tax asset	\$ 0	\$ 0

Page 33

## Schmitt Industries, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014

Deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the deferred tax asset will not be realized. The Company has recorded a substantial deferred tax asset related to temporary differences between book and tax bases of assets and liabilities. During the years ended May 31, 2016, 2015 and 2014, the Company increased its valuation allowance \$533,357, \$3,558, and \$155,252 respectively, as a result of the increase in the Company's deferred tax assets. The Company has provided a full valuation allowance against all of its deferred tax assets as the recent losses have been given more weight than projected future income when determining the need for a valuation allowance.

The Company has federal net operating loss carryforwards of approximately \$3.1 million which begin to expire in 2030 along with the federal general business and other credit carryforwards. The Company has state net operating loss carryforwards of approximately \$3.7 million which begin to expire in 2024.

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

	Year ended May 31,		
	2016	2015	2014
Statutory federal tax rate	(34.0)%	(34.0)%	(34.0)%
State taxes, net of federal benefit	(4.4)	(4.4)	(4.4)
Change in deferred tax valuation allowance	35.7	3.8	29.3
Stock-based compensation	1.2	28.1	4.2
R&E tax credits	0.7	(21.6)	1.5
Effect of foreign income tax rates	1.1	11.1	1.8
Permanent and other differences	1.0	29.1	3.4
Effective tax rate	1.3%	12.1%	1.8%

Each year the Company files income tax returns in the various federal, state and local income taxing jurisdictions in which it operates. These tax returns are subject to examination and possible challenge by the taxing authorities. Positions challenged by the taxing authorities may be settled or appealed by the Company. As a result, there is an uncertainty in income taxes recognized in the Company's financial statements in accordance with ASC Topic 740. The Company applies this guidance by defining criteria that an individual income tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements and provides guidance on measurement, derecognition, classification, accounting for interest and penalties, accounting in interim periods, disclosure, and transition. The liability for unrecognized tax benefits was \$0 as of May 31, 2016 and 2015.

Interest and penalties associated with uncertain tax positions are recognized as components of the Provision for income taxes. The liability for payment of interest and penalties was \$0 as of May 31, 2016 and 2015.

Several tax years are subject to examination by major tax jurisdictions. In the United States, federal tax years for Fiscal 2013 and after are subject to examination. In the United Kingdom, tax years for Fiscal 2012 and after are subject to examination. In Canada, tax years for Fiscal 2005 and after are subject to examination.

## Schmitt Industries, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014

## NOTE 4

## COMMITMENTS AND CONTINGENCIES

The Company entered into a 5-year lease of manufacturing equipment in May 2014. The lease is classified as a capital lease and the asset, valued at \$38,890, is included in the furniture, fixtures and equipment amount in Note 2 Property and Equipment as of May 31, 2016 and 2015.

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

	Year ending May 31,	
2017		\$ 9,019
2018		9,019
2019		12,384
2020		0
2021		0
Thereafter		0
<b>Total minimum lease payments</b>		<b>30,422</b>
Less: amount representing interest		(4,115)
<b>Present value of minimum lease payments <sup>(1)</sup></b>		<b>\$ 26,307</b>

(1) Reflected in other accrued liabilities on the balance sheet as of May 31, 2016 and 2015.

The Company leases certain facilities and equipment to support operations under non-cancelable operating leases and other contractual obligations. Total lease expense under operating leases for the years ended May 31, 2016, 2015 and 2014 amounted to \$73,688, \$59,481 and \$58,517, respectively.

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

	Year ending May 31,	
2017		\$ 51,905
2018		21,480
2019		21,480
2020		21,480
2021		5,370
Thereafter		0

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

ended May 31, 2016, 2015 and 2014 amounted to \$14,825, \$59,712 and \$30,386, respectively.



## Schmitt Industries, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014

## NOTE 5

## SEGMENT INFORMATION

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

	2016		Year Ended May 31, 2015		2014	
	Balancer	Measurement	Balancer	Measurement	Balancer	Measurement
Gross sales	\$ 8,257,036	\$ 4,728,905	\$ 9,132,167	\$ 5,191,970	\$ 8,675,628	\$ 4,472,945
Intercompany sales	(1,294,290)	(6,298)	(1,281,931)	26,885	(954,417)	(59,650)
Net sales	\$ 6,962,746	\$ 4,722,607	\$ 7,850,236	\$ 5,218,855	\$ 7,721,211	\$ 4,413,295
Operating income (loss)	\$ (992,342)	\$ (444,132)	\$ (323,288)	\$ 258,829	\$ (316,863)	\$ (195,542)
Depreciation expense	\$ 94,954	\$ 39,340	\$ 103,349	\$ 43,991	\$ 137,808	\$ 55,849
Amortization expense	\$ 0	\$ 111,530	\$ 0	\$ 119,232	\$ 0	\$ 134,636
Capital expenditures	\$ 3,520	\$ 0	\$ 58,700	\$ 7,927	\$ 56,192	\$ 0

*Geographic Information*

	2016		Year Ended May 31, 2015		2014	
	United States	Europe	United States	Europe	United States	Europe
North America	\$ 7,749,753	\$ 8,165,269	\$ 7,474,067			
Europe	1,435,280	1,194,186	1,773,928			
Asia	2,288,550	3,388,757	2,693,767			
Other markets	211,770	320,879	192,744			
Total Net Sales	\$ 11,685,353	\$ 13,069,091	\$ 12,134,506			

	2016		Year Ended May 31, 2015		2014	
	United States	Europe	United States	Europe	United States	Europe
Operating loss	\$ (1,255,589)	\$ (180,885)	\$ (69,399)	\$ 4,940	\$ (479,218)	\$ (33,187)
Depreciation expense	\$ 134,294	\$ 0	\$ 147,339	\$ 0	\$ 193,657	\$ 0

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Amortization expense	\$	111,530	\$	0	\$	119,233	\$	0	\$	134,636	\$	0
Capital expenditures	\$	3,520	\$	0	\$	66,627	\$	0	\$	56,192	\$	0

## Schmitt Industries, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014

*Segment and Geographic Assets*

	May 31, 2016	May 31, 2015
<b>Segment assets to total assets</b>		
Balancer	\$ 4,727,490	\$ 5,059,567
Measurement	3,910,132	4,247,684
Corporate assets	997,118	1,796,684
<b>Total assets</b>	<b>\$ 9,634,740</b>	<b>\$ 11,103,935</b>
<b>Geographic assets to long-lived assets</b>		
United States	\$ 965,452	\$ 1,110,878
Europe	0	0
<b>Total assets</b>	<b>\$ 965,452</b>	<b>\$ 1,110,878</b>
<b>Geographic assets to total assets</b>		
United States	\$ 8,772,666	\$ 10,107,523
Europe	862,074	996,412
<b>Total assets</b>	<b>\$ 9,634,740</b>	<b>\$ 11,103,935</b>

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

**NOTE 6****STOCK OPTIONS AND STOCK BASED COMPENSATION**

The Board of Directors adopted the 2014 Equity Incentive Plan (2014 Plan) in August 2014, the 2004 Stock Option Plan (2004 Plan) in August 2004 and the 1995 Stock Option Plan (1995 Plan) in December 1995, which was amended in August 1996 and restated in August 1998. The 2014 Plan provides for the grant of (i) stock options (both nonqualified and incentive stock options), (ii) stock appreciation rights or SARs, (iii) restricted stock, (iv) restricted stock units or RSUs, (v) performance awards, and (vi) other share-based awards. An incentive stock option granted under the 2014 Plan is intended to qualify as an incentive stock option (ISO) and nonstatutory stock option granted under the 2014 Plan are not intended to qualify as an ISO. An option granted under the 2004 Plan and/or 1995 Plan (the Plans) might be either an ISO, or an NSO. ISOs may be granted only to employees and members of the Board of Directors of the Company and are subject to certain limitations, in addition to restrictions applicable to all stock options under the Plan. Options not meeting these limitations will be treated as NSOs. The purchase price of ISOs is fair market value on the date of grant; the purchase price of NSOs may vary from fair market value. Vesting is at the discretion of the compensation committee of the Board of Directors, but generally is either 50% at grant date and 16.7% on each anniversary thereafter; 25% at grant date and 25% on each anniversary thereafter or 0% at grant date and 33% on each anniversary thereafter. The Company initially reserved 400,000 shares for issuance under the 1995 Plan and 300,000 shares for issuance under the 2004 Plan and 2014 Plan. The 1995 Plan expired in December 2005 and no additional options may be issued under the 1995 Plan, although expiration of the 1995 Plan did not affect the rights of persons who received stock grants under the 1995 Plan. The 2004 Plan expired in August 2015 and no additional options may be issued under the 2004 Plan. Stock-based compensation recognized in the Company's Consolidated Financial Statements for the years ended May 31, 2016, 2015 and 2014 includes compensation cost for stock-based awards granted. All outstanding options will expire no later than 2024.

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The Company uses 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

Page 37

## Schmitt Industries, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014

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 ASC Topic 718, 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 0.

*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 years ended May 31, 2016, 2015 and 2014, the value of all stock options granted using the Black-Scholes option pricing model as prescribed by ASC Topic 718 using the following assumptions:

	Year Ended May 31,		
	2016	2015	2014
Risk-free interest rate	N/A	2.7%	3.5%
Expected life	N/A	4.7 years	4.3 years
Expected volatility	N/A	55.3%	62.5%

**Stock-Based Compensation Under ASC Topic 718**

The total stock-based compensation expense recognized under ASC Topic 718 was \$58,198, \$72,574 and \$57,726 during Fiscal 2016, 2015 and 2014, respectively. All stock-based compensation expense has been recorded as general, administration and sales expense in the Consolidated Financial Statements.

As of May 31, 2016, the Company had a total of 147,500 outstanding stock options (107,500 vested and exercisable and 40,000 non-vested) with a weighted average exercise price of \$3.11. The Company estimates that a total of \$26,699 will be recorded as additional stock-based compensation expense for all options which were outstanding as of May 31, 2016, but which were not yet vested.



## Schmitt Industries, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014

Options outstanding and exercisable consist of the following as of May 31, 2016:

Number of Shares	Outstanding Options		Exercisable Options	
	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (yrs)	Number of Shares	Weighted Average Exercise Price
15,000	\$ 2.53	7.3	10,000	\$ 2.53
77,500	2.85	7.9	42,500	2.87
55,000	3.65	5.0	55,000	3.65
147,500	3.11	6.8	107,500	3.24

Options granted, exercised, canceled and expired under the Company's stock option plan during the years ended May 31, 2016, 2015 and 2014 are summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Options outstanding - May 31, 2013	301,666	\$ 4.06
Options granted	35,000	2.53
Options exercised	(5,000)	2.30
Options forfeited/cancelled	(50,000)	4.82
Options outstanding - May 31, 2014	281,666	3.77
Options granted	87,500	2.82
Options exercised	0	0.00
Options forfeited/cancelled	(36,666)	2.30
Options outstanding - May 31, 2015	332,500	3.68
Options granted	0	0.00
Options exercised	0	0.00
Options forfeited/cancelled	(185,000)	4.13
Options outstanding - May 31, 2016	147,500	3.11

The total intrinsic value of both outstanding and exercisable options as of May 31, 2016 and 2015 was \$0 and \$7,350, respectively. The total intrinsic value of options exercised during the years ended May 31, 2016, 2015 and 2014 was \$0, \$0 and \$3,025, respectively.

## Schmitt Industries, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## FOR THE YEARS ENDED MAY 31, 2016, 2015 AND 2014

## NOTE 7

## EARNINGS PER SHARE

Basic earnings per share is computed using the weighted average number of shares outstanding. Diluted earnings per share is computed using the weighted average number of shares outstanding, adjusted for dilutive incremental shares attributed to outstanding options to purchase common stock. The following table is a reconciliation of the numerators and denominators of the basic and diluted per share computations for each of the three years in the period ended May 31:

	Net income/(loss) (Numerator)	Weighted Average Shares (Denominator)	Per Share Amount
<b>Year ended May 31, 2016</b>			
Basic earnings per share			
Loss available to common stockholders	\$ (1,515,189)	2,995,910	\$ (0.51)
Effect of dilutive securities stock options	0	0	
Diluted earnings per share			
Loss available to common stockholders	\$ (1,515,189)	2,995,910	\$ (0.51)
<b>Year ended May 31, 2015</b>			
Basic earnings per share			
Loss available to common stockholders	\$ (93,669)	2,995,910	\$ (0.03)
Effect of dilutive securities stock options	0	0	
Diluted earnings per share			
Loss available to common stockholders	\$ (93,669)	2,995,910	\$ (0.03)
<b>Year ended May 31, 2014</b>			
Basic earnings per share			
Loss available to common stockholders	\$ (539,624)	2,995,910	\$ (0.18)
Effect of dilutive securities stock options	0	0	
Diluted earnings per share			
Loss available to common stockholders	\$ (539,624)	2,995,910	\$ (0.18)

## NOTE 8

## EMPLOYEE BENEFIT PLANS

The Company adopted the Schmitt Industries, Inc. 401(k) Profit Sharing Plan & Trust effective June 1, 1996. Employees must meet certain age and service requirements to be eligible. Participants may contribute up to 15% of their eligible compensation which may be partially matched by the Company. The Company may make further contributions in the form of a profit sharing contribution or a discretionary contribution. The Company made matching contributions in conjunction with employee contributions to the plan totaling \$57,178, \$51,999 and \$55,917 during the years ended May 31, 2016, 2015 and 2014, respectively.





*Report of Independent Registered Public Accounting Firm*

Board of Directors and Shareholders

Schmitt Industries, Inc.

We have audited the accompanying consolidated balance sheets of Schmitt Industries, Inc. and its subsidiaries (the Company) as of May 31, 2016 and 2015, and the related consolidated statements of operations and comprehensive loss, stockholders' equity and cash flows for the years ended May 31, 2016, 2015 and 2014. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Schmitt Industries, Inc. and subsidiaries as of May 31, 2016 and 2015 and the consolidated results of their operations and their cash flows for the years ended May 31, 2016, 2015 and 2014 in conformity with accounting principles generally accepted in the United States of America.

/s/ MOSS-ADAMS LLP

Portland, Oregon

August 5, 2016

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

***Evaluation of Disclosure Controls and Procedures***

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934, as amended (Exchange Act), is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. Our disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosures. 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.

An evaluation was carried out under the supervision and with the participation of the Company's management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report as defined in Exchange Act Rule 13a-15(e) and Rule 15d-15(e). Based on that evaluation, the CEO and CFO have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed in our Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to our management, including the our CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

***Management's Report on Internal Control Over Financial Reporting***

Our management is responsible for establishing and maintaining adequate internal controls over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)). Under the supervision and with the participation of our management, including our CEO and CFO, we conducted an evaluation of the effectiveness of our internal controls over financial reporting based on the framework in *Internal Controls Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control Integrated Framework*, our management concluded that our internal controls over financial reporting were effective as of May 31, 2016.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to SEC rules adopted in conformity with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

***Changes in Internal Control over Financial Reporting***

There were no changes in our internal control over financial reporting (as defined in Exchange Rules 13a-15(f) and 15d-15(f)) that occurred during the quarter ended May 31, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information**

None.

**PART III**

Certain information required by Part III is included in the Company's definitive Proxy Statement for its 2016 Annual Meeting of Shareholders (Proxy Statement) and is incorporated herein by reference. The Proxy Statement will be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934 not later than 120 days after the end of the fiscal year covered by this Report.

**Item 10. Directors, Executive Officers and Corporate Governance**

The information required by this item is included in the Company's Proxy Statement relating to the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

**Item 11. Executive Compensation**

The information required by this item is included in the Company's Proxy Statement relating to the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required by this item is included in the Company's Proxy Statement relating to the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

**Item 13. Certain Relationships and Related Transactions and Director Independence**

The information required by this item is included in the Company's Proxy Statement relating to the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

**Item 14. Principal Accounting Fees and Services**

The information required by this item is included in the Company's Proxy Statement relating to the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a) *Financial Statements:*

- (1) Consolidated Balance Sheets as of May 31, 2016 and 2015  
Consolidated Statements of Operations and Comprehensive Loss for the years ended May 31, 2016, 2015 and 2014  
Consolidated Statements of Cash Flows for the years ended May 31, 2016, 2015 and 2014  
Consolidated Statements of Stockholders' Equity for the years ended May 31, 2016, 2015 and 2014  
Notes to Consolidated Financial Statements for the years ended May 31, 2016, 2015 and 2014  
Reports of Independent Registered Public Accounting Firms

- (2) *Financial Statement Schedules:* All financial statement schedules are omitted either because they are not applicable, not required, or the required information is included in the financial statements or notes thereto.
- (3) *Exhibits:* Reference is made to the list on page 46 of the Exhibits filed with this report.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.**

By: /s/ David M. Hudson  
David M. Hudson  
*President and Chief Executive Officer*

Date: August 5, 2016

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on August 5, 2016.

<b>Signature</b>	<b>Title</b>
/s/ Wayne A. Case Wayne A. Case	Chairman of the Board
/s/ David M. Hudson David M. Hudson	Director, President and Chief Executive Officer (Principal Executive Officer)
/s/ Ann M. Ferguson Ann M. Ferguson	Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)
/s/ Maynard Brown Maynard Brown	Director
/s/ Charles Davidson Charles Davidson	Director
/s/ Michael J. Ellsworth Michael J. Ellsworth	Director

**INDEX TO EXHIBITS**

<b>Exhibits</b>	<b>Description</b>
Exhibits marked with an asterisk (*) are incorporated by reference to exhibits or appendices previously filed with the Securities and Exchange Commission, as indicated by the references in brackets. All other exhibits are filed herewith.	
*2.1	Asset Purchase Agreement between Schmitt Industries, Inc., and Glenn Valliant, an individual doing business as Optical Dimensions, dated September 30, 2009.  [Form 10-Q for the fiscal quarter ended November 30, 2009, Exhibit 2.1]
*3.1	Second Restated Articles of Incorporation of Schmitt Industries, Inc.  [Form 10-K for the fiscal year ended May 31, 1999, Exhibit 3(i)]
*3.2	Second Restated Bylaws of Schmitt Industries, Inc.  [Form 10-K for the fiscal year ended May 31, 1999, Exhibit 3(ii)]
*4.1	See exhibits 3.1 and 3.2 for provisions of the Articles of Incorporation and Bylaws defining the rights of security holders.
*10.1	Schmitt Industries, Inc. 2004 Stock Option Plan.  [Appendix B to Schedule 14A filed on August 23, 2004]
*10.2	Schmitt Industries, Inc. 2014 Equity Incentive Plan.  [Appendix A to Schedule 14A filed on August 26, 2014]
*14.1	Code of Ethics and Business Conduct.  [Form 10-K for the fiscal year ended May 31, 2004, Exhibit 14.1]
21.1	Subsidiaries of Schmitt Industries, Inc. as of May 31, 2016.
23.1	Consent of Independent Registered Public Accounting Firm.
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.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

Management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K.

