

SCHMITT INDUSTRIES INC
Form 10-Q
October 11, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: August 31, 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)
2765 NW Nicolai Street, Portland, Oregon 97210-1818
(Address of principal executive offices) (Zip Code)
(503) 227-7908
(Registrant's telephone number, including area code)

93-1151989

(IRS Employer Identification Number)

Indicate by check mark whether the registrant has (1) 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (check one):

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

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

The number of shares of each class of common stock outstanding as of September 30, 2016

Common stock, no par value

2,995,910

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Table of Contents**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements****SCHMITT INDUSTRIES, INC.****CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

| | August 31, 2016 | May 31, 2016 |
|---|---------------------|---------------------|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$ 1,002,158 | \$ 988,686 |
| Accounts receivable, net | 1,916,893 | 2,099,082 |
| Inventories | 4,625,843 | 4,727,977 |
| Prepaid expenses | 110,726 | 132,230 |
| Income taxes receivable | 6,106 | 8,432 |
| | 7,661,726 | 7,956,407 |
| Property and equipment, net | 981,199 | 965,452 |
| Other assets | | |
| Intangible assets, net | 684,998 | 712,881 |
| TOTAL ASSETS | \$ 9,327,923 | \$ 9,634,740 |
| LIABILITIES & STOCKHOLDERS EQUITY | | |
| Current liabilities | | |
| Accounts payable | \$ 710,320 | \$ 877,167 |
| Accrued commissions | 328,521 | 273,147 |
| Accrued payroll liabilities | 138,651 | 148,823 |
| Other accrued liabilities | 307,099 | 331,563 |
| Total current liabilities | 1,484,591 | 1,630,700 |
| Stockholders equity | | |
| Common stock, no par value, 20,000,000 shares authorized, 2,995,910 shares issued and outstanding at August 31, 2016 and May 31, 2016 | 10,578,960 | 10,569,522 |
| Accumulated other comprehensive loss | (439,035) | (394,518) |
| Accumulated deficit | (2,296,593) | (2,170,964) |
| Total stockholders equity | 7,843,332 | 8,004,040 |

| | | |
|--|--------------|--------------|
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 9,327,923 | \$ 9,634,740 |
|--|--------------|--------------|

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

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SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

FOR THE THREE MONTHS ENDED AUGUST 31, 2016 AND 2015

(UNAUDITED)

| | Three Months Ended August 31, | |
|---|----------------------------------|--------------|
| | 2016 | 2015 |
| Net sales | \$ 2,892,532 | \$ 3,104,384 |
| Cost of sales | 1,516,783 | 1,661,892 |
| Gross profit | 1,375,749 | 1,442,492 |
| Operating expenses: | | |
| General, administration and sales | 1,412,669 | 1,537,882 |
| Research and development | 78,847 | 86,912 |
| Total operating expenses | 1,491,516 | 1,624,794 |
| Operating loss | (115,767) | (182,302) |
| Other expense, net | (1,833) | (5,920) |
| Loss before income taxes | (117,600) | (188,222) |
| Provision for income taxes | 8,029 | 6,840 |
| Net loss | \$ (125,629) | \$ (195,062) |
| Net loss per common share: | | |
| Basic | \$ (0.04) | \$ (0.07) |
| Weighted average number of common shares, basic | 2,995,910 | 2,995,910 |
| Diluted | \$ (0.04) | \$ (0.07) |
| Weighted average number of common shares, diluted | 2,995,910 | 2,995,910 |
| Comprehensive loss | | |
| Net loss | \$ (125,629) | \$ (195,062) |
| Foreign currency translation adjustment | (44,517) | 6,359 |
| Total comprehensive loss | \$ (170,146) | \$ (188,703) |

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

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SCHMITT INDUSTRIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED AUGUST 31, 2016 AND 2015
(UNAUDITED)

| | Three Months Ended August 31, | |
|---|----------------------------------|--------------|
| | 2016 | 2015 |
| Cash flows relating to operating activities | | |
| Net loss | \$ (125,629) | \$ (195,062) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 54,147 | 65,247 |
| Gain on disposal of property and equipment | (17,509) | 0 |
| Stock based compensation | 9,438 | 22,199 |
| (Increase) decrease in: | | |
| Accounts receivable | 158,886 | 59,376 |
| Inventories | 63,793 | (218,283) |
| Prepaid expenses | 19,635 | 7,444 |
| Income taxes receivable | 2,326 | (1,210) |
| Increase (decrease) in: | | |
| Accounts payable | (161,133) | (110,002) |
| Accrued liabilities and customer deposits | 27,328 | 60,071 |
| Income taxes payable | 0 | 3,750 |
| Net cash provided by (used in) operating activities | 31,282 | (306,470) |
| Cash flows relating to investing activities | | |
| Purchases of property and equipment | (44,587) | 0 |
| Proceeds from the sale of property and equipment | 20,085 | 0 |
| Net cash used in investing activities | (24,502) | 0 |
| Effect of foreign exchange translation on cash | | |
| | 6,692 | 2,639 |
| Increase (decrease) in cash and cash equivalents | 13,472 | (303,831) |
| Cash and cash equivalents, beginning of period | 988,686 | 1,795,654 |
| Cash and cash equivalents, end of period | \$ 1,002,158 | \$ 1,491,823 |
| Supplemental disclosure of cash flow information | | |

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| | | | | |
|--|----|-------|----|-------|
| Cash paid during the period for income taxes | \$ | 5,703 | \$ | 4,300 |
| Cash paid during the period for interest | \$ | 568 | \$ | 709 |

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

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SCHMITT INDUSTRIES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

FOR THE THREE MONTHS ENDED AUGUST 31, 2016

(UNAUDITED)

| | Shares | Amount | Accumulated other comprehensive loss | Accumulated deficit | Total |
|---------------------------------|-----------|---------------|---|------------------------|--------------|
| Balance, May 31, 2016 | 2,995,910 | \$ 10,569,522 | \$ (394,518) | \$ (2,170,964) | \$ 8,004,040 |
| Stock-based compensation | 0 | 9,438 | 0 | 0 | 9,438 |
| Net loss | 0 | 0 | 0 | (125,629) | (125,629) |
| Other comprehensive loss | 0 | 0 | (44,517) | 0 | (44,517) |
| Balance, August 31, 2016 | 2,995,910 | \$ 10,578,960 | \$ (439,035) | \$ (2,296,593) | \$ 7,843,332 |

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

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SCHMITT INDUSTRIES, INC.

NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS

NOTE 1:

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial information included herein has been prepared by Schmitt Industries, Inc. (the Company or Schmitt) and its wholly owned subsidiaries. In the opinion of management, the accompanying unaudited Consolidated Financial Statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission and contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly its financial position as of August 31, 2016 and its results of operations and its cash flows for the periods presented. The consolidated balance sheet at May 31, 2016 has been derived from the Annual Report on Form 10-K for the fiscal year ended May 31, 2016. The accompanying unaudited financial statements and related notes should be read in conjunction with the audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended May 31, 2016. Operating results for the interim periods presented are not necessarily indicative of the results that may be experienced for the fiscal year ending May 31, 2017.

Revenue Recognition

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

Financial Instruments

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

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 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 \$42,240 and \$42,387 as of August 31, 2016 and May 31, 2016, 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 August 31, 2016 and May 31, 2016, inventories consisted of:

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| | August 31, 2016 | May 31, 2016 |
|-----------------|--------------------|-----------------|
| Raw materials | \$ 1,988,616 | \$ 2,030,655 |
| Work-in-process | 1,075,094 | 1,059,864 |
| Finished goods | 1,562,133 | 1,637,458 |
| | \$ 4,625,843 | \$ 4,727,977 |

Property and Equipment

Property and equipment are stated at cost. 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. As of August 31, 2016 and May 31, 2016, property and equipment consisted of:

| | August 31, 2016 | May 31, 2016 |
|-----------------------------------|--------------------|-----------------|
| Land | \$ 299,000 | \$ 299,000 |
| Buildings and improvements | 1,814,524 | 1,814,524 |
| Furniture, fixtures and equipment | 1,342,649 | 1,344,343 |
| Vehicles | 89,291 | 96,587 |
| | 3,545,464 | 3,554,454 |
| Less accumulated depreciation | (2,564,265) | (2,589,002) |
| | \$ 981,199 | \$ 965,452 |

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.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern. ASU 2014-15 will explicitly require management to assess an entity’s ability to continue as a going concern and to provide related

footnote disclosure in certain circumstances. The new standard is effective for annual reporting periods ending after December 15, 2016 and for annual periods and interim periods thereafter. The Company has not yet evaluated the potential effects of the adoption of ASU 2014-15 on its consolidated financial statements.

NOTE 2:

STOCK OPTIONS AND STOCK-BASED COMPENSATION

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

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

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

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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.

To determine stock-based compensation expense recognized for those options granted during the three months ended August 31, 2016 and 2015, the Company has computed the value of all stock options granted using the Black-Scholes option pricing model. No options were issued during the three months ended August 31, 2016 and 2015.

At August 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 \$17,262 will be recorded as additional stock-based compensation expense over a weighted-average period of 1.0 years for all options that were outstanding as of August 31, 2016, but which were not yet vested.

| Outstanding Options | | | Exercisable Options | |
|---------------------|---------------------------------|---|---------------------|---------------------------------|
| Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (yrs) | Number of Shares | Weighted Average Exercise Price |
| 15,000 | \$2.53 | 7.1 | 10,000 | \$2.53 |
| 77,500 | 2.85 | 7.6 | 42,500 | 2.87 |
| 55,000 | 3.65 | 4.8 | 55,000 | 3.65 |
| 147,500 | 3.11 | 6.5 | 107,500 | 3.24 |

Options granted, exercised, and forfeited or canceled under the Company's stock option plan during the three months ended August 31, 2016 are summarized as follows:

| | Three Months Ended August 31, 2016 | |
|---|------------------------------------|---------------------------------|
| | Number of Shares | Weighted Average Exercise Price |
| Options outstanding - beginning of period | 147,500 | \$ 3.11 |
| Options granted | 0 | 0 |

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| | | |
|-------------------------------------|---------|------|
| Options exercised | 0 | 0 |
| Options forfeited/canceled | 0 | 0 |
| Options outstanding - end of period | 147,500 | 3.11 |

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Table of Contents**NOTE 3:****EPS RECONCILIATION**

| | Three Months Ended August 31, | |
|--|----------------------------------|------------------|
| | 2016 | 2015 |
| Weighted average shares (basic) | 2,995,910 | 2,995,910 |
| Effect of dilutive stock options | 0 | 0 |
| Weighted average shares (diluted) | 2,995,910 | 2,995,910 |

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.

NOTE 4:**INCOME TAXES**

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

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

Other long-term liabilities related to tax contingencies were \$0 as of both August 31, 2016 and May 31, 2016. Interest and penalties associated with uncertain tax positions are recognized as components of the Provision for income taxes. The liability for payment of interest and penalties was \$0 as of August 31 2016 and May 31, 2016.

Several tax years are subject to examination by major tax jurisdictions. In the United States, federal tax years for Fiscal 2012 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.

Effective Tax Rate

The effective tax rate on consolidated net loss was 6.8% for the three months ended August 31, 2016. The effective tax rate on consolidated net loss differs from the federal statutory tax rate primarily due to changes in the deferred tax valuation allowance and certain expenses not being deductible for income tax reporting purposes. Management believes the effective tax rate for Fiscal 2017 will be approximately 10.4% due to the items noted above.

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

Segment Information

| | Three Months Ended August 31, | | | |
|-------------------------|-------------------------------|--------------|--------------|--------------|
| | 2016 | | 2015 | |
| | Balancer | Measurement | Balancer | Measurement |
| Gross sales | \$ 1,828,050 | \$ 1,344,054 | \$ 2,226,247 | \$ 1,186,065 |
| Intercompany sales | (267,174) | (12,398) | (298,752) | (9,176) |
| Net sales | \$ 1,560,876 | \$ 1,331,656 | \$ 1,927,495 | \$ 1,176,889 |
| Operating income (loss) | \$ (212,839) | \$ 97,072 | \$ (133,494) | \$ (48,808) |
| Depreciation expense | \$ 16,787 | \$ 9,477 | \$ 26,810 | \$ 10,555 |
| Amortization expense | \$ 0 | \$ 27,883 | \$ 0 | \$ 27,882 |
| Capital expenditures | \$ 44,587 | \$ 0 | \$ 0 | \$ 0 |

Geographic Information Net Sales by Geographic Area

| | Three Months Ended August 31, | |
|-----------------|-------------------------------|--------------|
| | 2016 | 2015 |
| North America | \$ 1,954,362 | \$ 2,085,315 |
| Europe | 323,412 | 252,311 |
| Asia | 498,620 | 689,270 |
| Other markets | 116,138 | 77,488 |
| Total net sales | \$ 2,892,532 | \$ 3,104,384 |

| | Three Months Ended August 31, | | | |
|--|-------------------------------|--------|---------------|--------|
| | 2016 | | 2015 | |
| | United States | Europe | United States | Europe |
| | | | | |

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| | | | | |
|----------------------|-------------|----------|--------------|-------------|
| Operating loss | \$ (94,165) | (21,602) | \$ (125,499) | \$ (56,803) |
| Depreciation expense | \$ 26,264 | \$ 0 | \$ 37,365 | \$ 0 |
| Amortization expense | \$ 27,883 | \$ 0 | \$ 27,882 | \$ 0 |
| Capital expenditures | \$ 44,587 | \$ 0 | \$ 0 | \$ 0 |

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

Table of Contents**Segment and Geographic Assets**

| | August 31, 2016 | May 31, 2016 |
|--|---------------------|---------------------|
| Segment assets to total assets | | |
| Balancer | \$ 4,703,630 | \$ 4,727,490 |
| Measurement | 3,616,029 | 3,910,132 |
| Corporate assets | 1,008,264 | 997,118 |
| Total assets | \$ 9,327,923 | \$ 9,634,740 |
| Geographic assets to long-lived assets | | |
| United States | \$ 981,199 | \$ 965,452 |
| Europe | 0 | 0 |
| Total long-lived assets | \$ 981,199 | \$ 965,452 |
| Geographic assets to total assets | | |
| United States | \$ 8,528,413 | \$ 8,772,666 |
| Europe | 799,510 | 862,074 |
| Total assets | \$ 9,327,923 | \$ 9,634,740 |

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

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

RESULTS OF OPERATIONS**Overview**

Schmitt Industries, Inc. designs, manufactures and markets computer-controlled vibration detection, balancing and process control equipment (the Balancer segment) to the worldwide machine tool industry and through its wholly owned subsidiary, Schmitt Measurement Systems, Inc., designs, manufactures and markets precision laser-based surface measurement products, laser-based distance measurement products and ultrasonic measurement systems (the Measurement segment) for a variety of industrial applications worldwide. The Company sells and markets its products in Europe through its wholly owned subsidiary, Schmitt Europe Ltd. (SEL), located in the United Kingdom. The Company is organized into two operating segments: the Balancer segment and the Measurement segment. The accompanying unaudited financial information should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended May 31, 2016.

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

For the three months ended August 31, 2016, total sales decreased \$211,852, or 6.8%, to \$2,892,532 from \$3,104,384 in the three months ended August 31, 2015. Balancer segment sales focus throughout the world on end-users, rebuilders and original equipment manufacturers of grinding machines with the target geographic markets in North America, South America, Asia and Europe. Balancer segment sales decreased \$366,619, or 19.0%, to \$1,560,876 for the three months ended August 31, 2016 compared to \$1,927,495 for the three months ended August 31, 2015, primarily due to weaker sales in North America, China and other parts of Asia, offset in part by increased sales into Europe and other parts of the world. The Measurement segment product line consists of laser-based light-scatter, distance measurement and dimensional sizing products and ultrasonic-based remote tank monitoring products for propane and diesel tanks. Total Measurement segment sales increased \$154,767, or 13.2%, to \$1,331,656 for the three months ended August 31, 2016 compared to \$1,176,889 for the three months ended August 31, 2015, primarily due to

increases in sales of our Xact remote tank monitoring products and related revenues from monitoring services along with increases in sales of our SMS products offset by decreases in sales associated with the two other product lines in the Measurement segment.

Operating expenses decreased \$133,278, or 8.2%, to \$1,491,516 for the three months ended August 31, 2016 from \$1,624,794 for the three months ended August 31, 2015. General, administration and sales expenses decreased \$125,213, or 8.1%, to \$1,412,669 for the three months ended August 31, 2016 from \$1,537,882 for the same period in the prior year. Research and development expenses decreased \$8,065, or 9.3%, to \$78,847 for the three months ended August 31, 2016 from \$86,912 for the three months ended August 31, 2015.

Net loss was \$125,629, or \$(0.04) per fully diluted share, for the three months ended August 31, 2016 as compared to net loss of \$195,062, or \$(0.07) per fully diluted share, for the three months ended August 31, 2015.

Table of Contents**Critical Accounting Policies**

There were no material changes in our critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended May 31, 2016.

Discussion of Operating Results

| | Three Months Ended August 31, | | | |
|-----------------------------------|-------------------------------|---------------|---------------------|---------------|
| | 2016 | | 2015 | |
| Balancer sales | \$ 1,560,876 | 54.0% | \$ 1,927,495 | 62.1% |
| Measurement sales | 1,331,656 | 46.0% | 1,176,889 | 37.9% |
| Total sales | 2,892,532 | 100.0% | 3,104,384 | 100.0% |
| Cost of sales | 1,516,783 | 52.4% | 1,661,892 | 53.5% |
| Gross profit | 1,375,749 | 47.6% | 1,442,492 | 46.5% |
| Operating expenses: | | | | |
| General, administration and sales | 1,412,669 | 48.8% | 1,537,882 | 49.5% |
| Research and development | 78,847 | 2.7% | 86,912 | 2.8% |
| Total operating expenses | 1,491,516 | 51.6% | 1,624,794 | 52.3% |
| Operating loss | (115,767) | -4.0% | (182,302) | -5.9% |
| Other loss, net | (1,833) | -0.1% | (5,920) | -0.2% |
| Loss before income taxes | (117,600) | -4.1% | (188,222) | -6.1% |
| Provision for income taxes | 8,029 | 0.3% | 6,840 | 0.2% |
| Net loss | \$ (125,629) | -4.3% | \$ (195,062) | -6.3% |

Sales Sales in the Balancer segment decreased \$366,619, or 19.0%, to \$1,560,876 for the three months ended August 31, 2016 compared to \$1,927,495 for the three months ended August 31, 2015. This decrease is primarily attributed to weaker sales in our North America, China and other Asia markets, offset in part by increased sales in Europe and other parts of the world. Sales in North America decreased \$225,527, or 21.9%, for the three months ended August 31, 2016 as compared to the three months ended August 31, 2015. Sales into China decreased \$177,656, or 42.9%, and sales into other parts of Asia decreased \$34,261, or 14.3%, for the three months ended August 31, 2016 as compared to the same period in the prior year. European sales increased \$33,453, or 15.8%, in the first quarter of Fiscal 2017 compared to the first quarter of Fiscal 2016. Sales in other regions of the world increased \$37,372, or 112.6%, in the first quarter of Fiscal 2017 as compared to the same quarter in the prior year.

Sales in the Measurement segment increased \$154,767, or 13.2%, to \$1,331,656 in the three months ended August 31, 2016 compared to \$1,176,889 in the three months ended August 31, 2015. Sales of Xact remote tank monitoring products and related revenues from monitoring services increased \$215,646, or 55.7%, during the first quarter of Fiscal 2017 as compared to the same period in the prior year. Sales of our SMS laser-based surface measurement products increased by \$12,373, or 20.4%, for the three months ended August 31, 2016 as compared to the same period

in the prior year. Sales of our Acuity laser-based distance measurement and dimensional-sizing products decreased \$14,244, or 2.2%, in the quarter ended August 31, 2016 as compared to the same quarter in the prior year, and sales of our Lasercheck products decreased \$59,008, or 70.2%, during the first quarter of Fiscal 2017 as compared to the same period in the prior year.

Gross margin Gross margin for the three months ended August 31, 2016 increased to 47.6% as compared to 46.5% for the three months ended August 31, 2015. The fluctuations in gross margin in the three months period ended August 31, 2016 compared to the same three month period in the prior fiscal year is primarily influenced by shifts in the product sales mix involving our five product lines.

Operating expenses Operating expenses decreased \$133,278, or 8.2%, to \$1,491,516 for the three months ended August 31, 2016 as compared to \$1,624,794 for the three months ended August 31, 2015. General, administrative and selling expenses decreased \$125,213, or 8.1%, for the three months ended August 31, 2016 as compared to the same period in the prior year primarily due to a reduction in travel and entertainment expense and decreases in personnel expenses.

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Other income Other income consists of interest income (expense), foreign currency exchange gain (loss) and other income (expense). Interest income (expense), net was \$(356) and \$(550) for the three months ended August 31, 2016 and 2015, respectively. Foreign currency exchange gains (losses) were \$(18,999) and \$(5,379) for the three months ended August 31, 2016 and 2015, respectively. The shifts in the foreign currency exchange are related to fluctuations of foreign currencies against the U.S. dollar during the current period. Other income (expense) was \$17,522 for the first quarter of Fiscal 2017 as compared to \$9 for the same period in the prior year. Other income in the period ended August 31, 2016 was primarily related to gains on disposals of two vehicles during the quarter.

Income taxes The Company's effective tax rate on consolidated net loss was 6.8% for the three months ended August 31, 2016. The effective tax rate on consolidated net loss differs from the federal statutory tax rate primarily due to the amount of income from foreign jurisdictions, changes in the deferred tax valuation allowance and certain expenses not being deductible for income tax reporting purposes. Management believes the effective tax rate for Fiscal 2017 will be approximately 10.4% due to the items noted above.

Net income (loss) Net loss was \$125,629, or \$(0.04) per diluted share, for the three months ended August 31, 2016 as compared to a net loss was \$195,062, or \$(0.07) per diluted share, for the three months ended August 31, 2015. The changes in the net loss for the first quarter of Fiscal 2017 as compared to the same period in the prior year is related to the mix of product sold in each of the respective quarters and a reduction of operating expenses in the first quarter of Fiscal 2017 as compared to the related period in the prior year.

LIQUIDITY AND CAPITAL RESOURCES

The Company's working capital decreased to \$6,177,135 as of August 31, 2016 as compared to \$6,325,707 as of May 31, 2016. Cash and cash equivalents increased \$13,472 to \$1,002,158 as of August 31, 2016 from \$988,686 as of May 31, 2016.

Cash provided by operating activities totaled \$31,282 for the three months ended August 31, 2016 as compared to cash used in operating activities of \$306,470 for the three months ended August 31, 2015. The change in cash provided by (used in) operating activities was impacted, in part, by the difference in net loss of \$125,629 for the quarter ended August 31, 2016 as compared to net loss of \$195,062 for the quarter ended August 31, 2015. Changes in accounts receivable, inventories and accounts payable and other accrued liabilities also impacted the total cash provided by/used in operating activities, with the result of the changes directly related to the timing of receipts and payments and the management of our inventory levels.

At August 31, 2016, the Company had accounts receivable of \$1,916,893 as compared to \$2,099,082 at May 31, 2016. The decrease in accounts receivable of \$182,189 was due to timing of receipts. Inventories decreased \$102,134 to \$4,625,843 as of August 31, 2016 as compared to \$4,727,977 at May 31, 2016, which is due primarily to the timing of purchases across our product lines. At August 31, 2016, total current liabilities decreased \$146,109 to \$1,484,591 as compared to \$1,630,700 at May 31, 2016. The decrease in accounts payable and other accrued expenses is primarily due to the timing of payments to our vendors and an increase in accrued commissions.

We believe that our existing cash and cash equivalents combined with the cash we anticipate to generate from operating activities 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.

Risk Factors

Please refer to the risk factors disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended May 31, 2016 for a listing of 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.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes from the information previously reported under Item 7A of our Annual Report on Form 10-K for the fiscal year ended May 31, 2016.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of August 31, 2016, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the Exchange Act). Based on the evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this Report, the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed in the Company's Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. 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.

Changes in Internal Control Over Financial Reporting

There has been no change in the Company's internal control over financial reporting that occurred during the Company's fiscal quarter ended August 31, 2016 that has materially affected, or is reasonably likely to materially affect, such internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 6. Exhibits

| Exhibit | Description |
|---------|--|
| 3.1 | Second Restated Articles of Incorporation of Schmitt Industries, Inc. [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. |
| 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. |

SIGNATURES

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

SCHMITT INDUSTRIES, INC.

(Registrant)

Date: October 11, 2016

/s/ Ann M. Ferguson
Ann M. Ferguson, Chief Financial Officer and
Treasurer

