

SCHMITT INDUSTRIES INC  
Form 10-K  
July 31, 2007

# 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, 2007**

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: **None**

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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 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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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, 2006, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$14,370,000 based upon the closing price of \$7.18 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 24, 2007, the registrant had 2,668,933 outstanding shares of Common Stock.

**Documents Incorporated by Reference**

Portions of the registrant's definitive Proxy Statement for its 2007 Annual Meeting of Shareholders are incorporated by reference into Part III hereof.

**PART I**

**Item 1. Business**

***Introduction***

Schmitt Industries, Inc. (the Company), an Oregon corporation, designs, assembles and markets computer-controlled balancing equipment (the Balancer Segment) primarily to the machine tool industry. Through its wholly owned subsidiary, Schmitt Measurement Systems, Inc. (SMS), an Oregon corporation, the Company designs, manufactures and markets precision laser measurement systems (the Measurement Segment). The Company also sells and markets its products in Europe through its wholly owned subsidiary, Schmitt Europe Ltd. (SEL), located in the United Kingdom. Effective May 30, 2005, the Company liquidated and dissolved its German subsidiary, Schmitt Europa, GmbH. The Company's executive offices are located at 2765 N.W. Nicolai Street, Portland, Oregon 97210, and its telephone number is (503) 227-7908.

**Balancer Segment**

The Company's principal product is the Schmitt Dynamic Balance System (the SBS System), consisting of a computer control unit, sensor, spindle-mounting adapter, and balance head. It is designed as an inexpensive highly accurate permanent installation on grinding machines. The Company acquired its original balancing equipment technology pursuant to a series of agreements from 1987 through 1991, substantially enhancing and advancing the patented technology since that time. Since inception the targeted customer base has been operators of grinding machines.

The SBS System is fully automated, eliminating the need to pre-balance such devices as grinding wheels. This reduces machine setup time and ensures a smoother and more efficient operation. 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 sensor that feeds a signal to a controller that filters the signal by revolutions per minute. The controller then 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.

Notable features of the SBS System include its ability to fit almost all 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 both English and metric systems, instrument grade calibration, short balance process, measurement of both displacement and/or velocity and minimal user maintenance.

Benefits to the system user include improved quality of finished parts, ease of product adaptation, 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 (camshafts, crankshafts, valves), bearings (roller and tapered types), ceramics (precision shaping), electric motors (shafts), pumps (shafts and turbines), aircraft (engine parts), and general manufacturing. Precision grinding has an established worldwide presence in all industrialized countries and is expanding as a method of material removal and 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 cylindrical, surface and specialty application grinding machines. SBS Systems are distributed to a variety of world markets through OEM (original equipment manufacturer) accounts, where a special pricing (20% discount) is offered to the machine builder incorporating the SBS System into its machine.

Examples of some well-known worldwide machine tool builders who have offered and/or installed the SBS System include ANCA (Australia), Capco Machinery (U.S.), Ecotech/SMTW (China/U.S.), Erwin Junker (U.S.), Landis Grinding (U.S.), Koyo Machinery (US, Japan), Micron Machinery Limited (Japan/U.S.), USACH Technologies, Tschudin (U.S.) and Weldon Machine Tool (U.S.). The Company currently sells its products directly to major machine builders in the U.S, Europe and Asia.

***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 rebuilders in the U.S. and Europe.



**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, Caterpillar, Eaton, Emerson Power Transmission, Ford Motor Company, General Electric, General Motors, Ingersoll Rand, Komatsu, Sumitomo Heavy Industries, SKF Bearing Industries, Timken, TRW Automotive Components and Universal Bearing.

In Fiscal 2007, 2006 and 2005, net sales of the Company's balancing products totaled \$7,923,627, \$7,818,669 and \$7,430,287, respectively. Net sales of balancing products accounted for 67%, 68% and 70% of the Company's total sales in Fiscal 2007, 2006 and 2005, respectively. See Note 7 to Consolidated Financial Statements.

### ***Competition***

Management believes the SBS System is one of only a few fully automatic balancing systems marketed in the world. Most competitive products require special setup and training or calibration to the specific machine. The Company believes the SBS System is currently the only balancing product that fits all machines with wheel sizes from 6 to 48 inches in diameter and a spindle rpm of 500 through 12,500.

Competitive products come from European companies located in Switzerland, Germany, Spain and Italy. These competitors produce electromechanical and water balancers similar to the SBS Systems. The Company considers these companies, with their established European base, to be the major competitors. The Company believes that these balancers have electronic deficiencies, rendering them less effective in solving essential balancing requirements. The Company also believes that they cannot achieve consistent balance levels at low speed (500 rpm) or at high speed (7,500 rpm) as the SBS system can. In addition, the Company also believes these balancers have inferior brush and cable assemblies that cause down time and high maintenance. Finally, the Company does not believe these companies can currently compete effectively with the SBS System in providing mounting adapters for all grinding machines.

Water balancers are an older European design still on the market that can be supplied by Schmitt when specifically requested by users. They require expensive plumbing and water chambers to be machined into the wheel hub while the SBS System does not. They are currently priced about 1.25 times the level of the SBS System. To install these systems, the grinding machines must be disassembled and parts remachined or replaced within the spindle assembly. This can take two days, far longer than required to install the SBS system. The water system is tuned or calibrated to the machine by a factory service technician while the SBS system can be installed by the operator. Water systems work at mid- and high-speeds but cannot balance in low rpm environments while SBS products work in both environments. Water systems require periodic monitoring while the SBS systems require little or no operator monitoring.

The SBS System list price is generally \$7,995 worldwide. Based on published price lists, competitors' electromechanical systems are priced at \$8,000 to \$10,000 worldwide while water balancers generally are priced at \$9,000 to \$11,000 worldwide. Management believes customers perceive the value of an automatic balancer to be approximately \$8,000, a sales price that has been constant for several years. Company pricing is geared to obtaining a dominant market position and meeting competitive supplier prices. The market strategy is to establish the SBS System as the foremost product with the best quality, reliability and performance and superior economic value.

### ***Measurement Segment***

The Company manufactures and markets a line of laser-based, precision measurement systems and operates a precision laser light scatter measurement laboratory. Light scatter technology involves using lasers, optics and detectors to direct a beam of light on a material sample and record its reflection/transmission. Analysis of information can determine material characteristics such as surface roughness, defects and dimensional sizing without introducing contaminants and causing changes to the tested material. The principal products are laser-based measurement products and technology applicable to both industrial and military markets. The Company has used patents, patent applications, trademarks and other proprietary technology to focus marketing efforts on industrial markets including electronics, computer disk and silicon wafer manufacturers.

There are four product lines: laser-based light-scatter measurement, dimensional sizing, research and other laser alignment products and a light-scatter measurement laboratory.

### ***Surface measurement products***

These products use a patented laser light scatter technology to perform rapid, accurate, repeatable and non-destructive, non-contact surface measurement tests that quantify surface micro-roughness. Products are sold to manufacturers of disk drives and silicon wafers, both industries

with fabrication processes that require precise and reliable measurements.

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Computer hard disks 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 following two products meet the challenges of disk drive manufacturers:

- The TMS-2000-RC (Texture Measurement System) product is 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 (the point of a needle is one million Angstroms in diameter).
- The TMS-2000-DUV-RC product measures the surface microroughness of ceramic/glass rather than aluminum substrates. Manufacturers require the technology and products to measure surface roughness of these ceramic/glass substrates to the same exact levels as those that measure aluminum. The Deep Ultra-violet light (DUV) technology and product uses the patented light scatter technology to measure the surface roughness of glass substrates to levels less than 0.5 Angstroms.

Customers include Hitachi/IBM, Seagate Substrates, Western Digital and Komag, Inc.

The Company offers two products devoted to the silicon wafer industry, the TMS-2000W-RC and TMS-3000W-RC. Both products provide fast, accurate, repeatable measurements for manufacturers of silicon wafers, computer chips 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 chemical deposition, grinding, polishing, etching, or any number of other production techniques, some method of measuring these surface characteristics is required. The wafer measurement products provide a way for customers in this industry to quantify and control their manufacturing process. The system provides measurements to a few hundredths of an Angstrom, a level unachievable by competing devices.

#### ***Dimensional sizing products***

These products are used in a wide range of industrial applications including steel casting, paper production, medical imaging, crane control and micron-level part and surface inspection. Presently, there are four AccuRange (AR) product lines: the AR4000 distance measurement sensor, the AR4000 Line Scanner and the AR600 and AR200 series of triangulating laser displacement sensors.

The AR4000 optical distance measurement sensor is used for most diffuse reflective surfaces, but is ideally suited to level and position measurement, machine vision, autonomous vehicle navigation and 3D imaging applications. It operates by emitting a collimated laser beam that is reflected from the target surface and collected by a sensor. The sensor is suitable for a wide variety of distance measurement applications that demand high accuracy and fast response times. Notable features include the operating range for most surfaces (zero to fifty feet), fast response time (50 kHz maximum sample rate), compact and lightweight power design and has a tightly collimated output beam for small spot size. There are three output beam configurations available: visible infrared, eye safe infrared and reflective tape targets.

The AR4000 Line Scanner is used with the AR4000 to scan and collect distance data over a full circle. The scanner consists of a balanced, rotating mirror and motor with position encoder and mounting hardware for use with the AR4000. The scanner deflects the beam 90 degrees, sweeping it through a full circle as it rotates. The product can scan at rates of up to 2600 lines per minute, sweeps the laser beam through a full 360 degrees and is both compact and lightweight.

The AR600 series is a family of triangulating laser displacement sensors with excellent accuracy and sensitivity. The sensor projects 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 line includes 11 models measuring displacements from 1/8" to 50" and accuracy's down to .00015" (4 microns). They can operate on all types of surfaces at speeds up to 1250 samples/second. The product is extremely sensitive and can detect glass and liquid surfaces and also detect multiple surfaces of transparent materials, allowing great flexibility in specialized applications.





The AR700 is a new series of triangulation laser displacement sensors that the Company is developing and testing to supplement the existing line of AR600 sensors. The AR700 will provide performance advanced over the AR600 in accuracy, repeatability, and sample speed. The first product offering of this new family of sensors will be released in Fiscal 2007 and include measurement ranges from displacements of 1/8" up to 4" and accuracy down to .00006" (1.5microns). The AR700 is smaller than the AR600 and features increased speeds of up to 5000 samples/second while maintaining the flexibility to measure extremely sensitive surfaces.

The AR200 line is the most compact series of triangulating laser displacement sensors. Four models cover metric measurement ranges from six to fifty millimeters. All models boast a 1/500 accuracy rating for measurements within twelve microns. The AR200 sensor is the only sensor of its kind to feature pushbutton selection of output signals. All models are standard with analog, limit switch and serial outputs. The AR200 sensors, much like the longer-range AR600 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 and -50M 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.

### ***Research and other measurement products***

The Company's CASI Scatterometers are sold to companies and institutions involved in research efforts. 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 measurement instruments providing customers with precise roughness measurements 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  $\mu$ Scan 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  $\mu$ Scan 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 flat or curved surfaces under any lighting conditions.

### ***Light-scatter measurement laboratory***

The Company provides a highly advanced measurement services laboratory, using CASI Scatterometers, to a wide variety of industrial and commercial businesses that require precise measurements only advanced laser light scatter technology can provide. The value of the laboratory is not only its extremely precise measurement capability but also the test item is not altered, touched or destroyed. Thus, the laboratory is widely used by manufacturers of critical optical components in aerospace and defense systems and other industrial companies, universities and government agencies.

In Fiscal 2007, 2006 and 2005, net sales of Measurement products totaled \$3,958,449, \$3,684,691 and \$3,160,942 respectively and accounted for 33%, 32% and 30% of the Company's total sales in Fiscal 2007, 2006 and 2005 respectively. See Note 7 to Consolidated Financial Statements.

### ***Competition***

Management believes its surface measurement products are one of only a few systems that provide fast, accurate, repeatable microroughness measurements for computer hard disk manufacturers and the silicon wafer industry. The Company believes its surface measurement products are currently the only systems that can provide measurements to a few hundredths of an angstrom ( $\text{\AA}$ -a unit of measure equal to 1 hundred-millionth of a centimeter) with reproducibility  $\pm 0.2\text{\AA}$  or 1% and repeatability of  $\pm 0.1\text{\AA}$ . The differences between our surface measurement products and other optical techniques (which include profilometers, scanning tunneling microscopes, atomic force microscopes or interferometers) are that scanning tunneling microscopes, atomic force microscopes and optical profilometers require the intervention of a skilled operator and perform measurements relatively slowly, whereas our surface measurement product is much simpler and, consequently, can make measurements more rapidly while still maintaining excellent repeatability and accuracy. Stylus profilometers are simpler devices which require less skilled operators, however, measurements must be conducted under vibration isolation conditions, and large areas require numerous scans, they are generally destructive to soft materials such as most coated optics.

The market for 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 our sensors and competitive products we feature pushbutton selection of output signals in certain models and our sensors can be programmed using serial commands through a PC computer. The AR200 displacement sensor can not be overloaded and measures accurately even when a mirror reflects the entire light beam back to the detector.

Competitive surface measurement products and dimensional sizing products come from established multinational competitors, some of which are significantly larger and have greater financial, engineering, manufacturing and marketing resources. Company pricing is geared to obtaining a dominant market position and meeting competitive supplier prices. The market strategy is to establish measurement products as products with the best quality, reliability and performance and superior economic value.

**Sales by Geographic Area**

In Fiscal 2007, 2006 and 2005, the Company recorded net sales of its products in the United States, its country of domicile, of \$5,855,118, \$5,709,044 and \$5,610,274, respectively. Sales in the last three fiscal years by geographic areas are:

|             | North America | Europe       | Asia         | Others       |
|-------------|---------------|--------------|--------------|--------------|
| Fiscal 2007 | \$ 6,055,129  | \$ 2,098,677 | \$ 2,702,531 | \$ 1,025,739 |
| Fiscal 2006 | \$ 5,878,538  | \$ 1,764,347 | \$ 2,919,556 | \$ 940,919   |
| Fiscal 2005 | \$ 5,872,740  | \$ 2,076,089 | \$ 2,122,384 | \$ 520,016   |

**Business and Marketing Strategy**

The Company designs, assembles and markets all of its products with operations divided into a number of different areas.

**Balancer Segment Products**

The Vice President of Operations directs production of Balancer segment products including production, assembly, and purchasing, engineering and technical services. Product marketing for all Balancer segment products is managed by the President/CEO. Two marketing managers are responsible for domestic sales, one marketing manager is responsible for sales in Europe and another is responsible for sales in mainland China, Taiwan and Korea. The Company also has one person who performs field service/sales. Finally, research and development efforts are supervised directly by the President/CEO and the Vice President of Operations.

The Company markets and sells the Balancer segment products in a variety of ways. First are the channels provided by independent manufacturer s representatives and distributors. There are currently approximately 25 individuals and/or organizations in the United States acting in one of these capacities. Independent sales agents are paid a 10% commission; distributors are sold products at a 20% discount.

Second, OEMs include the Balancer segment products on the machine tools they produce. Users thus purchase the Balancer segment 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 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/or the President/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 distribution center 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 the European subsidiary in the United Kingdom, who in turn sells and distributes the products.



### **Measurement Segment Products**

The Vice President of Operations directs production of all Measurement segment products including production, assembly, and purchasing, engineering and technical services.

Similar to the Balancer segment, the Measurement segment uses a variety of methods to market and sell its products. First, a Marketing Manager, under the direction of the President/CEO, directs the overall worldwide marketing efforts for surface measurement products. Second, both a marketing and a sales manager, again under the direction of the President/CEO, direct the overall worldwide marketing and sales efforts for dimensional sizing products. Third, the Company has an exclusive distribution agreement with a company in Asia for the promotion and sale of surface measurement products in China, Taiwan, Malaysia, Singapore, Thailand and the Philippines. In addition, there are distribution agreements with one company in Japan and two in Korea. Trade shows also represent a significant amount of marketing/sales effort. Company representatives operate a display booth featuring demonstrations of Measurement segment products along with product and technical literature. Representatives from all facets of the market to which the Company directs its sales efforts attend these trade shows. Finally, one of the best marketing channels is the testing laboratory. Once customers see the capabilities of the technology, it can lead to orders for the Company's laser based light scatter measurement products.

All Measurement segment products are assembled in the Portland, Oregon facility and shipped worldwide directly to customers. The Balancer and Measurement segment customer bases each consist of over 250 companies.

### **Backlog**

The Company does not generally track backlog. Normally, orders are shipped within a few days 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. The primary outside supplier of electronic assemblies is Silicon Forest Electronics of Vancouver, Washington, a custom supplier of assembled electronic products for several Pacific Northwest companies. In the event of supply problems, the Company believes that two or three alternatives could be developed within thirty days to supplement or replace Silicon Forest Electronics.

Mechanical parts for the Company's products are produced by high quality CNC machine shops. The Company is not dependent on any one supplier of mechanical components. Principal suppliers of components for the Company's products include MacKay Manufacturing of Spokane, Washington; Davis Tool of Portland, Oregon; and Forest City Gear of Roscoe, Illinois.

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. On November 4, 2005, the Company received its certification to the newer ISO 9001:2000 requirements.

### **Proprietary Technology**

The Company's success depends in part on its proprietary technology, which the Company attempts to protect 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 as 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.



SBS and SMS are registered trademarks and are affixed to all products and literature created in the Company's balancer and measurement product lines, respectively.

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 marks, 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 both product 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. In the past fiscal year, the Company has developed the following new product:

The AR700 is a new series of triangulation laser displacement sensors that the Company is developing and testing to supplement the existing line of AR600 sensors. The AR700 will provide performance advanced over the AR600 in accuracy, repeatability, and sample speed. The first product offering of this new family of sensors will be released in Fiscal 2008 and include measurement ranges from displacements of 1/8" up to 4" and accuracy down to .00006" (1.5microns). The AR700 is smaller than the AR600 and features increased speeds of up to 5000 samples/second while maintaining the flexibility to measure extremely sensitive surfaces.

During Fiscal 2007, 2006 and 2005, the Company's research and development expense totaled \$88,425, \$81,815 and \$42,395, respectively. The Fiscal 2007 levels are consistent with Fiscal 2006 and are higher than Fiscal 2005 as the Company devoted much of its 2005 internal labor efforts (most R&D costs are internal labor costs) to expanding production levels and the transition of engineering and production of dimensional sizing products from Menlo Park, CA to Portland, OR. Management expects amounts expended for R&D in Fiscal 2008 to increase over the levels experienced in Fiscal 2007.

### **Employees**

As of July 16, 2007, the Company employed 34 individuals worldwide on a full-time basis. There were no regular part-time employees. None of the Company's employees is covered by a collective bargaining agreement.

## **Item 1A. Risk Factors**

### **Business Risks**

This report includes forward-looking statements as that term is defined in Section 21E of the Securities Exchange Act of 1934. Forward-looking statements can be identified by the use of forward-looking terminology such as believes, expects, may, will, should, seeks, approximate, intends, plans, estimates, anticipates, or hopes, or the negative of those terms or other comparable terminology, or by discussions of strategy, plans or intentions. For example, this section contains numerous forward-looking statements. All forward-looking statements in this report are made based on management's current expectations and estimates, which involve risks and uncertainties, including those described in the following paragraphs. Among these factors are the following:

- *Demand for Company products may change.*
- *New products may not be developed to satisfy changes in consumer demands.*
- *Failure to protect intellectual property rights could adversely affect future performance and growth.*

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- *Production time and the overall cost of products could increase if any of the primary suppliers are lost or if any primary supplier increased the prices of raw materials.*
- *Fluctuations in quarterly and annual operating results make it difficult to predict future performance.*
- *The Company may not be able to reduce operating costs quickly enough if sales decline.*
- *The Company maintains a significant investment in inventories in anticipation of future sales.*
- *Future success depends in part on attracting and retaining key management and qualified technical and sales personnel.*
- *The Company faces risks from international sales and currency fluctuations.*

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Such risks and uncertainties could cause actual results to be materially different from those in the forward-looking statements. Readers are cautioned not to place undue reliance on the forward-looking statements in this report. We assume no obligation to update such information.

*Demand for Company products may change:*

During Fiscal 2006 and 2005 the Company experienced increased demand for its Balancer products in North America, its largest market, attributed primarily to an improving economy in North America. However, during Fiscal 2007 Balancer sales in North America have declined 8.3% when compared to Fiscal 2006. The conditions and circumstances could change in future periods and as a result demand for the Company's products could decline. Management is responding to these risks in two ways. First, it appears there is still a significant portion of the marketplace that is not using the automatic balancing products of the Company or any of its competitors. The Company will therefore continue to devote part of its future R&D efforts toward developing products that will both broaden the scope of Balancing products offered to the current customer base. Second, there are uses for the Company's Balancer products in industries other than those in the Company's historic customer base. Management is devoting time to identify these markets and educate those markets on the value of those products within their operations.

The laser light-scatter products of the Measurement segment have relied heavily upon sales to disk drive and silicon wafer manufacturers. The Company had experienced increasing sales in Fiscal 2006; however, sales during Fiscal 2007 have decreased 13.6%. Previous information had indicated continued improving demand for and sales of disk drive products. U.S. retail sales of external drives by disk drive manufacturers rose an estimated 75% during the third calendar quarter of 2006 citing demand fueled by need to convert photos, video and other content into digital form. Recently, however, certain disk drive manufacturers have scaled back their outlook for the current calendar year, blaming a price war over high-capacity desktop computer drives, which now store as much as about one trillion bytes of data. The long-term impact on demand for the Company's surface Measurement products cannot be predicted with any certainty.

Management will continue to market these products to these historic markets as it appears no other technology has been introduced that would make the laser light-scatter products technologically obsolete. There is the belief that once market conditions improve in the disk drive and silicon wafer markets, demand for the Company's products and technology will increase although most likely not to historic levels. Also, management believes there are other uses for the Company's laser light scatter technology and continues to evaluate R&D efforts to develop new products and introduce them to the marketplace.

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

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

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

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

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

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



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

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

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

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

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

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

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

Future success depends on the efforts and continued services of key management, technical and sales personnel. Significant competition exists for such personnel and there is no assurance key technical and sales personnel can be retained nor assurances there will be the ability to attract, assimilate and retain other highly qualified technical and sales personnel as required. There is also no guarantee key employees will not leave and subsequently compete against the Company. The inability to retain key personnel could adversely impact the business, financial condition and results of operations.

*The Company faces risks from international sales and currency fluctuations:*

The Company markets and sells its products worldwide and international sales have accounted for and are expected to continue to account for a significant portion of future revenue. International sales are subject to a number of risks, including: the imposition of governmental controls; trade restrictions; difficulty in collecting receivables; changes in tariffs and taxes; difficulties in staffing and managing international operations; political and economic instability; general economic conditions; and fluctuations in foreign currencies. No assurances can be given 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.

**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 with total approximate square footage of 40,500 square feet. SEL occupies a 755-square foot facility in Coventry, England pursuant to a two year lease beginning May 7, 2007 with a basic monthly rent of £1,360 (approximately \$2,690 as of May 31, 2007).

**Item 3. Legal Proceedings**

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

**Item 4. Submission of Matters to a Vote of Security Holders**

No matters were submitted to a vote of the security holders of the Company during the fourth quarter ended May 31, 2007.



## 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 sales prices of the Company's Common Stock as reported on the NASDAQ Capital Market for the periods indicated.

| Year Ended May 31, 2007 | High    | Low     |
|-------------------------|---------|---------|
| First Quarter           | \$ 7.99 | \$ 6.58 |
| Second Quarter          | \$ 7.86 | \$ 6.27 |
| Third Quarter           | \$ 7.98 | \$ 7.04 |
| Fourth Quarter          | \$ 8.20 | \$ 7.20 |

| Year Ended May 31, 2006 | High     | Low     |
|-------------------------|----------|---------|
| First Quarter           | \$ 11.95 | \$ 7.69 |
| Second Quarter          | \$ 9.10  | \$ 5.40 |
| Third Quarter           | \$ 7.47  | \$ 5.47 |
| Fourth Quarter          | \$ 8.39  | \$ 5.78 |

As of July 24, 2007, there were 2,668,933 shares of Common Stock outstanding held by approximately 175 holders of record. The number of holders does not include individual participants in security position listings; the Company believes that there are more than 1,750 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.

**Issuer Purchases of Equity Securities**

None.

**Item 6. Selected Financial Data**

*In thousands, except per share information*

| Year Ended                                 | 5/31/07   | 5/31/06   | 5/31/05   | 5/31/04  | 5/31/03    |
|--|-----------|-----------|-----------|----------|------------|
| Sales                                      | \$ 11,882 | \$ 11,503 | \$ 10,591 | \$ 7,925 | \$ 7,420   |
| Net Income (Loss)                          | \$ 1,285  | \$ 1,350  | \$ 1,608  | \$ 517   | \$ (1,487) |
| Net Income (Loss) Per Share, Basic         | \$ .49    | \$ .52    | \$ .64    | \$ .21   | \$ (.60)   |
| Weighted Average No. Shares, Basic         | 2,649     | 2,606     | 2,528     | 2,439    | 2,468      |
| Net Income (Loss) Per Share, Diluted       | \$ .47    | \$ .49    | \$ .59    | \$ .20   | \$ (.60)   |
| Weighted Average No. Shares, Diluted       | 2,763     | 2,746     | 2,709     | 2,524    | 2,468      |
| Stockholders' Equity                       | \$ 11,365 | \$ 9,814  | \$ 7,979  | \$ 6,114 | \$ 5,665   |
| Total Assets                               | \$ 12,471 | \$ 10,927 | \$ 9,075  | \$ 7,100 | \$ 6,272   |
| Long-term Debt (including current portion) | \$        | \$ 22     | \$ 53     | \$ 67    | \$ 24      |

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following information contains certain forward-looking statements that anticipate future trends or events. These statements are based on certain assumptions that may prove to be erroneous and are subject to certain risks including but not limited to the uncertainties of the Company's new product introductions, the risks of increased competition and technological change in the Company's industries and other factors detailed in the Company's SEC filings. Accordingly, actual results may differ, possibly materially, from the predictions contained herein.



## RESULTS OF OPERATIONS

### Overview

Balancer segment sales focus throughout the world on end-users, rebuilders and original equipment manufacturers of grinding machines with the target geographic markets in North America, Asia and Europe. Combined Balancer sales increased 1.3% for the year ended May 31, 2007 compared to the year ended May 31, 2006. North American sales declined (8.3%) in the year ended May 31, 2007 compared to the year ended May 31, 2006. Recent weakness in industrial production toward the end of 2006 especially in the motor vehicle sectors has caused production in other manufacturing industries to soften. General economic data indicates a slowing in the growth of business capital spending on orders and shipments of equipment other than high-tech and transportation equipment. These economic conditions in the worldwide automotive, bearing and aircraft industries and its impact on the machine tool industry are the reason for softening Balancer orders. Machine tool industry customers are optimistic regarding short term demand for grinding machines although the recent weakness in industrial production and business conditions in North America indicate growth rates for their products which incorporate the Balancer segment product line will be lower than those experienced in Fiscal 2006 and 2005. Market demand in Asia for the Balancer segment products remains strong with that region showing a 33.7% increase for the year ended May 31, 2007 compared to the year ended May 31, 2006. The European market grew 10.1% in Fiscal 2007 compared to Fiscal 2006. Sales in all Other markets decreased (29.3%) in the year ended May 31, 2007 compared to the year ended May 31, 2006. As with the North American market, the duration of the stronger demand in Asia and conditions in the European and all Other markets cannot be forecasted with any certainty.

The Measurement segment product line consists of both laser light-scatter and dimensional sizing products. Combined Measurement sales increased 7.4% for the year ended May 31, 2007 compared to the year ended May 31, 2006. The increased sales volume is primarily due to the delivery of a CASI Scatterometer during the second fiscal quarter of 2007, increase in sales dimensional sizing products of 18.8% offset by decreased shipments of laser light-scatter products for disk drive and silicon wafer manufacturers of (2.7%). The Measurement segment's largest market, North America, increased 25.5% in the year ended May 31, 2007 compared to the year ended May 31, 2006. Market demand in Asia, historically the second largest geographic market for Measurement products, showed a (54.5%) decrease for the year ended May 31, 2007 compared to the year ended May 31, 2006 as sales in the three months ended May 31, 2007 were off (71.8%) from the sales reported in the three months ended May 31, 2006 on lower unit sales of laser light-scatter products for disk drive and silicon wafer manufacturers. As noted below sales can be very cyclical in the Measurement segment. The business operations and prospects for these product lines are summarized as follows:

**Laser light-scatter products for disk drive and silicon wafer manufacturers** The primary target markets for Measurement products have been disk drive and silicon wafer manufacturers and companies and organizations involved in research efforts. Certain segments of these targeted industries have seen consolidation into very large international manufacturers. Sales totaled \$1,895,185 for the year ended May 31, 2007 compared to the \$1,948,386 for the year ended May 31, 2006. Previous information had indicated continued improving demand for and sales of disk drive products. U.S. retail sales of external drives by disk drive manufacturers rose an estimated 75% during the third calendar quarter of 2006 citing demand fueled by need to convert photos, video and other content into digital form. Recently, however, certain disk drive manufacturers have scaled back their outlook for the current calendar year, blaming a price war over high-capacity desktop computer drives, which now store as much as one trillion bytes of data. Sales to customers in these industries can be very cyclical and therefore the impact of the demand in the disk drive industry on sales to the Company's laser light-scatter products is unknown at this time and cannot be forecasted with any certainty.

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

**Dimensional sizing products** These products are marketed and sold into a wide array of industries and used in applications from steel casting, paper production, crane control and medical imaging to micron level part and surface inspection. Sales totaled \$2,063,264 for the year ended May 31, 2007 compared to the \$1,736,305 for the year ended May 31, 2006. Sales of these products can be cyclical and therefore the duration of the continued demand cannot be forecasted with any certainty.

The Company entered into a convertible promissory note agreement with Xtero Datacom, Inc. of Vancouver, British Columbia pursuant to which the Company will loan up to \$250,000 USD to Xtero to fund product development and testing of Xtero satellite measurement technologies. The advances under the loan agreement are based on established milestones being achieved by Xtero in the beta field testing of their technology over the next 90 days. The loan is convertible into equity of Xtero at the sole option of Schmitt Industries, Inc. On February 14, 2007, Schmitt advanced \$125,000 to Xtero and advanced an additional \$75,000 on May 24, 2007.

### **Critical Accounting Policies**

**Revenue Recognition** The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectibility is probable. For sales to all customers, including manufacturer representatives, distributors or their third-party customers, these criteria are met at the time product is shipped. When other significant obligations remain after products are delivered, revenue is recognized only after such obligations are fulfilled.

**Cash Equivalents and Short Term Investments** The Company generally invests excess cash in money market funds and investment grade highly liquid securities. The Company considers securities that are highly liquid, readily convertible into cash and have original maturities of less than three months when purchased to be cash equivalents. At May 31, 2007, short-term investments are classified as available-for-sale. The carrying amounts of cash equivalents and short term investments are stated at cost, which approximate fair market value because of their short maturities. There were no related unrealized holding gains or losses at May 31, 2007.

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

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

**Deferred 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. In Fiscal 2005 and Fiscal 2006, management concluded future operations would produce sufficient earnings so that a portion of this asset could be used in future periods to reduce federal and state tax liabilities. Management continues to review the level of the valuation allowance on a quarterly basis. There can be no assurance that the Company's future operations will produce sufficient earnings so that the deferred tax asset can be fully utilized.

**Intangible Assets** There is a periodic review of intangible and other long-lived assets for impairment. This review consists of the analysis of events or changes in circumstances that would indicate the carrying amount of the asset may not be recoverable. Recoverability is determined by comparing the forecasted future net cash flows from the operations to which the assets relate, based on management's best estimates using the appropriate assumptions and projections at the time, to the carrying amount of the assets. If the carrying value is determined to be in excess of future operating cash flows, the asset is considered impaired and a loss is recognized equal to the amount by which the carrying amount exceeds the estimated fair value of the assets. As of May 31, 2007, management does not believe impairment, as defined above, exists.

### **Recently issued accounting pronouncements**

See Note 1 of Notes to Consolidated Financial Statements for a discussion of recently issued accounting pronouncements.

**Discussion of operating results**

|                    | Year ended May 31, 2007 |       | Balancer     |       | Measurement  |       |
|--------------------|-------------------------|-------|--------------|-------|--------------|-------|
|                    | Consolidated Dollars    | %     | Dollars      | %     | Dollars      | %     |
| Sales              | \$ 11,882,076           | 100.0 | \$ 7,923,627 | 100.0 | \$ 3,958,449 | 100.0 |
| Cost of sales      | 5,254,205               | 44.2  | 3,898,908    | 49.2  | 1,355,297    | 34.2  |
| Gross profit       | 6,627,871               | 55.8  | \$ 4,024,719 | 50.8  | \$ 2,603,152 | 65.8  |
| Operating expenses | 4,859,421               | 40.9  |              |       |              |       |
| Operating income   | \$ 1,768,450            | 14.9  |              |       |              |       |

|                    | Year ended May 31, 2006 |       | Balancer     |       | Measurement  |       |
|--------------------|-------------------------|-------|--------------|-------|--------------|-------|
|                    | Consolidated Dollars    | %     | Dollars      | %     | Dollars      | %     |
| Sales              | \$ 11,503,360           | 100.0 | \$ 7,818,669 | 100.0 | \$ 3,684,691 | 100.0 |
| Cost of sales      | 5,029,714               | 43.7  | 3,772,692    | 48.3  | 1,257,022    | 34.1  |
| Gross profit       | 6,473,646               | 56.3  | \$ 4,045,977 | 51.7  | \$ 2,427,669 | 65.9  |
| Operating expenses | 4,740,050               | 41.2  |              |       |              |       |
| Operating income   | \$ 1,733,596            | 15.1  |              |       |              |       |

|                    | Year ended May 31, 2005 |       | Balancer     |       | Measurement  |       |
|--------------------|-------------------------|-------|--------------|-------|--------------|-------|
|                    | Consolidated Dollars    | %     | Dollars      | %     | Dollars      | %     |
| Sales              | \$ 10,591,229           | 100.0 | \$ 7,430,287 | 100.0 | \$ 3,160,942 | 100.0 |
| Cost of sales      | 4,460,769               | 42.1  | 3,473,858    | 46.8  | 986,911      | 31.2  |
| Gross profit       | 6,130,460               | 57.9  | \$ 3,956,429 | 53.2  | \$ 2,174,031 | 68.8  |
| Operating expenses | 4,914,000               | 46.4  |              |       |              |       |
| Operating income   | \$ 1,216,460            | 11.5  |              |       |              |       |

Worldwide sales of Balancer products increased 1.3% in the year ended May 31, 2007 compared to the year ended May 31, 2006 as sales to the Asian markets increased by 33.7% offset by a decline in the North American market of (8.3%). European sales grew 10.1% in Fiscal 2007 to \$1,651,631 compared to Fiscal 2006 sales of 1,500,214. Sales in all Other markets decreased to \$597,426 in the year ended May 31, 2006 compared to the \$845,198 for the year ended May 31, 2005, a (29.3%) decrease. Unit sales prices of Balancer products in North America, Asia and Other markets are relatively stable and therefore any increases or decreases in the dollar amount of sales between fiscal periods can generally be attributed to an increase or decrease in the number of units sold. The Balancer product sales increase in Asia is attributed to continued expansion and penetration of the sales efforts in China. The increased sales in Europe are primarily attributed to changes in foreign exchange rates between the two fiscal periods. The large percentage decrease in Other markets was predominately a result of lower unit sales in Australia, Japan and South American markets.

Measurement product sales increased 7.4% in the year ended May 31, 2007 compared to the year ended May 31, 2006 as sales of the Company's dimensional sizing products increased by 18.8% offset by decrease in surface measurement products of (2.7%). The sales of surface measurement products in the year ended May 31, 2007 compared to the year ended May 31, 2006 decreased as unit sales to customers in the Asia markets declined.

Cost of sales for both the Balancer and Measurement segments increased (as a percentage of sales) in the year ended May 31, 2007 compared to the year ended May 31, 2006 primarily due to the product sales mix as production labor and overhead costs were relatively stable. Balancer margins were also negatively impacted as a result of higher sales in foreign markets as a large portion of those sales are made through distributors who receive pricing net of commissions and other sales costs.

The decrease in operating expenses (as a percentage of sales) between Fiscal 2007 and 2006 occurred primarily due to increased sales and continued reduction of operating expenses in the Company's foreign operations. The decrease in operating expenses between Fiscal 2006 and 2005 resulted from the liquidation and dissolution of the Company's German subsidiary, Schmitt Europa, GmbH, effective May 30, 2005. The costs in the foreign operations decreased due to the reduction in sales and administration staff that occurred due to the consolidation of Schmitt Europa, GmbH operations into Schmitt Europe Ltd.





Sales by Schmitt Europe Ltd. totaled \$2,184,351 for the year ended May 31, 2007 compared to sales of \$1,810,377 in the year ended May 31, 2006. Approximately 11.5% of the increase was due to higher unit sales volumes, primarily due to the CASI Scatterometer sale, and also general expansion of the sales efforts in the dimensional sizing products with the remainder due to the changes in foreign exchange rates between the two fiscal periods.

Net sales outside North America accounted for approximately 49% of the Company's revenues in Fiscal 2007 and Fiscal 2006 and 45% in Fiscal 2005. Some foreign customers purchase in their own country's currencies, thereby imposing on the Company a currency risk. Of total sales in Fiscal 2007, 2006 and 2005, approximately 18%, 15% and 20%, respectively, were denominated in currencies other than U.S. dollars. To date, currency fluctuations have had minimal impact on sales. However, significant variations in the value of the U.S. dollar, relative to currencies of countries in which the Company has significant competitors, can impact future sales. The Company does not engage in currency hedging. In addition, the longer payment cycles of international sales can have a negative impact on liquidity. The Company believes international sales will continue to grow in future periods.

The net income for Fiscal 2007 of \$1,284,825 (\$0.47 per fully diluted share) compared to net income of \$1,350,129 (\$0.49 per fully diluted share) and net income of \$1,608,140 (\$0.59 per fully diluted share) in Fiscal 2006 and 2005, respectively. Net income in Fiscal 2006 included a \$280,223 reduction in the deferred tax asset valuation allowance which reduced the Fiscal 2006 income tax provision. Net income in Fiscal 2005 included two significant items; a foreign exchange loss of \$174,274 which was incurred due to the closure of the German subsidiary (Schmitt Europa, GmbH); and \$640,000 income tax benefit due to the reduction in the deferred tax asset valuation allowance. Management believes the effective tax rate in future periods will reflect a normal combined state and federal rate.

A substantial portion of the Company's revenues are derived from sales to end users through selling agents. The Company is dependent on the sales activities of its selling agents, and there can be no assurance these agents will continue to be successful in their efforts to market the Company's products. The Company enjoys substantial repeat business from a broad base of customers, but there is no assurance these customers will continue to buy the Company's products.

In Fiscal years 2007, 2006 or 2005, sales to any single customer did not exceed 10% of total revenues.

The Company operates in highly competitive industries characterized by increasingly rapid technological changes. The Company's competitive advantage and future success are therefore dependent on its ability to develop new products, qualify these new products with its customers, successfully introduce these products to the marketplace on a timely basis, commence production to meet customer demands and develop new markets in the industries for its products and services. The successful introduction of new technology and products is increasingly complex. If the Company is unable, for whatever reason, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, its results of operations could be adversely impacted.

## **LIQUIDITY AND CAPITAL RESOURCES**

The Company's ratio of current assets to current liabilities increased to 9.8 to 1 at May 31, 2007 compared to 8.1 to 1 at May 31, 2006. Cash, cash equivalents and available for sale short term investments totaled \$5,477,711 as of May 31, 2007 compared to \$3,538,012 at May 31, 2006. As of May 31, 2007 the Company had \$1,513,061 in cash and cash equivalents compared to \$1,552,072 at May 31, 2006. As of May 31, 2007 the Company had \$3,964,650 in short term investments compared to \$1,985,940 at May 31, 2006. Short term investments consisted of highly liquid A1-P1 rated commercial paper securities maturing through October 2007.

During the year ended May 31, 2007, cash provided by operating activities amounted to \$2,130,747 with the changes described as follows:

- Net income for the year ended May 31, 2007 of \$1,284,825 plus non-cash items: depreciation and amortization of \$205,911, loss on disposal of property and equipment \$5,235, deferred taxes of \$490,723, stock based compensation related items of \$25,704.
- Accounts receivable generated cash as the balance decreased to a May 31, 2007 balance of \$1,454,179 compared to \$1,983,090 at May 31, 2006, a 26.7% decrease. The Company generally experiences a payment cycle of 30-90 days on invoices, depending on the geographic market. Management believes its credit and collection policies are effective and appropriate for the marketplace. There can be no assurance that the Company's collection procedures will continue to be successful, particularly with current economic conditions.



- Inventories increased to a May 31, 2007 balance of \$3,690,363 compared to \$3,241,590 at May 31, 2006, a 13.8% increase. The Company maintains levels of inventory sufficient to satisfy normal customer demands plus an increasing short-term delivery requirement for a majority of its Balancer products. Management believes its ability to provide prompt delivery gives it a competitive advantage for certain sales.
- Prepaid expenses decreased to \$71,331 from a balance of \$77,626 at May 31, 2006 with the decrease due to prepaid fees, trade show costs and various business and insurance costs.
- Trade accounts payable used cash as the balance decreased to \$335,820 from a balance of \$403,490 at May 31, 2006 primarily due to normal fluctuations in timing of payment of outstanding payable balances.
- Other accrued liabilities (including customer deposits, commissions, payroll items and other accrued expenses) increased to a balance of \$628,436 from \$626,785 at May 31, 2006.

During the year ended May 31, 2007, net cash used in investing activities was \$2,370,945, consisting of net additions to property and equipment of \$192,235, \$200,000 promissory note advance and net purchases of short term investments of \$1,978,710. Net cash provided by financing activities amounted to \$119,959 which consisted of common stock issued on exercised stock options and related items of \$141,571 net of repayments of long-term obligations of \$21,612.

The following summarizes contractual obligations at May 31, 2007 and the effect on future liquidity and cash flows:

| Years ending May 31, | Long term obligations | Operating leases | Total contractual obligations |
|----------------------|-----------------------|------------------|-------------------------------|
| 2008                 | \$                    | \$ 52,000        | \$ 52,000                     |
| 2009                 |                       | 38,000           | 38,000                        |
| 2010                 |                       | 5,000            | 5,000                         |
| Thereafter           |                       |                  |                               |
| Total                | \$                    | \$ 95,000        | \$ 95,000                     |

Management has historically responded to business challenges that had a negative impact on operations and liquidity by reducing operating expenses, developing new products and attempting to penetrate new markets for the Company's products. As a result of these efforts, results of operations and cash flow from operations have improved. Management believes its cash flows from operations, its available credit resources and its cash position will provide adequate funds on both a short-term and long-term basis to cover currently foreseeable debt payments, lease commitments and payments under existing and anticipated supplier agreements. Management believes that such cash flow (without the raising of external funds) is sufficient to finance current operations, projected capital expenditures, anticipated long-term sales agreements and other expansion-related contingencies during Fiscal 2008. However, in the event the Company fails to achieve its operating and financial goals for Fiscal 2008, management may be required to take certain actions to finance operations in that time period. These actions could include, but are not limited to, implementation of cost cutting measures and/or entering into additional borrowing arrangements collateralized by assets.

#### 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, 2007. However, the Company could be exposed to interest rate risk at any time in the future and, therefore, employs established policies and procedures to manage its exposure to changes in the market risk of its marketable securities.

The Company's interest income and expense are most sensitive to changes in the general level of U.S. and European interest rates. In this regard, changes in U.S. and European interest rates affect the interest earned on the Company's interest bearing cash equivalents and short term investments. The Company has a variable rate line of credit facility with a bank but there is no outstanding balance as of May 31, 2007. 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.

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**Foreign Currency Risk**

The Company markets and sells its products worldwide and international sales have accounted for and are expected to continue to account for a significant portion of future revenue. The Company operates a subsidiary in the United Kingdom and acquires certain materials and services from vendors transacted in foreign currencies. Therefore, the Company's business and financial condition is sensitive to currency exchange rates or any other restrictions imposed on their currencies. For the years ended May 31, 2007, 2006 and 2005, results of operations included gains (losses) on foreign currency translation of \$20,774, \$(9,757) and \$(184,106), respectively. The foreign exchange loss in Fiscal 2005 was directly attributable to the closure, liquidation and pending dissolution of the Company's German subsidiary, Schmitt Europa, GmbH. In the fourth quarter of Fiscal 2005, management chose to terminate the only two employees in that country, eliminating the need for a separate German company. As there will be no future activity in that subsidiary, the accumulated foreign exchange loss, included in other comprehensive income on the balance sheet in prior periods, was recognized in the fourth quarter of Fiscal 2005. The foreign exchange gains or losses in Fiscal 2007 and 2006 are primarily attributable to Company's United Kingdom subsidiary, Schmitt Europe, Ltd.

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## Item 8. Financial Statements and Supplementary Data

**SCHMITT INDUSTRIES, INC.**  
**CONSOLIDATED BALANCE SHEETS**

|  | May 31, 2007         | May 31, 2006         |
|--|----------------------|----------------------|
| <b>ASSETS</b>  |                      |                      |
| <b>Current assets</b>  |                      |                      |
| Cash and cash equivalents  | \$ 1,513,061         | \$ 1,552,072         |
| Short-term investments   | 3,964,650            | 1,985,940            |
| Accounts receivable, net   | 1,454,179            | 1,983,090            |
| Inventories  | 3,690,363            | 3,241,590            |
| Prepaid expenses   | 71,331               | 77,626               |
| Deferred tax asset   | 144,957              | 116,080              |
|  | 10,838,541           | 8,956,398            |
| <b>Property and equipment</b>  |                      |                      |
| Land   | 299,000              | 299,000              |
| Buildings and improvements   | 1,336,181            | 1,275,922            |
| Furniture, fixtures and equipment  | 826,380              | 1,180,648            |
| Vehicles   | 97,955               | 96,849               |
|  | 2,559,516            | 2,852,419            |
| Less accumulated depreciation and amortization   | (1,333,738 )         | (1,643,047 )         |
|  | 1,225,778            | 1,209,372            |
| <b>Other assets</b>  |                      |                      |
| Long-term deferred tax asset   | 32,780               | 552,380              |
| Other assets   | 373,797              | 208,405              |
|  | 406,577              | 760,785              |
| <b>TOTAL ASSETS</b>  | <b>\$ 12,470,896</b> | <b>\$ 10,926,555</b> |
| <b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b>   |                      |                      |
| <b>Current liabilities</b>   |                      |                      |
| Accounts payable   | \$ 335,820           | \$ 403,490           |
| Accrued commissions  | 225,782              | 250,835              |
| Accrued payroll liabilities  | 83,365               | 138,801              |
| Other accrued liabilities  | 319,289              | 237,149              |
| Income taxes payable   | 142,108              | 60,237               |
| Current portion of long-term obligations   |                      | 15,204               |
| <b>Total current liabilities</b>   | <b>1,106,364</b>     | <b>1,105,716</b>     |
| <b>Long-term obligations</b>   |                      |                      |
|  |                      | 6,408                |
| <b>Stockholders equity</b>   |                      |                      |
| Common stock, no par value, 20,000,000 shares authorized,<br>2,664,419 and 2,625,045 shares issued and outstanding at<br>May 31, 2007 and May 31, 2006, respectively |                      |                      |
|  | 8,114,251            | 7,946,976            |
| Accumulated other comprehensive loss   | (122,050 )           | (220,051 )           |
| Retained earnings  | 3,372,331            | 2,087,506            |
| <b>Total stockholders equity</b>   | <b>11,364,532</b>    | <b>9,814,431</b>     |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>   | <b>\$ 12,470,896</b> | <b>\$ 10,926,555</b> |

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

**SCHMITT INDUSTRIES, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

|   | Year Ended May 31, |               |               |
|---|--------------------|---------------|---------------|
|   | 2007               | 2006          | 2005          |
| <b>Net sales</b>                                  | \$ 11,882,076      | \$ 11,503,360 | \$ 10,591,229 |
| Cost of sales                                     | 5,254,205          | 5,029,714     | 4,460,769     |
| <b>Gross profit</b>                               | 6,627,871          | 6,473,646     | 6,130,460     |
| <b>Operating expenses:</b>                        |                    |               |               |
| General, administration and sales                 | 4,770,996          | 4,658,235     | 4,871,605     |
| Research and development                          | 88,425             | 81,815        | 42,395        |
| Total operating expenses                          | 4,859,421          | 4,740,050     | 4,914,000     |
| <b>Operating income</b>                           | 1,768,450          | 1,733,596     | 1,216,460     |
| Other income (expense)                            | 226,375            | 50,076        | (214,320)     |
| <b>Income before income taxes</b>                 | 1,994,825          | 1,783,672     | 1,002,140     |
| Provision (benefit) for income taxes              | 710,000            | 433,543       | (606,000)     |
| <b>Net income</b>                                 | \$ 1,284,825       | \$ 1,350,129  | \$ 1,608,140  |
| <b>Net income per common share, basic</b>         | \$ 0.49            | \$ 0.52       | \$ 0.64       |
| Weighted average number of common shares, basic   | 2,649,284          | 2,606,039     | 2,527,665     |
| <b>Net income per common share, diluted</b>       | \$ 0.47            | \$ 0.49       | \$ 0.59       |
| Weighted average number of common shares, diluted | 2,763,061          | 2,746,402     | 2,708,797     |

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

**Schmitt Industries, Inc.**  
**Consolidated Statements of Cash Flows**

|   | Year Ended May 31, |              |              |
|---|--------------------|--------------|--------------|
|   | 2007               | 2006         | 2005         |
| <b>Cash flows relating to operating activities</b>                                |                    |              |              |
| Net income  | \$ 1,284,825       | \$ 1,350,129 | \$ 1,608,140 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                    |              |              |
| Depreciation and amortization   | 205,911            | 210,606      | 214,933      |
| Loss on disposal of property and equipment  | 5,235              |              |              |
| Deferred taxes  | 490,723            | (28,460)     | (640,000)    |
| Stock based compensation  | 46,423             |              |              |
| Tax benefit related to stock options  | 36,124             | 335,238      |              |
| Excess tax benefit from stock based compensation                                  | (56,843)           |              |              |
| (Increase) decrease in:   |                    |              |              |
| Accounts receivable   | 549,186            | 126,053      | (293,726)    |
| Inventories   | (441,984)          | 291,723      | (618,220)    |
| Prepaid expenses  | 6,489              | 26,666       | 20,056       |
| Income taxes receivable   |                    |              | 35,894       |
| Increase(decrease) in:  |                    |              |              |
| Accounts payable  | (73,013)           | (93,716)     | (68,340)     |
| Accrued liabilities and customer deposits   | (4,200)            | 106,607      | 166,131      |
| Income taxes payable  | 81,871             | 34,090       | 26,147       |
| Net cash provided by operating activities   | 2,130,747          | 2,358,936    | 451,015      |
| <b>Cash flows relating to investing activities</b>                                |                    |              |              |
| Purchase of short-term investments  | (11,478,710)       | (1,985,940)  |              |
| Maturities of short-term investments  | 9,500,000          |              |              |
| Purchase of property and equipment  | (197,235)          | (116,868)    | (93,060)     |
| Proceeds from sale of property and equipment                                      | 5,000              |              |              |
| Advance on convertible promissory note  | (200,000)          |              |              |
| Net cash used in investing activities   | (2,370,945)        | (2,102,808)  | (93,060)     |
| <b>Cash flows relating to financing activities</b>                                |                    |              |              |
| Repayments on long-term obligations   | (21,612)           | (31,258)     | (42,064)     |
| Common stock issued on exercise of stock options                                  | 84,728             | 115,640      | 135,279      |
| Excess tax benefit from stock based compensation                                  | 56,843             |              |              |
| Net cash provided by financing activities   | 119,959            | 84,382       | 93,215       |
| <b>Effect of foreign exchange translation on cash</b>                             | 81,228             | 34,603       | 121,595      |
| <b>Increase (decrease) in cash and cash equivalents</b>                           | (39,011)           | 375,113      | 572,765      |
| <b>Cash and cash equivalents, beginning of period</b>                             | 1,552,072          | 1,176,959    | 604,194      |
| <b>Cash and cash equivalents, end of period</b>                                   | \$ 1,513,061       | \$ 1,552,072 | \$ 1,176,959 |
| <b>Supplemental Disclosure of Cash Flow Information</b>                           |                    |              |              |
| Cash paid during the period for interest  | \$ 340             | \$ 872       | \$ 1,083     |
| Cash paid during the period for income taxes                                      | \$ 143,734         | \$ 139,065   | \$ 7,853     |
| <b>Supplemental Schedule of Noncash Investing and Financing Activities</b>        |                    |              |              |
| Fixed assets financed   | \$                 | \$           | \$ 27,861    |

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





**SCHMITT INDUSTRIES, INC.**  
**Consolidated Statements of Changes in Stockholders' Equity**  
**And Comprehensive Income**

|  | Shares    | Amount       | Accumulated<br>other<br>comprehensive<br>loss | Retained<br>earnings | Total         | Total<br>comprehensive<br>income |
|--|-----------|--------------|---|----------------------|---------------|----------------------------------|
| <b>Balance, May 31, 2004</b>                                 | 2,474,461 | \$ 7,360,819 | \$ (376,249 )                                 | \$ (870,763 )        | \$ 6,113,807  |                                  |
| Stock options exercised                                      | 85,226    | 135,279      |   |                      | 135,279       |                                  |
| Net income   |           |              |   | 1,608,140            | 1,608,140     | \$ 1,608,140                     |
| Other comprehensive income                                   |           |              | 121,595                                       |                      | 121,595       | 121,595                          |
| <b>Balance, May 31, 2005</b>                                 | 2,559,687 | \$ 7,496,098 | \$ (254,654 )                                 | \$ 737,377           | \$ 7,978,821  |                                  |
| <b>Comprehensive income, year ended May 31, 2005</b>         |           |              |   |                      |               | \$ 1,729,735                     |
| Stock options exercised and related tax benefit of \$335,238 | 65,358    | 450,878      |   |                      | 450,878       |                                  |
| Net income   |           |              |   | 1,350,129            | 1,350,129     | \$ 1,350,129                     |
| Other comprehensive income                                   |           |              | 34,603  |                      | 34,603        | 34,603                           |
| <b>Balance, May 31, 2006</b>                                 | 2,625,045 | \$ 7,946,976 | \$ (220,051 )                                 | \$ 2,087,506         | \$ 9,814,431  |                                  |
| <b>Comprehensive income, year ended May 31, 2006</b>         |           |              |   |                      |               | \$ 1,384,732                     |
| Stock options exercised and related tax benefit of \$36,124  | 39,374    | 120,852      |   |                      | 120,852       |                                  |
| Stock based compensation                                     |           | 46,423       |   |                      | 46,423        |                                  |
| Net income   |           |              |   | 1,284,825            | 1,284,825     | \$ 1,284,825                     |
| Other comprehensive income                                   |           |              | 98,001  |                      | 98,001        | 98,001                           |
| <b>Balance, May 31, 2007</b>                                 | 2,664,419 | \$ 8,114,251 | \$ (122,050 )                                 | \$ 3,372,331         | \$ 11,364,532 |                                  |
| <b>Comprehensive income, year ended May 31, 2007</b>         |           |              |   |                      |               | \$ 1,382,826                     |

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

**Schmitt Industries, Inc.**  
**Notes to Consolidated Financial Statements**  
**For The Years Ended May 31, 2007, 2006 and 2005**

**NOTE 1**  
**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Operations**

Schmitt Industries, Inc. (the Company) designs, assembles, markets and distributes electronic and mechanical components for machine tool products and laser measurement systems worldwide.

**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 Europa GmbH (SEG). Effective May 31, 2005 SEG has been liquidated. All significant intercompany accounts and transactions have been eliminated in the preparation of the consolidated financial statements.

**Revenue Recognition**

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectibility is reasonably assured. 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. Substantially all product sales are sold FCA (free carrier) shipping point and any related shipping and handling costs are expensed as incurred and included in cost of sales.

**Cash Equivalents and Short Term Investments**

The Company generally invests excess cash in money market funds and investment grade highly liquid securities. The Company considers securities that are highly liquid, readily convertible into cash and have original maturities of less than three months when purchased to be cash equivalents. At May 31, 2007, short-term investments are classified as available-for-sale. The carrying amounts of cash equivalents and short term investments are stated at cost, which approximate fair market value because of their short maturities. There were no related unrealized holding gains or losses at May 31, 2007.

**Accounts Receivable**

The Company maintains credit limits for all customers based upon several factors, included but not limited to 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 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. Changes in the Company's allowance for doubtful accounts are as follows:

|                      | <b>Year Ended May 31,</b> |             |             |
|----------------------|---------------------------|-------------|-------------|
|                      | <b>2007</b>               | <b>2006</b> | <b>2005</b> |
| Beginning balance    | \$ 52,186                 | \$ 41,366   | \$ 32,550   |
| Bad debt expense     | 39,513                    | 39,513      | 40,527      |
| Accounts written off | (70,881 )                 | (28,693 )   | (31,711 )   |
| Ending balance       | \$ 20,818                 | \$ 52,186   | \$ 41,366   |

**Inventory**

Inventory is valued at the lower of cost or market with cost determined on the average cost basis. As of May 31, 2007 and 2006, inventories consisted of:

|               | <b>May 31, 2007</b> | <b>May 31, 2006</b> |
|---------------|---------------------|---------------------|
| Raw materials | \$ 1,638,256        | \$ 1,578,767        |

The accompanying notes are an integral part of these consolidated statements

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|                 |              |              |
|-----------------|--------------|--------------|
| Work-in-process | 530,415      | 368,592      |
| Finished goods  | 1,521,692    | 1,294,231    |
|                 | \$ 3,690,363 | \$ 3,241,590 |

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Management performs various analyses to evaluate inventory balances to ensure recorded amounts reflect estimated net realizable value. Changes in the Company's allowance for slow moving inventories are as follows:

|                                      | Year Ended May 31, |            |            |
|--------------------------------------|--------------------|------------|------------|
|                                      | 2007               | 2006       | 2005       |
| Beginning balance                    | \$ 172,945         | \$ 163,414 | \$ 172,696 |
| Items added to allowance             | 151,866            | 18,777     | 94,664     |
| Items disposed or used in production | (49,438 )          | (9,246 )   | (103,946 ) |
| Ending balance                       | \$ 275,373         | \$ 172,945 | \$ 163,414 |

### 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.

### Foreign Currency Translation

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.

### Advertising

Advertising costs included in general, administrative and selling, are expensed when the advertising first takes place. Advertising expense was \$112,562, \$82,322 and \$87,853 for the fiscal years ended May 31, 2007, 2006 and 2005, respectively.

### Research and Development Costs

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

### Stock-Based Compensation

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

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of June 1, 2006, the first day of our 2007 fiscal year. In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for periods prior to the first quarter of Fiscal 2007 have not been restated to reflect this change. Stock-based compensation recognized during the period is based on the value of the portion of the stock-based award that will vest during the period, adjusted for expected forfeitures. The compensation cost for awards granted prior to May 31, 2006 is based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 while awards granted on or after June 1, 2006 follow the provisions of SFAS 123(R) to determine the grant date fair value and compensation cost. Compensation cost for all stock-based awards is recognized using the straight-line method.

### 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. In Fiscal 2005 and 2006, management concluded future operations would produce



sufficient earnings so that a portion of this asset could be used in future periods to reduce federal and state tax liabilities. Management continues to review the level of the valuation allowance on a quarterly basis. There can be no assurance that the Company's future operations will produce sufficient earnings so that the deferred tax asset can be fully utilized.

### **Intangible and Other Long Term Assets**

Other long term assets include definite-lived intangible assets and a convertible promissory note. Amortizable intangible assets, purchased technology and patents, are amortized over their estimated useful lives ranging from eleven to seventeen years.

During Fiscal 2007 the Company entered into a convertible promissory note agreement with Xtero Datacom, Inc. of Vancouver, British Columbia pursuant to which the Company will loan up to \$250,000 USD to Xtero to fund product development and testing of Xtero satellite measurement technologies. The advances under the loan agreement are based on established milestones being achieved by Xtero in the beta field testing of their technology. The loan is convertible into equity of Xtero at the sole option of Schmitt Industries, Inc. As of May 31, 2007, Schmitt advanced \$200,000 to Xtero.

There is a periodic review of intangible and other long-lived assets for impairment. This review consists of the analysis of events or changes in circumstances that would indicate the carrying amount of the asset may not be recoverable. Recoverability is determined by comparing the forecasted future net cash flows from the operations to which the assets relate, based on management's best estimates using the appropriate assumptions and projections at the time, to the carrying amount of the assets. If the carrying value is determined to be in excess of future operating cash flows, the asset is considered impaired and a loss is recognized equal to the amount by which the carrying amount exceeds the estimated fair value of the assets. As of May 31, 2007, management does not believe impairment, as defined above, exists.

### **Earnings Per Share**

Basic earnings per share is computed using the weighted average number of common shares outstanding. Diluted earnings 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.

### **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 1-1/2% if the invoice is paid within ten days, with the net amount payable in 30 days.

### **Financial Instruments**

Based on borrowing rates currently available to the Company for bank loans with similar terms and maturities, the fair value of the Company's long-term debt approximates the carrying value. Furthermore, the carrying value of all other financial instruments potentially subject to valuation risk (principally consisting of cash and cash equivalents, short term investments, accounts receivable and accounts payable) also approximate fair value because of their short-term maturities.

### **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.

### **Recently issued accounting pronouncements**

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





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

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of SFAS 157 are effective for the fiscal year beginning June 1, 2008. The Company is currently evaluating the impact of the provisions of SFAS 157.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an Amendment of FASB Statement No. 115*. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The provisions of SFAS 159 are effective for the fiscal year beginning June 1, 2008. The Company is currently evaluating the impact of the provisions of SFAS 159.

### Reclassifications

Certain reclassifications have been made to the 2006 and 2005 amounts to conform to 2007 presentations.

### NOTE 2 LINE OF CREDIT

The Company has a \$1.0 million bank line of credit agreement secured by U.S. accounts receivable, inventories and general intangibles. Interest is payable at the bank's prime rate, 8.25% as of May 31, 2007, and the agreement expires on September 1, 2007. There were no outstanding balances on the line of credit at May 31, 2007.

### NOTE 3 INCOME TAXES

The provision (benefit) for income taxes are as follows:

|   | Years ended May 31, |            |               |
|---|---------------------|------------|---------------|
|   | 2007                | 2006       | 2005          |
| Current   | \$ 226,000          | \$ 109,100 | \$ 34,000     |
| Deferred  | 501,936             | 604,666    | 420,167       |
| Decrease in valuation allowance                 | (17,936 )           | (280,223 ) | (1,060,167 )  |
| Total (benefit from) provision for income taxes | \$ 710,000          | \$ 433,543 | \$ (606,000 ) |

Deferred tax assets (liabilities) are comprised of the following components:

|  | 2007       | 2006       |
|--|------------|------------|
| Depreciation   | \$ 52,177  | \$ 62,869  |
| Net operating loss carryforwards   |            | 197,958    |
| Deferred taxes related to the decline in fair market value of long-term investment | 694,696    | 694,696    |
| Other deferred items, net  | 200,560    | 500,569    |
| Gross deferred tax assets  | 947,433    | 1,456,092  |
| Deferred tax asset valuation allowance   | (769,696 ) | (787,632 ) |
| Net deferred tax asset   | \$ 177,737 | \$ 668,460 |



The net deferred tax asset is classified as follows:

|                              | 2007       | 2006       |
|------------------------------|------------|------------|
| Current deferred tax asset   | \$ 144,957 | \$ 116,080 |
| Long-term deferred tax asset | 32,780     | 552,380    |
| Net deferred tax asset       | \$ 177,737 | \$ 668,460 |

Deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the deferred tax asset will not be realized. The Company has recorded a substantial deferred tax asset related to the expected realization of net operating loss carryforwards for federal income tax purposes and other temporary differences between book and tax bases of assets and liabilities. Due to the uncertainty of utilization of the Company's net operating losses and in consideration of other factors, management recorded a valuation allowance on the deferred tax asset at May 31, 2003.

During Fiscal 2005 and 2006, management concluded future operations would produce sufficient earnings so that portions of this asset could be used in future periods to reduce federal and state tax liabilities and the allowance was reduced to reflect the amount of the deferred tax asset management believes can be utilized in future periods. Our effective tax rate on consolidated net income was 35.6% for the year ended May 31, 2007. Our effective tax rate on consolidated net income differs from the federal statutory tax rate primarily due to certain expenses not deductible for income tax reporting offset by lower effective tax rates on net income reported by the Company's wholly owned subsidiary, Schmitt Europe Ltd. (SEL), located in the United Kingdom. The net effective tax expense on consolidated net income in Fiscal 2006 and Fiscal 2005 differs from the federal statutory tax rate primarily due to a reduction in the valuation allowance at November 30, 2005 and May 31, 2005. Management believes the effective tax rate on consolidated net income in future periods will reflect a normal combined state and federal rate, net of the effect from expenses not deductible for income tax reporting and net income or losses reported by SEL.

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 income due to the following:

|  | Years ended May 31, |   |       |   |        |    |
|--|---------------------|---|-------|---|--------|----|
|  | 2007                |   | 2006  |   | 2005   |    |
| 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 |                     |   | (15.7 | ) | (105.8 | )  |
| Permanent and other differences            | (2.8                | ) | 1.6   |   | 6.9    |    |
| Effective tax rate                         | 35.6                | % | 24.3  | % | (60.5  | )% |

#### **NOTE 4 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 further make either a profit sharing contribution or a discretionary contribution. As of June 1, 2005 the Company resumed matching contributions in conjunction with employee contributions to the plan and made contributions totaling \$68,662 during Fiscal 2007 and \$45,041 during Fiscal 2006. There were no contributions made by the Company to this Plan during the year ended May 31, 2005.

**NOTE 5**  
**LONG-TERM OBLIGATIONS**

As of May 31, 2007, there were no outstanding obligations under capital leases or purchase contracts. During Fiscal 2005, the Company entered into a purchase contract for \$27,861. The agreement calls for monthly principal and interest payments of \$810 and carries interest at 1.9%. During Fiscal 2004, the Company entered into an equipment lease, which was treated as a capital lease, and a purchase contract totaling \$78,477. One lease expired in Fiscal 2006 and the second expired in Fiscal 2007. Equipment recorded under the capital lease was \$48,477, with related accumulated depreciation of \$37,704 at May 31, 2007.

The Company leases certain facilities and equipment to support operations under non-cancelable operating leases and other contractual obligations. Total rent expense for the years ended May 31, 2007, 2006 and 2005 amounted to \$64,824, \$41,806 and \$67,133, respectively.

The approximate future minimum commitments under leases and contractual obligations for each of the years ending May 31 are as follows:

| Years ending May 31, |           |
|----------------------|-----------|
| 2008                 | \$ 52,000 |
| 2009                 | \$ 38,000 |
| 2010                 | \$ 5,000  |
| Thereafter           | \$        |

**NOTE 6**  
**COMMITMENTS AND CONTINGENCIES**

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, 2007, 2006 and 2005 amounted to \$89,350, \$87,567 and \$79,268, respectively.

**NOTE 7**  
**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 measurement systems (Measurement). The Company operates in three principal geographic markets, United States, Europe and Asia.

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|                                       | Year Ended May 31,<br>2007 |              | 2006         |              | 2005         |              |
|---------------------------------------|----------------------------|--------------|--------------|--------------|--------------|--------------|
|                                       | Balancer                   | Measurement  | Balancer     | Measurement  | Balancer     | Measurement  |
| Gross sales                           | \$ 8,587,432               | \$ 4,077,510 | \$ 8,429,409 | \$ 3,765,191 | \$ 8,276,258 | \$ 3,188,941 |
| Intercompany sales                    | (663,805 )                 | (119,061 )   | (610,740 )   | (80,500 )    | (845,971 )   | (27,999 )    |
| Net sales                             | \$ 7,923,627               | \$ 3,958,449 | \$ 7,818,669 | \$ 3,684,691 | \$ 7,430,287 | \$ 3,160,942 |
| Operating income                      | \$ 697,330                 | \$ 1,071,120 | \$ 674,446   | \$ 1,059,150 | \$ 274,710   | \$ 941,750   |
| Intercompany rent expense<br>(income) | \$ (30,000 )               | \$ 30,000    | \$ (30,000 ) | \$ 30,000    | \$ (30,000 ) | \$ 30,000    |
| Depreciation expense                  | \$ 143,569                 | \$ 27,734    | \$ 139,905   | \$ 36,097    | \$ 137,184   | \$ 43,146    |
| Amortization expense                  | \$                         | \$ 34,608    | \$           | \$ 34,604    | \$           | \$ 34,603    |
| Advances on convertible note          | \$ 200,000                 | \$           | \$           | \$           | \$           | \$           |
| Capital expenditures                  | \$ 171,207                 | \$ 26,028    | \$ 54,903    | \$ 61,965    | \$ 103,658   | \$ 17,263    |

**Geographic Information**

|                      | Year Ended May 31, |               |               |
|----------------------|--------------------|---------------|---------------|
|                      | 2007               | 2006          | 2005          |
| North American       |                    |               |               |
| United States        | \$ 5,855,118       | \$ 5,709,044  | \$ 5,610,274  |
| Canada and Mexico    | 200,011            | 169,494       | 262,466       |
| North American total | 6,055,129          | 5,878,538     | 5,872,740     |
| European             |                    |               |               |
| Germany              | 261,979            | 313,655       | 552,438       |
| Intercompany         |                    | (10,293 )     |               |
| Germany total        | 261,979            | 303,362       | 552,438       |
| United Kingdom       | 1,159,406          | 1,081,981     | 1,276,968     |
| Intercompany         | (724,417 )         | (677,415 )    | (873,970 )    |
| United Kingdom total | 434,989            | 404,566       | 402,998       |
| Other European       | 1,401,709          | 1,056,419     | 1,120,653     |
| Total European       | 2,098,677          | 1,764,347     | 2,076,089     |
| Asia                 | 2,702,531          | 2,919,556     | 2,122,384     |
| Other markets        | 1,025,739          | 940,919       | 520,016       |
| Total Net Sales      | \$ 11,882,076      | \$ 11,503,360 | \$ 10,591,229 |

|                              | Year Ended May 31,<br>2007 |            | 2006          |           | 2005          |               |
|------------------------------|----------------------------|------------|---------------|-----------|---------------|---------------|
|                              | United States              | Europe     | United States | Europe    | United States | Europe        |
| Operating income (loss)      | \$ 1,475,710               | \$ 292,740 | \$ 1,730,712  | \$ 2,884  | \$ 1,547,349  | \$ (330,889 ) |
| Depreciation expense         | \$ 159,953                 | \$ 11,350  | \$ 164,394    | \$ 11,608 | \$ 172,903    | \$ 7,427      |
| Amortization expense         | \$ 34,608                  | \$         | \$ 34,604     | \$        | \$ 34,603     | \$            |
| Advances on convertible note | \$ 200,000                 | \$         | \$            | \$        | \$            | \$            |
| Capital expenditures         | \$ 196,787                 | \$ 448     | \$ 112,101    | \$ 4,767  | \$ 120,921    | \$            |

**Segment and Geographic Assets**

|                                   | May 31, 2007  | May 31, 2006  |
|-----------------------------------|---------------|---------------|
| Segment assets to total assets    |               |               |
| Balancer                          | \$ 5,022,717  | \$ 4,659,418  |
| Measurement                       | 1,792,731     | 2,060,665     |
| Corporate assets                  | 5,655,448     | 4,206,472     |
| Total assets                      | \$ 12,470,896 | \$ 10,926,555 |
| Geographic assets to total assets |               |               |
| United States                     | \$ 11,812,573 | \$ 10,164,617 |
| Europe                            | 658,323       | 761,938       |
| Total assets                      | \$ 12,470,896 | \$ 10,926,555 |

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

**NOTE 8****STOCK OPTIONS AND STOCK BASED COMPENSATION**

The Board of Directors adopted the 2004 Stock Option Plan (2004 Plan) in August 2004 and the 1995 Stock Option Plan (1995 Plan) in December 1995, which plan was amended in August 1996 and restated in August 1998. An option granted under the 2004 Plan and/or 1995 Plan (the Plans) might be either an incentive stock option (ISO), or a nonstatutory stock option (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 is either 50% at grant date and 16.7% on each anniversary thereafter or 50% at grant date and 25% 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. 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. Stock-based compensation recognized in the Company's Consolidated Financial Statements for the year ended May 31, 2007 includes compensation cost for stock-based awards granted prior to, but not fully vested as of, May 31, 2006. There were no stock-based awards granted subsequent to May 31, 2006. All outstanding options will expire no later than 2015.

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

- *Risk-Free Interest Rate.* The Company bases the risk-free interest rate on the implied yield currently available on U.S. Treasury issues with an equivalent remaining term approximately equal to the expected life of the award.
- *Expected Life.* The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determines the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules and pre-vesting and post-vesting forfeitures.
- *Expected Volatility.* The Company estimates the volatility of its common stock at the date of grant based on the historical volatility of its common stock. The volatility factor the Company uses is based on its historical stock prices over the most recent period commensurate with the estimated expected life of the award. These historical periods may exclude portions of time when unusual transactions occurred.



- *Expected Dividend Yield.* The Company has never paid any cash dividends on its common stock and does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero.
- *Expected Forfeitures.* The Company uses relevant historical data to estimate pre-vesting option forfeitures. The Company records stock-based compensation only for those awards that are expected to vest.

The Company has computed, to determine stock-based compensation expense recognized for the year ended May 31, 2007 and for pro forma disclosure purposes for the years ended May 31, 2006 and 2005, the value of all stock options granted using the Black-Scholes option pricing model as prescribed by SFAS No. 123(R) using the following assumptions:

|                                |               |
|--------------------------------|---------------|
| <b>Risk-free interest rate</b> | 3.8-4.45 %    |
| <b>Expected life</b>           | 4.0-4.7 years |
| <b>Expected volatility</b>     | 95-102 %      |

#### Stock-Based Compensation Under FAS 123(R)

The following table summarizes stock-based compensation expense related to stock-based awards under SFAS 123(R) for the year ended May 31, 2007 and what certain operating results would have been without the effects of applying SFAS No. 123(R).

|                                     | As reported  | Pro Forma without effects of applying SFAS No. 123(R) |
|-------------------------------------|--------------|---|
| General, administration and sales   | \$ 4,770,996 | \$ 4,724,573  |
| Income before income taxes          | \$ 1,994,825 | \$ 2,041,248  |
| Net income                          | \$ 1,284,825 | \$ 1,313,422  |
| Cash flow from operating activities | \$ 2,130,747 | \$ 2,187,590  |
| Cash flow from financing activities | \$ 119,959   | \$ 63,116   |
| Basic earnings per share            | \$ 0.49      | \$ 0.50   |
| Diluted earnings per share          | \$ 0.47      | \$ 0.48   |

At May 31, 2007 the Company had a total of 175,871 outstanding stock options (159,247 vested and exercisable and 16,624 non-vested) with a weighted average exercise price of \$2.57. The Company estimates that a total of approximately \$50,517 will be recorded as additional stock-based compensation expense over the period beginning with the year ending May 31, 2008 through the fiscal year ending May 31, 2009, for all options which are outstanding as of May 31, 2007, 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 |  |
| 76,247              | \$ 1.20                         | 4.8   | 76,247              | \$ 1.20                         |  |
| 68,124              | 2.30                            | 6.8   | 65,625              | 2.30                            |  |
| 5,000               | 5.80                            | 8.4   | 3,750               | 5.80                            |  |
| 26,500              | 6.58                            | 8.3   | 13,625              | 6.58                            |  |
| 175,871             | \$ 2.57                         | 6.2   | 159,247             | \$ 2.22                         |  |





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Options granted, exercised, canceled and expired under the Company's stock option plan during the years ended May 31, 2007, 2006 and 2005 are summarized as follows:

|                                    | Number of<br>Shares | Weighted<br>Average<br>Exercise Price |
|------------------------------------|---------------------|---------------------------------------|
| Options outstanding - May 31, 2004 | 170,516             | \$ 1.20                               |
| Options granted                    | 165,500             | 2.30                                  |
| Options exercised                  | (85,226 )           | 1.59                                  |
| Options forfeited/cancelled        |                     |                                       |
| Options outstanding - May 31, 2005 | 250,790             | \$ 1.79                               |
| Options granted                    | 34,000              | 6.47                                  |
| Options exercised                  | (63,294 )           | 1.83                                  |
| Options forfeited/cancelled        | (5,000 )            | 2.30                                  |
| Options outstanding - May 31, 2006 | 216,496             | \$ 2.52                               |
| Options granted                    |                     |                                       |
| Options exercised                  | (39,374 )           | 2.15                                  |
| Options forfeited/cancelled        | (1,251 )            | 6.58                                  |
| Options outstanding - May 31, 2007 | 175,871             | \$ 2.57                               |

The total intrinsic value of outstanding and exercisable options at May 31, 2007 was \$922,001 and \$889,883, respectively. The total intrinsic value of options exercised during the years ended May 31, 2007, 2006 and 2005 was \$198,207, \$402,122 and \$428,106, respectively.

**Pro Forma Information under SFAS 123 and APB 25**

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

The following table illustrates the effect on the Company's net income and basic and diluted net income per share for the years ended May 31, 2006 and 2005 had compensation cost for the plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS 123.

|   | Year Ended May 31, |              |
|---|--------------------|--------------|
|   | 2006               | 2005         |
| Net income, as reported   | \$ 1,350,129       | \$ 1,608,140 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax | (120,411 )         | (230,865 )   |
| Pro forma net income  | \$ 1,229,718       | \$ 1,377,275 |
| Earnings per share - basic  |                    |              |
| As reported   | \$ 0.52            | \$ 0.64      |
| Pro forma   | \$ 0.47            | \$ 0.54      |
| Earnings per share - diluted  |                    |              |
| As reported   | \$ 0.49            | \$ 0.59      |
| Pro forma   | \$ 0.45            | \$ 0.51      |

**NOTE 9****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, 2007:

|   | Income<br>(Numerator) | Weighted<br>Average Shares<br>(Denominator) | Per Share<br>Amount |
|---|-----------------------|---|---------------------|
| <b>Year ended May 31, 2007</b>              |                       |   |                     |
| Basic earnings per share                    |                       |   |                     |
| Income available to common stockholders     | \$ 1,284,825          | 2,649,284                                   | \$ 0.49             |
| Effect of dilutive securities stock options |                       | 113,777                                     |                     |
| Diluted earnings per share                  |                       |   |                     |
| Income available to common stockholders     | \$ 1,284,825          | 2,763,061                                   | \$ 0.47             |
| <b>Year ended May 31, 2006</b>              |                       |   |                     |
| Basic earnings per share                    |                       |   |                     |
| Income available to common stockholders     | \$ 1,350,129          | 2,606,039                                   | \$ 0.52             |
| Effect of dilutive securities stock options |                       | 140,363                                     |                     |
| Diluted earnings per share                  |                       |   |                     |
| Income available to common stockholders     | \$ 1,350,129          | 2,746,402                                   | \$ 0.49             |
| <b>Year ended May 31, 2005</b>              |                       |   |                     |
| Basic earnings per share                    |                       |   |                     |
| Income available to common stockholders     | \$ 1,608,140          | 2,527,665                                   | \$ 0.64             |
| Effect of dilutive securities stock options |                       | 181,132                                     |                     |
| Diluted earnings per share                  |                       |   |                     |
| Income available to common stockholders     | \$ 1,608,140          | 2,708,797                                   | \$ 0.59             |

**NOTE 10****RELATED PARTY TRANSACTIONS**

Effective June 1, 2004, the Company entered into a contract to provide consulting services to PulverDryer USA, Inc., ( PulverDryer ) pursuant to which PulverDryer paid the Company \$8,000 a month from June 2004 through October 2004. PulverDryer also buys certain products from the Company at normal prevailing rates. The Company and PulverDryer extended the contract from November 1, 2004 forward at that same monthly fee of \$8,000. Product sales to PulverDryer during the fiscal years ended May 31, 2007, 2006 and 2005 totaled \$35,300, \$152,305 and \$88,873, respectively.

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

**NOTE 11**

## QUARTERLY FINANCIAL DATA

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

| 2007 Quarter Ended            | August<br>31 | November<br>30 | February<br>28 | May<br>31 |
|-------------------------------|--------------|----------------|----------------|-----------|
| Sales                         | \$ 3,073     | \$ 2,930       | \$ 2,971       | \$ 2,909  |
| Gross profit                  | \$ 1,598     | \$ 1,642       | \$ 1,250       | \$ 1,667  |
| Net income                    | \$ 271       | \$ 271         | (1) \$ 388     | \$ 355    |
| Net income per share, basic   | \$ .10       | \$ .10         | (1) \$ .15     | \$ .13    |
| Net income per share, diluted | \$ .10       | \$ .10         | (1) \$ .14     | \$ .13    |
| Market Price of Common Stock  |              |                |                |           |
| High                          | \$ 7.99      | \$ 7.86        | \$ 7.98        | \$ 8.20   |
| Low                           | \$ 6.58      | \$ 6.27        | \$ 7.04        | \$ 7.20   |

  

| 2006 Quarter Ended            | August<br>31 | November<br>30 | February<br>28 | May<br>31 |
|-------------------------------|--------------|----------------|----------------|-----------|
| Sales                         | \$ 2,665     | \$ 2,606       | \$ 2,707       | \$ 3,525  |
| Gross profit                  | \$ 1,428     | \$ 1,506       | \$ 1,414       | \$ 2,126  |
| Net income                    | \$ 243       | \$ 395         | \$ 198         | \$ 514    |
| Net income per share, basic   | \$ .09       | \$ .15         | \$ .08         | \$ .20    |
| Net income per share, diluted | \$ .09       | \$ .14         | \$ .07         | \$ .19    |
| Market Price of Common Stock  |              |                |                |           |
| High                          | \$ 11.95     | \$ 9.10        | \$ 7.47        | \$ 8.39   |
| Low                           | \$ 7.69      | \$ 5.40        | \$ 5.47        | \$ 5.78   |

(1) As reported in our Quarterly Report on Form 10-Q for the three and nine months ended February 28, 2007, net income as previously reported in our Quarterly Report on Form 10-Q for the three and six months ended November 30, 2006 was restated as the provision for income taxes did not consider certain income taxes on a portion of net income from the Company's wholly owned subsidiary located in the United Kingdom.

***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 as of May 31, 2007 and 2006, and the related consolidated statements of operations, changes in stockholders' equity and comprehensive income and cash flows for each of the three years in the period ended May 31, 2007. These 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 audit to obtain reasonable assurance about whether the 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 audit 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 financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the consolidated financial statements, the Company changed its method of accounting for stock-based compensation as a result of adopting Statement of Financial Accounting Standards No. 123(R), Share-Based Payment (Revised 2004), effective June 1, 2006.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Schmitt Industries, Inc. as of May 31, 2007 and 2006 and the results of its operations and its cash flows for each of the three years in the period ended May 31, 2007 in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP

Portland, Oregon  
July 30, 2007

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

None.

**Item 9A. Controls and Procedures**

(a) Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based on their evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective as of the end of the period covered by this report.

(b) There have been no changes in our internal controls that occurred during the period covered by this report that has materially affected, or is 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 2007 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 2007 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 2007 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 2007 Annual Meeting of Shareholders and is incorporated herein by reference.

This table shows information about equity awards under the Company's equity compensation plans at May 31, 2007:

| Plan Category  | Number of Securities to be issued upon exercise of outstanding options<br>a | Weighted-average exercise price of outstanding options<br>b | Number of Securities remaining available for future issuance under equity compensation plans (excluding securities in column a)<br>c |
|--|---|---|--|
| Equity compensation plans approved by security holders | 175,871   | \$ 2.57   | 275,000  |

Equity compensation plans not approved by  
security holders

175,871

\$

2.57

275,000

35

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**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 2007 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 2007 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, 2007 and 2006  
Consolidated Statements of Operations for the years ended May 31, 2007, 2006 and 2005  
Consolidated Statements of Cash Flows for the years ended May 31, 2007, 2006 and 2005  
Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income for the years ended May 31, 2007, 2006 and 2005  
Notes to Consolidated Financial Statements for the years ended May 31, 2007, 2006 and 2005  
Report of Independent Registered Public Accounting Firm
- (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 38 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/ Wayne A. Case  
Wayne A. Case  
*Chairman of the Board, President  
and Chief Executive Officer*

Date: July 31, 2007

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 July 31, 2007.

| <b>Signature</b>                                   | <b>Title</b>  |
|--|---|
| /s/ Wayne A. Case<br>Wayne A. Case                 | Chairman of the Board, President and Chief Executive Officer<br>(Principal Executive Officer) |
| /s/ Michael S. McAfee<br>Michael S. McAfee         | Chief Financial Officer/Treasurer<br>(Principal Financial and Accounting Officer)             |
| /s/ Maynard Brown<br>Maynard Brown                 | Director  |
| /s/ Timothy D.J. Hennessy<br>Timothy D.J. Hennessy | Director  |
| /s/ David M. Hudson<br>David M. Hudson             | Director  |
| /s/ Michael J. Ellsworth<br>Michael J. Ellsworth   | Director  |

**INDEX TO EXHIBITS**

**Exhibits**

**Description**

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.

|       |  |
|-------|--|
| *3.1  | Second Restated Articles of Incorporation of Schmitt Industries, Inc. (the Company).<br><b>[Form 10-K for the fiscal year ended May 31, 1999, Exhibit 3(i)]</b>                        |
| *3.2  | Second Restated Bylaws of the Company.<br><b>[Form 10-K for the fiscal year ended May 31, 1999, Exhibit 3(ii)]</b>   |
| *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. Amended & Restated Stock Option Plan (the 1995 Plan).<br><b>[Form 10-K for the fiscal year ended May 31, 1999, Exhibit 10.1]</b>                              |
| *10.2 | Employment Agreement of Wayne A. Case dated January 1, 2004.<br><b>[Form 10-Q for the fiscal quarter ended February 29, 2004, Exhibit 10.1]</b>  |
| *10.3 | Schmitt Industries, Inc. 2004 Stock Option Plan.<br><b>[Appendix B to Schedule 14A filed on August 23, 2004]</b>   |
| *10.4 | Employment Agreement of Michael S. McAfee dated September 21, 2005.<br><b>[Form 8-K filed on September 23, 2005, Exhibit 10.1]</b>   |
| *14.1 | Code of Ethics and Business Conduct.<br><b>[Form 10-K for the fiscal year ended May 31, 2004, Exhibit 14.1]</b>  |
| 21.1  | Subsidiaries of Schmitt Industries, Inc. as of May 31, 2007.   |
| 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. |

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