

QEP CO INC  
Form 10-Q  
October 23, 2006

---

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

Washington, D.C. 20549

---

**FORM 10-Q**

---

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

For the quarterly period ended August 31, 2006

Or

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

Commission File Number 0-21161

---

**Q.E.P. CO., INC.**

(Exact name of registrant as specified in its charter)

---

**DELAWARE**  
(State or other jurisdiction of

incorporation or organization)

**1001 BROKEN SOUND PARKWAY NW, SUITE A, BOCA RATON, FLORIDA 33487**

(Address of principal executive offices)(Zip Code)

**13-2983807**  
(I.R.S. Employer

Identification No.)

Registrant's telephone number, including area code: (561) 994-5550

## Edgar Filing: QEP CO INC - Form 10-Q

---

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

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 number of shares outstanding of each of the registrant's classes of common stock as of October 9, 2006 is 3,489,841 shares of Common Stock, par value \$0.001 per share.

---

**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

Q.E.P. CO., Inc. and Subsidiaries

Consolidated Balance Sheets

(In thousands, except share data)

	August 31, 2006	February 28, 2006
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 671	\$ 852
Accounts receivable, less allowance for doubtful accounts of approximately \$248 and \$361 as of August 31, 2006 and February 28, 2006, respectively	32,171	33,258
Inventories	31,562	34,128
Prepaid expenses and other current assets	2,991	3,717
Deferred income taxes	660	617
<b>Total current assets</b>	<b>68,055</b>	<b>72,572</b>
Property and equipment, net	7,666	8,296
Goodwill	9,453	16,799
Other intangible assets, net	2,958	3,109
Other assets	220	310
<b>Total Assets</b>	<b>\$ 88,352</b>	<b>\$ 101,086</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Trade accounts payable	\$ 18,193	\$ 24,041
Accrued liabilities	7,510	7,655
Lines of credit	28,905	26,284
Current maturities of long term debt	4,397	4,431
Put warrant liability	982	2,298
<b>Total current liabilities</b>	<b>59,987</b>	<b>64,709</b>
Notes payable	3,658	4,950
Other long-term debt	2,888	4,197
Deferred income taxes	217	213
<b>Total Liabilities</b>	<b>66,750</b>	<b>74,069</b>
Commitments and Contingencies		
<b>SHAREHOLDERS EQUITY</b>		
Preferred stock, 2,500,000 shares authorized, \$1.00 par value; 336,660 shares issued and outstanding at August 31, 2006 and February 28, 2006, respectively	337	337
Common stock; 20,000,000 shares authorized, \$.001 par value; 3,465,841 shares 3,484,841 and 3,458,341 shares issued and outstanding at August 31, 2006 and February 28, 2006, respectively	3	3
Additional paid-in capital	9,781	9,539
Retained earnings	14,792	21,205
Treasury stock; 82,940 shares and 70,940 held at cost outstanding at August 31, 2006 and February 28, 2006,	(639)	(543)
Accumulated other comprehensive income	(2,672)	(3,524)

Edgar Filing: QEP CO INC - Form 10-Q

21,602

27,017

**TOTAL LIABILITIES AND SHAREHOLDERS EQUITY**

**\$88,352**

**\$101,086**

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

## Q.E.P. CO., INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands except per share data)

(Unaudited)

	For the Three Months Ended August 31,		For the Six Months Ended August 31,	
	2006	2005 As Restated	2006	2005 As Restated
Net sales	\$ 54,476	\$ 52,947	\$ 108,608	\$ 102,818
Cost of goods sold	39,612	38,546	78,478	74,068
Gross profit	14,864	14,401	30,130	28,750
Operating costs and expenses:				
Shipping	5,557	5,286	11,105	10,320
General and administrative	5,083	4,640	10,135	9,222
Selling and marketing	3,733	3,666	7,291	7,110
Impairment loss on goodwill and other intangibles	7,598		7,598	
Other expense (income), net	(1)	(12)	(3)	(1,164)
Total operating costs and expenses	21,970	13,580	36,126	25,488
Operating income (loss)	(7,106)	821	(5,996)	3,262
Change in put warrant liability	1,231	(381)	1,316	962
Interest expense, net	(732)	(643)	(1,456)	(1,131)
Income (loss) before provision for income taxes	(6,607)	(203)	(6,136)	3,093
Provision (benefit) for income taxes	124	172	265	851
Net income (loss)	\$ (6,731)	\$ (375)	\$ (6,401)	\$ 2,242
Net income (loss) per share:				
Basic	\$ (1.94)	\$ (0.11)	\$ (1.85)	\$ 0.65
Diluted	\$ (1.94)	\$ (0.11)	\$ (1.85)	\$ 0.58
Weighted-average number of common shares outstanding				
Basic	3,474	3,458	3,469	3,458
Diluted	3,474	3,458	3,469	3,834

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

## Q.E.P. CO., INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	For the Six Months Ended August 31,	
	2006	2005 As Restated
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (6,401)	\$ 2,242
Adjustments to reconcile net income (loss) to net cash provided by in operating activities:		
Depreciation and amortization	1,284	2,048
Impairment loss on goodwill and other intangibles	7,598	
Change in fair value of put warrant liability	(1,316)	(962)
Write-off of Holland accumulated foreign translation	447	
Bad debt expense	70	223
Gain on sale of business		(1,120)
Stock-based compensation expense	120	
Deferred income taxes	(40)	(148)
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	1,017	(2,704)
Inventories	2,567	(490)
Prepaid expenses and other current assets	726	421
Other assets	12	(307)
Trade accounts payable and accrued liabilities	(6,001)	1,139
Net cash provided by operating activities	83	342
<b>Cash flows from investing activities:</b>		
Capital expenditures	(353)	(816)
Acquisitions, net of cash acquired		(2,330)
Net cash used in investing activities	(353)	(3,146)
<b>Cash flows from financing activities:</b>		
Net (payments) borrowings under lines of credit	2,164	(48)
Borrowings of long-term debt		3,209
Repayments of long-term debt	(1,390)	(955)
Repayments of acquisition debt	(1,380)	(482)
Payments related to the purchase of treasury stock	(60)	(60)
Proceeds from exercise of stock options	129	10
Dividends	(10)	(8)
Net cash (used in) provided by financing activities	(547)	1,666
Effect of exchange rate changes on cash	636	(271)
Net decrease in cash	(181)	(1,409)
Cash and cash equivalents at beginning of period	852	1,869
Cash and cash equivalents at end of period	\$ 671	\$ 460

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

---

**Q.E.P. CO., INC. AND SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**NOTE A Interim Reporting**

The accompanying financial statements for the interim periods are unaudited and include the accounts of Q.E.P. Co., Inc. and its subsidiaries, which are collectively referred to as we, us, our, Q.E.P. or the Company. The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q for interim financial reporting pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). While these statements reflect all normal recurring adjustments which are, in the opinion of management, necessary for fair presentation of the results of the interim period, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Therefore, the interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in our annual report filed on Form 10-K/A for the fiscal year ended February 28, 2006.

Effective with the 2007 fiscal year, we modified our accounting treatment for cooperative advertising and in-store service expenses with our home center customers. The modification was necessary because we changed certain terms in our vendor buying agreement with a large home center customer and believe under the new terms we could no longer reasonably estimate the fair value of the benefit received from these arrangements. According to the guidance under Emerging Issues Task Force 01-9, Accounting for Consideration Given By a Vendor To a Customer (Including a Reseller of the Vendor's Products), if the estimated value received cannot be specifically identified, these promotional funds should be accounted for as a reduction of selling price and netted against gross sales. Prior to March 1, 2006, we classified these items as selling and marketing expense in our consolidated statement of operations. For the three and six months ended August 31, 2005 these expenses totaled \$1.5 million and \$2.9 million, respectively. For comparative purposes, these amounts have been reclassified resulting in a reduction in sales, gross profit and selling and marketing expenses in our domestic segment, with no impact on our financial condition, operating income or net earnings.

In the financial statements prepared for the three and six month periods presented for fiscal 2006, the change in the value of the put warrant liability was recorded in operating expenses. In the presentation included in this interim report, the amount has been reclassified below operating income for all periods presented.

All significant intercompany transactions have been eliminated.

We are a leading manufacturer, marketer and distributor of a broad line of specialty tools and flooring related products for the home improvement market. Under brand names including Q.E.P.<sup>®</sup>, ROBERTS<sup>®</sup>, Capitol<sup>®</sup>, QSet, Vitrex<sup>®</sup> and Elastiment, we market specialty tools and flooring related products used primarily for the surface preparation and installation of ceramic tile, carpet, vinyl and wood flooring. Q.E.P. and our subsidiaries market approximately 3,000 products in the U.S., Canada, Europe, Australia and Latin America. We sell our products primarily to large home improvement retail centers, as well as traditional distribution outlets in all of the markets we serve.



**NOTE B Restatement of Consolidated Financial Statements**

We have restated the value of the put warrant liability as of the August 31, 2005 and as of the end of the 2006 fiscal year. During these periods, we estimated the value of the put warrant liability using methods and valuation techniques required by the put warrant agreement and in accordance with Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. We reconsidered the methodology used after discussions with the SEC and determined to value the put warrant liability by calculating the difference between our closing stock price at the end of a reporting period and the exercise price of \$3.63 per share multiplied by the 325,000 warrants granted. We believe this methodology provides an appropriate estimate of entity value. As a result, the estimated value of the put warrant liability has been restated for all years in which the warrants were outstanding. This change has no impact on our previously reported operating income or cash flows generated from operations. Changes to the fair value of the put warrants are recognized in earnings. The updated methodology has also been applied to all periods presented for fiscal 2007. The restated amounts as compared to the initially reported information is as follows (in thousands except per share data):

	Three Months Ended August 31, 2005		Six Months Ended August 31, 2005	
	As Previously Reported	As Restated	As Previously Reported	As Restated
Change in put warrant liability	346	(381)	(158)	962
Income (loss) before provision for income taxes	524	(203)	1,973	3,093
Provision for income taxes	172	172	851	851
Net income (loss)	\$ 352	\$ (375)	\$ 1,122	\$ 2,242
Net income (loss) per share:				
Basic	\$ 0.10	\$ (0.11)	\$ 0.32	\$ 0.65
Diluted	\$ 0.10	\$ (0.11)	\$ 0.31	\$ 0.58
Weighted-average number of common shares outstanding				
Basic	3,458	3,458	3,458	3,458
Diluted	3,601	3,458	3,609	3,834

We have also reconsidered the economic characteristics in our geographic regions and have included segment disclosure in accordance with Statement of Financial Accounting Standards No. 131 *Disclosures About Segments of an Enterprise and Related Information* in this report.

**NOTE C Inventories**

Inventories consisted of the following (in thousands):

	August 31, 2006	February 28, 2006
Raw materials and work-in-process	5,608	5,822
Finished goods	25,954	28,306
	31,562	34,128

**NOTE D Goodwill and Intangible Assets**

Under Statement of Financial Accounting Standard No. 142 *Goodwill and Other Intangible Assets*, intangible assets with definite lives are amortized while intangibles with indefinite lives, such as goodwill, are tested annually for impairment or when changes events or changes in

circumstances indicate the carrying value may not be recoverable. We perform an impairment test on goodwill during the second quarter of

each fiscal year. The impairment test completed in the second quarter of fiscal 2007 has resulted in a non-cash impairment charge of \$7.6 million. Details of the impairment test are described in Footnote E below. We will continue to assess the impairment of goodwill and other assets in accordance with SFAS No. 142 in the future. If our operating performance and resulting cash flows in the future are less than expected, an additional impairment charge could be incurred which may have a material impact on our results of operations.

All other intangible assets are subject to amortization. The total balance of definite-lived intangible assets is classified as follows (in thousands):

	Weighted Avg Useful Life	May 31, 2006			February 28, 2006		
		Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Trademarks	20	2,999	(904)	2,095	2,971	(820)	2,151
Other intangibles	5	1,280	(417)	863	1,327	(369)	958
		\$ 4,279	\$ (1,321)	\$ 2,958	\$ 4,298	\$ (1,189)	\$ 3,109

We incurred \$0.1 million and \$0.2 million of amortization expense in the three and six months ended August 31, 2006. We expect to incur a total of approximately \$0.3 million in fiscal 2007. Other intangibles include customer lists, non-compete agreements, patents and financing fees.

#### NOTE E Impairment of Goodwill

In accordance with SFAS No. 142, goodwill and other intangible assets with indefinite lives are tested for impairment annually and when events or changes in circumstances indicate an impairment could exist. In performing this assessment, we compare the carrying value of our reporting units to their fair value.

During the second quarter of fiscal 2007, we completed our annual impairment test on the goodwill and other intangible assets currently recorded. Earnings forecasts for each of our segments were updated in support of the fair value estimates used in the impairment tests. The valuations were based on market approaches, the present value of future cash flows and closing price of our stock as at August 31, 2006. These tests indicated that the carrying amount of the goodwill exceeded fair value in our Mexico, U.K. and U.S. operating entities, and led us to conclude that goodwill was impaired. As of the time of the filing, we have not finalized the second step of the impairment analysis due to the timing of the 10-Q filing relative to the occurrence of the events of impairment and other issues. The second step of the impairment analysis will be finalized in the third quarter of fiscal 2007. However, we have determined that an impairment loss is probable and could be reasonably estimated. Therefore, as permitted under the provisions of FASB Statement No. 142, we recorded an estimated non-cash impairment charge of \$7.6 million to reduce the carrying value of goodwill and other intangibles to its implied fair value. The implied fair value of goodwill was estimated through the allocation of the fair value to the underlying assets and liabilities. The non-cash charge was recorded at our domestic (\$6.3 million), Europe (\$1.0 million) and Other (\$0.3 million) segments.

The fair value of the reporting unit under step one was determined by an independent third-party using methodologies that include both a market and an income approach. The market approach includes analysis of publicly traded companies comparable in terms of functions performed, financial strengths, and markets serviced, along with a survey of transactions involving similar public and non-public companies. The income approach was based on the economic benefit stream of discounted future cash flows. After the non-cash charge for impairment, \$6.9 million of goodwill remains recorded on our domestic segment, \$0.9 million in our Canada segment, \$0.3 million in our Europe segment and \$1.4 million in our Australia/New Zealand segment. No balance remains in our Other segment.

We will continue to assess the potential of impairment of goodwill and other indefinite-lived intangibles in accordance with FASB Statement No. 142 in future periods. Should our business prospects change, and our expectations for acquired business be further reduced, or other circumstances that affect our business dictate, we may be required to recognize additional impairment charges in accordance with SFAS No. 142.

**NOTE F Debt***Revolving Credit Facility*

Currently, we have a loan agreement in place with two domestic financial institutions to provide a revolving credit facility, mortgage and term note financing. In March 2005, we amended the facility to consolidate our term notes and increase the amount of borrowing capacity to \$27 million through February 2006 and \$29 million thereafter under the revolving facility under the same formula for eligible accounts receivable and inventory that previously existed. The revolving facility was also extended to July 2008. These loans are collateralized by substantially all of our assets. The agreement also prohibits incurring certain additional indebtedness, limits certain investments, advances or loans, restricts substantial asset sales and capital expenditures and prohibits the payment of dividends, except for dividends due on our Series A and C preferred stock.

As of February 28, 2006, we were in violation of financial covenants under the credit facility that required we maintain a certain senior debt to trailing EBITDA ratio and a certain fixed charge coverage ratio. On March 20, 2006 we were granted a waiver of the non-compliance of these covenants from the lenders. Further, it was determined that we were in violation of an additional financial covenant under the credit facility that required we maintain a certain liabilities to tangible net worth ratio. On June 1, 2006, we received a waiver of this covenant. Also in June 2006, the loan agreement was amended with respect to certain financial covenants. The June 2006 amendment also resulted in a fee of less than \$0.1 million and an increase in the interest rate to a range from Libor plus 1.5% to Libor plus 2.25%.

The credit agreement was further amended on October 23, 2006 to exclude from the covenant calculations the effect of the goodwill impairment charge and the losses recorded related to the Holland transaction. Both the disposition of assets and obligations and the realization of the foreign currency translation as discussed in Footnote M related to Holland were excluded. Without this amendment the excluded items recorded in the second quarter of fiscal 2007 would have caused us to be in violation as of August 31, 2006 of the same EBITDA and fixed charge coverage covenants discussed above.

At August 31, 2006 the rate was Libor (5.41%) plus 2.5% and we had borrowed approximately \$24.9 million and had \$3.7 million available for future borrowings under our revolving loan facility net of approximately \$0.4 million in outstanding letters of credit.

*International Credit Facilities*

Our Australian subsidiary has a payment facility that allows it to borrow against a certain percentage of inventory and accounts receivable. At August 31, 2006, the maximum permitted borrowing was approximately \$2.2 million of which \$1.7 was outstanding. The facility is considered a demand note and carries with it a rate of the Australian Commercial Bill Rate (6.3%) plus 2%.

In connection with the purchase of the assets of Vitrex Ltd., our United Kingdom subsidiary entered into two financing arrangements with HSBC Bank in the United Kingdom. The first financing arrangement allows for borrowing up to £1.0 million (approximately U.S. \$1.9 million) based on the advancement of up to 80% of the value of accounts receivable. In addition, the subsidiary may borrow up to £0.4 million (approximately U.S. \$0.8 million) against the value of the inventory. Both of these facilities are collateralized by substantially all of the assets of the subsidiary (approximately \$8.1 million) as well as a parent company guaranty. On August 31, 2006, \$2.1 million was borrowed under these facilities. Both are considered short-term demand notes and have an interest rate of 6.5%.

*Term Loan Facilities*

As discussed previously, in March 2005, we amended our term loan agreements by consolidating the then existing two term facilities into one three year term facility. In addition, we received approximately \$3.0 million of additional term financing under the amendment. The amendment provides for repayment of this facility at a rate of \$0.2 million per month at an interest rate of Libor plus 2.13% to Libor plus 2.63% through April 2008. The amendment also formally released our Chairman and Chief Executive Officer of his guaranty of one of the term loans. In June 2006, the loan agreements were amended to increase the interest rate to Libor plus 2.13% to Libor plus 2.88%. The balance on this term note was \$3.3 million at August 31, 2006.

Our Australian subsidiary has entered into three term loan facilities with an Australian financial institution to provide financing of up to AUD 1.7 million (US \$1.3 million). These facilities expire in April 2007, June 2008 and October 2008. The loans require quarterly payments of AUD 0.2 million (US \$0.1 million) and a final balloon payment. The balance of these term notes was US \$1.0 million at August 31, 2006. The term loan is collateralized by substantially all of the assets of the subsidiary (approximately \$11.0 million) as well as a guaranty by the parent company.

#### NOTE G Stock Based Compensation

We grant stock options for a fixed number of shares to employees and directors with an exercise price equal to at least 85% of the fair market value of the shares at the date of grant. Option term, vesting and exercise periods vary, except that the term of an option may not exceed 10 years. As of the current date, however, no options have been issued at a discount to market price.

We also grant stock appreciation rights for a fixed number of shares to various members of management. These rights vest three years after the grant date. The exercise price of the stock appreciation rights is equal to the fair market value of the shares at the date of grant.

In the first quarter of fiscal 2007, we adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, which revises SFAS 123, *Accounting for Stock-Based Compensation*. Prior to the adoption we applied Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for stock options. Because we granted stock options to employees at exercise prices equal to fair market value on the date of grant, no compensation cost was recognized for option grants in periods prior to fiscal 2007.

Under SFAS No. 123R, we are required to select a valuation technique or option-pricing model that meets the criteria as stated in the standard, which includes a binomial model and the Black-Scholes model. At present, we are continuing to use the Black-Scholes model, which requires the input of subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options and stock appreciation rights before exercising, the interest rate, the estimated volatility of our common stock price over the expected term and the number of options and stock appreciation rights that will ultimately not complete their vesting requirements. For fiscal 2007, the expected stock price volatility is based primarily on the historical volatility of our stock. Changes in the subjective assumptions can materially affect the estimate of fair value of stock-based compensation. The following table represents the assumptions used to estimate the fair value of options issued during the second quarter of the 2007 fiscal year and the six months ended August 31, 2006 and stock appreciation rights outstanding as of August 31, 2006:

Expected stock price volatility	39.3%
Expected lives of options:	
Directors and officers	3 years
Employees	3 years
Risk-free interest rate	4.8%
Expected dividend yield	0.0%

No options or stock appreciation rights were issued in the first quarter of fiscal 2007.

The adoption of SFAS No. 123R, applying the modified prospective method, as elected, requires us to recognize stock options and stock appreciation rights granted prior to the adoption of SFAS No. 123 under the fair value method and expense these amounts over the remaining vesting period of the award. In the three and six months ended August 31, 2006, we recognized compensation expense of less than \$0.1 million and \$0.1 million, respectively, related to stock options issued and stock appreciation rights granted in previous periods. If the underlying assumptions do not change, the total compensation cost related to non-vested awards not yet recognized is \$0.7 million and is expected to be recognized over three years.

*Stock Option Information*

The following table summarizes information about stock options as of August 31, 2006.

Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$ 3.65 - \$ 5.55	95,750	4.0	\$ 4.24	95,750	\$ 4.24
\$ 5.56 - \$ 7.25	151,125	5.0	\$ 6.76	91,125	\$ 6.76
\$ 7.26 - \$ 15.66	87,000	8.6	\$ 9.62	20,334	\$ 12.18
Total	333,875			207,209	

Activity under our stock option plan as of August 31, 2006 and changes during the six months ended August 31, 2006 are as follows:

	Shares	Weighted Average Exercise Price
Options outstanding at February 28, 2006	326,375	\$ 7.65
Exercised	(26,500)	\$ 5.14
Granted	110,000	\$ 7.25
Cancelled or forfeited	(76,000)	\$ 11.86
Options outstanding at August 31, 2006	333,875	
Intrinsic value of exercisable options	\$ 2,444,264	
Weighted average term of exercisable options	5.7	

As of August 31, 2006, 1.0 million shares were authorized to be issued under our current option plan. The intrinsic value of options exercised during fiscal 2007 was less than \$0.1 million.

*Stock Appreciation Rights*

As of August 31, 2006, there are 173,400 stock appreciation rights outstanding that were granted to various members of management from fiscal 2005 through fiscal 2007, 81,000 of which were issued in the second quarter of fiscal 2007. The rights vest 100% three years after their grant date. As a result, none of the stock appreciation rights are exercisable on August 31, 2006. The average stock price associated with these grants ranges from \$7.05 to \$14.20 per share.

*Comparison to Pro Forma Information*

The following table reflects net income and diluted earnings per share for the three and six months ended August 31, 2006, compared with proforma information for the three and six months ended August 31, 2005 had compensation cost been determined in accordance with the fair value-based method prescribed by SFAS No. 123R (in thousands except per share data):

	Three Months Ended August 31, 2005	Six Months Ended August 31, 2005
Net income (loss) as reported under APB 25	\$ (375)	\$ 2,242
Subtract stock-based compensation expense determined under fair value-based method, net of related tax effect	(37)	(67)

Edgar Filing: QEP CO INC - Form 10-Q

Net income (loss) including stock-based compensation expense	\$	(412)	\$	2,175
Income (loss) per share:				
Diluted, as reported for prior periods	\$	(0.11)	\$	0.58
Diluted, including the effect of stock based compensation expense	\$	(0.12)	\$	0.57

**NOTE H Income Taxes**

We recorded a provision for income taxes in the three and six months ended August 31, 2006 of approximately \$0.1 million and \$0.3 million, respectively. This compares with a provision for \$0.2 million and \$0.9 million in the same periods in fiscal 2006. In all periods presented, the change in the put warrant liability is non-deductible for tax purposes. In the jurisdictions that have been affected by the impairment loss on goodwill, a valuation allowance has been recorded for any deferred tax benefit associated with the loss. After removing the put warrant expense, the non-taxable accumulated foreign currency translation related to our disposition of assets in Holland and the impairment loss on goodwill from the calculation, the effective tax rate in the three and six months ended August 31, 2006 was 60% and 45%, respectively. The effective rate was in excess of our statutory rate due to an adjustment to a prior year tax assessment in the second quarter of fiscal 2007. This rate compares with 97% and 40% in the three and six months ended August 31, 2005. The fiscal 2006 provision was based upon the statutory tax rates available in every jurisdiction in which we operate as adjusted for tax contingencies.

**NOTE I Earnings Per Share**

Basic earnings per share is computed by dividing net income, after deducting preferred stock dividends accumulated during the period, by the weighted average number of shares of common stock outstanding. Diluted earnings per share is computed by dividing net income, after deducting preferred stock dividends accumulated during the period, by the weighted average number of shares of common and dilutive common stock equivalent shares outstanding. The amount of preferred stock dividends is immaterial in all periods presented. There were 0.1 million and less than 0.1 million of common stock equivalent shares excluded from the dilutive earnings per share calculation because they were anti-dilutive in the three and six month periods ended August 31, 2006. In both periods presented for fiscal 2006, the amount of antidilutive shares was less than 0.1 million. The following is a reconciliation of the number of shares used in the basic and diluted computation of income per shares (in thousands)

	For the Three Months		For the Six Months	
	Ended August 31, 2006	2005	Ended August 31, 2006	2005
Weighted average number of common shares outstanding - basic	3,473	3,458	3,468	3,458
Dilution from stock options and warrants				376
Weighted average number of common shares outstanding - diluted	3,473	3,458	3,468	3,834

**NOTE J Comprehensive Income**

We record foreign currency translation adjustments as other comprehensive income. For the three and six months ended August 31, 2006, our comprehensive income (loss) totaled \$0.6 million and \$0.9 million, respectively. This compares with \$0.1 million and \$0.3 million for the same periods in fiscal 2006.

**Note K Segment Information**

After discussions with the SEC, we have reconsidered the economic characteristics of operations in our geographic regions and have included segment disclosure in accordance with Statement of Financial Accounting Standards No. 131 *Disclosures About Segments of an enterprise and related Information* in this Report. We have determined we operate in five business segments domestic, Canada, Europe, Australia/New Zealand and Other. Management has chosen to organize the segments into geographic areas, with each segment being the responsibility of a segment manager. Each segment markets and sells flooring-related products to the residential, new construction, do-it-yourself and professional remodeling and renovation markets and home centers. The European segment is made up of our operations in the UK, France, Holland and Germany. The Australia/New Zealand segment is made up of our operations in Australia and New Zealand. The Other segment is made up of operations in Latin America and other geographic areas.



Edgar Filing: QEP CO INC - Form 10-Q

The performance of the business is evaluated at the segment level. We manage cash, debt and income taxes centrally. Accordingly, we evaluate performance of our segments based on operating earnings exclusive of financing activities and income taxes. Segment results were as follows (in thousands):

	For the Three Months		For the Six Months	
	Ended August 31,		Ended August 31,	
	2006	2005	2006	2005
<b>Revenues</b>				
Domestic	\$ 36,759	\$ 37,285	\$ 73,351	\$ 71,265
Canada	6,030	4,750	11,678	9,548
Europe	5,309	4,904	11,121	10,481
Australia/New Zealand	5,625	5,325	11,009	10,257
Other	753	683	1,449	1,267
	\$ 54,476	\$ 52,947	\$ 108,608	\$ 102,818
<b>Operating income</b>				
Domestic	\$ 366	\$ 468	\$ 679	\$ 1,109
Canada	733	574	1,305	1,208
Europe	(846)	(474)	(774)	(607)
Australia/New Zealand	293	227	476	384
Other	(55)	14	(87)	4
Sub total	491	809	1,599	2,098
Other (income) expense	(1)	(12)	(3)	(1,164)
Impairment loss on goodwill and other intangibles	7,598		7,598	
<b>Operating income (loss)</b>	\$ (7,106)	\$ 821	\$ (5,996)	\$ 3,262
Change in put warrant liability	1,231	(381)	1,316	962
Interest expense, net	(732)	(643)	(1,456)	(1,131)
<b>Income (loss) before provision for income taxes</b>	\$ (6,607)	\$ (203)	\$ (6,136)	\$ 3,093
	<b>As of August 31,</b>	<b>As of February 28,</b>		
	<b>2006</b>	<b>2006</b>		
<b>Total assets</b>				
Domestic	\$ 53,092	\$ 66,771		
Canada	8,901	9,104		
Europe	11,888	11,818		
Australia/New Zealand	11,875	11,347		
Other	2,596	2,046		
	\$ 88,352	\$ 101,086		

The results from the Canadian operations are included as their own segment according to the provisions of Statement of Financial Accounting Standards No. 131 *Disclosures about Segments of an Enterprise and Related Information*. The reported results do not contain allocations of corporate expenses and sales infrastructure and their product costs are not burdened based on Canada's level of sales to external customers.

Amounts are attributed to the country of the legal entity that recognized the sale or holds the assets. The intercompany sales are billed at prices we have established. The price takes into account the product cost and overhead of the selling location.

**NOTE L Contingencies**

Edgar Filing: QEP CO INC - Form 10-Q

We are involved in litigation from time to time in the course of business. In the opinion of management, no material legal proceedings are pending to which we or any of our property is subject.

We are subject to federal, state and local laws, regulations and ordinances governing activities or operations that may have adverse environmental effects, such as discharges to air and water, handling and disposal practices for solid, special and hazardous wastes, and imposing liability for the cost of clean up, and for certain damages resulting from sites of past spills, disposal or other releases of hazardous substances (together, Environmental Laws ). Sanctions which may be imposed for violation of Environmental Laws include the payment or reimbursement of investigative and clean up costs, administrative penalties and, in certain cases, prosecution under environmental criminal statutes. Our manufacturing facilities are subject to environmental regulation by, among other agencies, the Environmental Protection Agency, the Occupational Safety and Health Administration, and various state authorities in the states where such facilities are located. Our activities, including manufacturing operations at our leased facilities, are subject to the requirements of Environmental Laws. We believe that the cost of compliance with Environmental Laws to date has not been material. We are not currently aware of any situations requiring remedial or other action which would involve a material expense, or expose us to material liability under Environmental Laws. As our operations involve the storage, handling, discharge and disposal of substances which are subject to regulation under Environmental Laws, there can be no assurance that we will not incur any material liability under Environmental Laws in the future or will not be required to expend funds in order to effect compliance with applicable Environmental Laws.

We completed testing at our facility in Bramalea, Ontario, Canada for leakage of hazardous materials and, as a result, in fiscal 1999 we prepared a plan to remediate the contamination over a period of years and this plan was subsequently approved by the Canadian Ministry of Environment. We recorded a reserve for potential environmental liability on the closing date of the Roberts Consolidated Industries, Inc. acquisition of approximately \$0.3 million and this amount was subsequently increased by \$0.4 million to \$0.7 million based on an estimate for the cost of remediation. We have incurred additional expense of \$0.1 million in fiscal 2007. Through fiscal 2006, we have spent approximately \$0.7 million and anticipate spending less than \$0.1 million on ongoing monitoring of wells and other environmental activity per year for the next few years.

We received notice from the United States Environmental Protection Agency that an entity identified as Roberts Consolidated Industries, Inc. may be involved in the contamination of landfill sites in Clark County, Ohio and Santa Barbara County, California. In addition, in April 2003, the record owner of certain real property in Vancouver, Washington informed us that an entity known as Roberts Consolidated Industry, Inc. owned or operated the facility during which time hazardous substances were disposed of or released at the site and pursuant to Washington State law, it is also liable for remedial action costs at the site. At this time, we are not aware whether these entities are predecessors to any of its affiliates or whether they are unrelated entities.

During fiscal 2005, we settled a lawsuit that was filed on December 27, 2002 whereby Roberts Holdings International, Inc., an inactive subsidiary, was named as a third party defendant in a case before the United States District Court for the Western District of Michigan titled *Strebor Inc. v. International Paper Co.*, Case No. 1:02 CV0948. The third party plaintiff alleged that Roberts Holding is a successor to a company known as Roberts Consolidated Industries, Inc. and is required to indemnify previous owners for costs associated with the clean-up of a property in Kalamazoo, Michigan. We agreed to pay \$50,000 per year beginning in October 2004 for five consecutive years in settlement of this action.

During fiscal 2006, French tax authorities have assessed income and value-added taxes of approximately \$1.6 million, including interest and penalties, on certain transactions of a wholly-owned subsidiary. We had discussions with the French Tax Authority in the second quarter of fiscal 2007, and we are currently providing additional documentation related to the issue. No provision has been made in the financial statements related to this assessment.

**NOTE M Restructuring of Operations in Holland***Disposition of Assets and Obligations*

On August 31, 2006, we entered into a license and royalty agreement with Estillon B.V., a European supplier of carpet specialty tools, granting Estillon rights to manufacture, market and distribute products using our Roberts® and Smoothedge® to customers, other than mass merchants, in certain European Union countries. This agreement also provides for certain supplier arrangements for our products with Estillon. At the same time, an additional agreement was executed with Estillon whereby Estillon purchased inventory and accounts receivable from us in exchange for cash. Estillon also assumed certain future warehousing and employee obligations. As a result of this license and royalty agreement and the sale agreements, we will no longer conduct direct operations in Holland. All future obligations related to the employees, the facilities in Holland and the disposition of assets have been accrued as of August 31, 2006. We recorded a charge of \$0.4 million for the write-off of Holland's accumulated foreign currency translation as of August 31, 2006, which is recorded in general and administrative expenses. We expect that the disposition of assets will be completed within one year. Any difference between the accrual and the realized value of the asset will be recorded at the time of disposition.

*Restructuring*

We began the process of restructuring one of our foreign operations during the fourth quarter of fiscal 2005. The costs of the restructuring, principally related to termination benefits that are expected to be paid through fiscal year 2008. Total cumulative costs charged to expense were \$0.6 million as of August 31, 2006. All amounts related to the restructuring are recorded in our Europe segment. Changes in the liability associated with the restructuring are recorded in general and administrative expense and are as follows (in thousands):

	<b>Six Months Ended</b>	
	<b>August 31, 2006</b>	
Beginning liability	\$	159
Costs charged to expense		(22)
Costs paid or settled		(74)
Foreign currency translation adjustment		13
Ending liability	\$	76

**NOTE N Recent Accounting Pronouncements**

In February 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS No. 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. We adopted the standard as of March 1, 2006 and the standard did not have an impact on our financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Income Tax Uncertainties*. FIN 48 defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. The recently issued literature also provides guidance on the de-recognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. FIN 48 also includes guidance concerning accounting for income tax uncertainties in interim periods and increases the level of disclosures associated with any recorded income tax uncertainties. FIN 48 is effective for fiscal years beginning after December 15, 2006 (our fiscal year ending February 28, 2008). The differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption will be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. We are still evaluating the impact, if any, of adopting the provisions of FIN 48 on our financial position, results of operations and liquidity.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB No. 108 is effective for fiscal years ending after November 15, 2006 (our fiscal year ending February 28, 2007). We are currently assessing the impact, if any, the adoption of SAB No. 108 will have on our operating income or net earnings. The cumulative effect, if any, of applying the provisions of SAB No. 108 will be reported as an adjustment to beginning-of-year retained earnings.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, SFAS No. 157 does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning after December 15, 2007 (our fiscal year ending February 28, 2009). We are currently evaluating the impact, if any, the adoption of SFAS No. 157 will have on our operating income or net earnings.

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

### Executive Overview

We are a worldwide leader in the manufacturing, marketing and distribution of a broad line of specialty tools and flooring related products, marketing over 3,000 specialty tools and related products used primarily for surface preparation and installation of ceramic tile, carpet, vinyl and wood flooring. Our products are sold to home improvement retailers, specialty distributors to the hardware, construction, flooring and home improvement trades, chain or independent hardware, tile and carpet retailers for use by the do-it-yourself consumer as well as the construction or remodeling professional, and original equipment manufacturers. We have executed a growth strategy intended to improve overall performance and profitability of operations that included acquisitions, the reduction of risk associated with certain large customer concentrations and the enhancement of cross selling of product among our channels of distribution.

We operate in five business segments: domestic, Canada, Europe, Australia/New Zealand and Other. Management has chosen to organize the segments into geographic areas, with each segment being the responsibility of a segment manager. Each segment markets and sells flooring-related products to the residential, new construction, do-it-yourself and professional remodeling and renovation markets and home centers. The European segment is made up of our operations in the UK, France, Holland and Germany. The Other segment is made up of operations in Latin America and other geographic areas

In the second quarter of fiscal 2007, we experienced an increase in sales of approximately 3% over the same period in the previous fiscal year. The increase in revenue was 2% at our combined domestic and Canadian segments, resulting primarily from increases in sales within several product categories including carpet tools and underlayment. The increases in sales of underlayment were the result of sales of new products introduced to our home center customers in the latter half of fiscal 2006. The increase in sales in carpet tools reflects sales of new products along with our continued efforts to provide our home center customers with a comprehensive product strategy. These efforts have afforded us an improved strategic position in relation to our competitors. Sales increased 8% in our Europe segment, 6% in our Australia/New Zealand segment and 10% in our Other segment

In the first half of fiscal 2007, revenue increased 6% over the same period in the previous year. The increase was 5% in our domestic segment resulting from increased sales of underlayment and carpet tools offset by smaller reductions in other product types including carpet tack strips.

Overall sales to our home center customers increased approximately 9% and 10%, respectively, in the three and six months ended August 31, 2006 compared to the same periods in the previous fiscal year. The increase in home center sales primarily reflects further penetration of our existing product offerings in current home center locations. Increases in product sales in fiscal 2007 compared to fiscal 2006 were somewhat offset by increases in sales rebates due to the additional sales volume

Gross profit increased in the three and six months ended August 31, 2006 compared to the same periods in the previous fiscal year due primarily to additional sales volume. In the second quarter of fiscal 2007, compared to the second quarter of fiscal 2006, gross profit as a percent of sales increased slightly from 27.2% to 27.3%. In the six months ended August 31, 2006 compared to the six months ended August 31, 2005, gross margin as a percent of sales decreased from 28.0% to 27.7%. We have continued to experience increases in raw material prices during fiscal 2007. The results for the first quarter of fiscal 2006 do not reflect price increases that occurred later in the year, contributing to the decrease in gross margin as a percent of sales. Only a portion of these cost increases were able to be passed on to our customers. The increases in cost were offset by positive changes in product mix resulting from the increased sales of underlayment and carpet tools.

## **Recent Developments**

### *Impairment Loss on Goodwill and Other Intangibles*

During the second quarter of fiscal 2007, we completed our annual impairment test on the goodwill and other intangible assets currently recorded. These tests indicated that the carrying amount of the goodwill exceeded fair value in our Mexico, UK and domestic operating entities, and led us to conclude that goodwill was impaired. We recorded a non-cash impairment charge of \$7.6 million to reduce the carrying value of goodwill to its implied fair value. The non-cash charge was recorded at our domestic (\$6.3 million), Europe (\$1.0 million) and Other (\$0.3 million) segments.

### *Disposition of Assets and Obligations in Holland*

On August 31, 2006, we entered into a license and royalty agreement with Estillon B.V., a European supplier of carpet specialty tools, granting Estillon rights to manufacture, market and distribute products using our Roberts® and Smoothedge® to customers, other than mass merchants, in Holland, France and Germany. At the same time, an additional agreement was executed with Estillon whereby Estillon purchased certain inventory and accounts receivable from us in exchange for cash.

As a result of this license and royalty agreement and the sale agreements, we will no longer conduct direct operations in Holland. In fiscal 2006, we recorded an operating loss in Holland of \$1.3 million, which included expenses to restructure the operation in order to reduce ongoing losses. As a result of this transaction, we no longer expect to incur material losses in this territory.

Related to the transaction in Holland, we recorded after-tax loss on the sale of the assets and obligations of \$0.4 million in the second quarter of fiscal 2007. In addition, we realized a translation loss related to the assets and obligations sold, resulting in the reclassification of \$0.4 million from comprehensive income to operating expenses. Both amounts were recorded in the Europe segment in the second quarter of fiscal 2007.

## **Accounting Policies and Estimates**

### *Revenue Recognition*

We recognize revenue when products are shipped and title has passed to the customer, the selling price is fixed and determinable, and collectibility of the sales price is reasonably assured. We provide for estimated costs of future anticipated product returns based on historical experience, when the related revenues are recognized. We record estimated reductions to revenue for customer programs including volume-based incentives. Guaranteed discounts to our home center customers are recorded as a reduction in revenue.

### *Inventories*

We record inventory at the lower of standard cost, which approximates actual cost, or market. We maintain reserves for excess and obsolete inventory based on market conditions and expected future demand. If actual market conditions were to be less favorable than those projected by management, additional inventory reserves could be required.

### *Accounts Receivable*

Our accounts receivable are principally due from home centers or flooring accessory distributors. Credit is extended based on an evaluation of a customer's financial condition, and collateral is not required. Accounts receivable are due at various times based on each customer's credit worthiness and selling arrangement. The outstanding balances are stated net of an allowance for doubtful accounts. We determine our allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the customer's previous loss history, the customer's ability to pay its obligations and the condition of the general economy and the industry as a whole.

### *Impairment Evaluations*

We evaluate the recoverability of long-lived assets, including property, plant and equipment, and identifiable intangible assets, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We perform indefinite-lived impairment tests on at least an annual basis and more frequently in certain circumstances. When we determine that the carrying amount of long-lived assets may not be recoverable based upon the existence of certain indicators, the assets are assessed for impairment based on the future undiscounted cash flows expected to result from the use of the asset. For goodwill and other indefinite-lived intangibles, impairment assessments are generally determined using the estimated future discounted cash flows of the asset's reporting unit using a discount rate determined by management to be commensurate with the risk inherent in the current business model. In both instances, if the carrying amount of the asset being tested exceeds its fair value, an impairment of the value has occurred and the asset may be written down. Our annual impairment assessment date is August 31<sup>st</sup>.

During the second quarter of fiscal 2007, we completed our annual impairment test on the goodwill and other intangible assets currently recorded. These tests indicated that the carrying amount of the goodwill exceeded fair value in our Mexico, UK and domestic operating entities, and led us to conclude that goodwill and other intangibles were impaired. Therefore, under the provisions of Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, we recorded a non-cash impairment charge of \$7.6 million to reduce the carrying value of goodwill and other intangibles to their implied fair value.

### *Income Taxes*

We are required to estimate income tax in each jurisdiction in which we operate. This process involves estimating actual current tax exposure and deferred income taxes to reflect the tax consequences on future years of differences between the tax basis of assets and liabilities and their financial reporting amounts each year-end. We must then consider the likelihood that any deferred tax assets will be recoverable from future taxable income and to the extent that we believe that recoverability is not likely, we establish a valuation allowance.

### *Put Warrant Liability*

As the result of the requirements of a financing arrangement entered into during fiscal 2001, we are required to value the liability associated with warrants that can be put to us at any time based on criteria set forth in the associated warrant agreement. We historically estimated the value of this liability using valuation methods and techniques required in the warrant agreement, requiring us to estimate expected future performance. We reconsidered the methodology used after discussions with the SEC and determined to value the put warrant liability using our closing stock price for each reporting period. We



believe this methodology provides an appropriate estimate of entity value as described by the put warrant agreement. Changes to the fair value of the put warrant liability are recognized in earnings, and in the three and six months ended August 31, 2006, we recognized income of \$1.2 million and \$1.3 million, respectively. The put warrants will continue to be revalued on a quarterly basis as long as they remain outstanding which could result in either significant increases or reductions in our annual and quarterly net income. In addition, the actual settlement amount of the put warrant liability could differ materially from the value determined by our stock price.

## Results of Operations

### Revenue

Net sales by segment for the three and six months ended August 31, 2006 (the first six months and second quarter of fiscal 2007, respectively) compared to the three and six months ended August 31, 2005 (the first six months and second quarter of fiscal 2006, respectively) are as follows (in thousands except percentages):

	Three Months Ended August 31,			Percent Change	Six Months Ended August 31,			Percent Change
	2006	2005	Variance		2006	2005	Variance	
Domestic	\$ 36,759	\$ 37,285	\$ (526)	-1%	\$ 73,351	\$ 71,265	\$ 2,086	3%
Canada	6,030	4,750	1,280	27%	11,678	9,548	2,130	22%
Europe	5,309	4,904	405	8%	11,121	10,481	640	6%
Australia/New Zealand	5,625	5,325	300	6%	11,009	10,257	752	7%
Other	753	683	70	10%	1,449	1,267	182	14%
Total	\$ 54,476	\$ 52,947	\$ 1,529	3%	\$ 108,608	\$ 102,818	\$ 5,790	6%

### Domestic and Canada

The decrease in sales in our domestic segment in the three months ended August 31, 2006 was primarily the result of a reduction in sales of adhesive and carpet tack strip products as compared with the same period previous year. For the combined domestic and Canadian segments the reduction in sales of adhesive products was approximately \$1.4 million and carpet tack strips was approximately \$0.7 million in the second quarter of fiscal 2007 as compared to the same period in the previous year. The sales of adhesives products were somewhat augmented in the second quarter of fiscal 2006 as the result of the rollout of new products to our home center customers. The initial order to stock the home center locations with the new product line makes for enhanced sales volumes in the period. The elevated sales level in the second quarter of fiscal 2006 is the primary reason for the decrease in sales in comparison with the current quarter. The reduction in sales of carpet tack strip products reflects the discontinuation of the sales of certain products to our home center customers.

These amounts were offset by increases in sales in the domestic and Canadian segments in the second quarter of fiscal 2007 compared to the second quarter of fiscal 2006 of carpet tools (approximately \$1.4 million) and underlayment (approximately \$1.3 million). The increase in sales of underlayment primarily results from new products that were offered to our home center customers in the second half of fiscal 2006. The increase in sales of carpet tools reflects sales of new products along with our continued efforts to provide our home center customers with a comprehensive product strategy. These efforts afford us an improved strategic position in relation to our competitors.

The increase in sales in the domestic and Canadian segments for the six months ended August 31, 2006 compared to the same period in the previous year was the result of increased sales of underlayment (approximately \$3.2 million) and carpet tools (\$2.3 million) offset by smaller reductions in other product types including carpet tack strips (approximately \$0.9 million). Once again, sales of products to home center customers positively affected underlayment products and carpet tools as it did in the second quarter, while a discontinuation of sales of certain products to home center customers negatively affected the sales of carpet tack strips.

Overall sales to our home center customers increased approximately 9% and 10% in the three and six months ended August 31, 2006 compared to the same periods in the previous fiscal year. The increase in

home center sales primarily reflects further penetration of our existing product offerings in current home center locations. Increases in product sales in fiscal 2007 compared to fiscal 2006 were somewhat offset by increases in sales rebates due to the additional sales volume for both periods presented.

Sales in our international subsidiaries were positively affected in the three and six months ended August 31, 2006 compared to the three and six month periods ended August 31, 2005 by a change in currency translation rates between the periods. Revenue increased \$0.5 million in the second quarter of fiscal 2007 and \$0.4 million in the first half of fiscal 2007 due to the effect of changes in translation rates, primarily generated by changes in the Canadian Dollar compared with the U.S. Dollar. Consequently, the positive effect on revenue is primarily recorded in our Canada segment.

#### Other Segments

The increase in sales in our European segment in the second quarter of fiscal 2007 compared to the second quarter in fiscal 2006 is primarily the result of increases in the UK (\$0.6 million) and France (\$0.4 million). For the first half of fiscal 2007 compared to the first half of fiscal 2006, the increase in the UK and France was \$1.0 million and \$0.9 million, respectively, offset by the decrease in Holland of \$1.3 million. During the two previous fiscal years, operations in Holland have been strategically reduced due to ongoing losses, resulting in the reduction in sales. Sales in the UK in fiscal 2006 were reduced by rebates to home center customers, and these rebates did not affect the fiscal 2007 periods as significantly. In France, the increases are primarily due to increased sales to additional home center locations during fiscal 2007.

All increases in sales in the Australia/New Zealand segment continue to reflect growth in the region in both home center and distribution sales. Increases in revenue in the Other segment are primarily the result of further penetration of the home center market in Mexico.

Revenue from our non-North American subsidiaries was 21% and 22%, respectively of total revenue in the three and six months ended August 31, 2006. This percentage was 21% for all periods presented for fiscal 2006.

#### Gross Profit

Gross profit by segment for the three and six months ended August 31, 2006 compared to the three and six months ended August 31, 2005 are as follows (in thousands except percentages):

	Three Months Ended August 31,				Six Months Ended August 31,			
	2006	2005	Variance	Percent Change	2006	2005	Variance	Percent Change
Domestic	\$ 9,299	\$ 9,503	\$ (204)	-2%	\$ 19,092	\$ 18,610	\$ 482	3%
Canada	1,912	1,526	386	25%	3,639	3,125	514	16%
Europe	1,495	1,279	216	17%	3,132	3,004	128	4%
Australia/New Zealand	1,952	1,846	106	6%	3,799	3,564	235	7%
Other	206	247	(41)	-17%	468	447	21	5%
Total	\$ 14,864	\$ 14,401	\$ 463	3%	\$ 30,130	\$ 28,750	\$ 1,380	5%

#### Domestic and Canada

The decrease in gross margin in the domestic segment in the second quarter of fiscal 2007 compared to the same period in fiscal 2006 was the result of decreases in sales volume and margin for wet saws and a reduction in sales volumes for adhesives as previously discussed. For the combined domestic and Canadian segments, the decrease related to sales volume and margin for wet saws was approximately \$0.5 million while the reduction related to the sales volume for adhesives was approximately \$0.4 million. The reduction in margin for wet saws reflects increased marketing efforts with our home center customers.

The decreases in gross margin discussed previously for the three month period ended August 31, 2006 compared to the same period in the previous year were offset by the increased sales volume for the carpet tool (approximately \$0.7 million) and underlayment products (approximately \$0.6 million) described above in the domestic and Canadian segments.



Increased sales volumes for our carpet tools (approximately \$1.2 million) and underlayment (approximately \$1.2 million) were the primary driver behind the increase in gross margin in the domestic and Canadian segments for the six months ended August 31, 2006 compared to the same period in the previous year. These amounts were somewhat offset by reductions in margins on wet saws (approximately \$0.4 million), and reductions resulting from strategic changes in our carpet tape seaming business (approximately \$0.2 million). We sold our domestic carpet tape seaming business in fiscal 2006 as part of the acquisition of Capitol USA. As a result, we began purchasing these carpet tape products subsequent to the transaction from outside vendors. Products previously manufactured internally are now being purchased from external sources at an increased cost. As a result, the gross margin on sales of these products has been reduced in fiscal 2007 in comparison to periods prior to the sale.

Gross margin in was positively affected in the three and six months ended August 31, 2006 compared to the three and six month periods ended August 31, 2005 by a change in currency translation rates between the periods. Gross margin increased \$0.1 million and \$0.5 million, respectively, in the second quarter and first six months of fiscal 2007 compared to the same period in fiscal 2006 due to the effect of changes in translation rates, primarily generated by changes in the Canadian Dollar compared with the U.S. Dollar. Consequently, the positive effect on gross margin is primarily recorded in our Canada segment.

We have also continued to experience increases in raw material prices worldwide during fiscal 2007. While we have continued to make improvements in our manufacturing processes, and have continued to raise prices to our customers in response to the increases in raw materials, these efforts have been largely offset by increases in the cost of raw materials. As a result, gross margin as a percent of revenue in the second quarter of fiscal 2007 is consistent with the same measure in the second quarter of fiscal 2006. For the six month periods, we have experienced a slight decrease in gross margin as a percent of revenue in fiscal 2007 compared with fiscal 2006.

#### Other Segments

Additional sales volume in the UK is the primary reason for the increase in gross margin in the Europe segment in the three and six month periods ended August 31, 2006 compared to the same periods in the previous year. As previously discussed, the revenue in the UK increased because the 2006 fiscal year periods have been burdened by additional sales rebates amounts related to home center customers. For the six month period ended August 31, 2006, the increases in margin resulting from increased revenue in the UK were offset by reductions in gross margin in Holland. The decrease in Holland was the result of the strategic reduction as discussed previously.

Increased sales volume was the primary reason for the increase in gross margin in our Australia/New Zealand segment in the second quarter and first half of fiscal 2007 compared to the same periods in fiscal 2006.

The effect of changes in foreign currency exchange rates on gross profit was immaterial in the Europe, Australia/New Zealand and Other segments in the three and six month ended August 31, 2006.

#### Operating Expenses

Operating expenses by segment for the three and six months ended August 31, 2006 compared to the three and six months ended August 31, 2005 are as follows (in thousands except percentages):

	Three Months Ended August 31,				Six Months Ended August 31,			
	2006	2005	Variance	Percent Change	2006	2005	Variance	Percent Change
Domestic	\$ 15,885	\$ 9,976	\$ 5,909	59%	\$ 26,513	\$ 18,255	\$ 8,258	45%
Canada	1,180	952	228	24%	2,334	1,917	417	22%
Europe	3,376	1,752	1,624	93%	4,942	3,610	1,332	37%
Australia/New Zealand	1,659	1,619	40	2%	3,322	3,180	142	4%
Other	533	233	300	129%	832	443	389	88%
Total	\$ 22,633	\$ 14,532	\$ 8,101	56%	\$ 37,943	\$ 27,405	\$ 10,538	38%

Shipping expenses for the three and six months ended August 31, 2006 were approximately \$5.6 and \$11.1 million, respectively compared to approximately \$5.3 million and \$10.3 million for the same periods in fiscal 2006. The increase in shipping expenses in both periods is primarily due to the increased level of business activity in our Canadian segment. In addition, shipping costs increased due to higher freight costs from common carriers resulting from increased fuel costs, although the increases were somewhat lessened in the second quarter of fiscal 2007 compared to the first quarter. In all periods presented, shipping expenses remained consistent as a percent of sales at approximately 10%.

General and administrative expenses for the three months ended August 31, 2006 were \$5.1 million compared to \$4.6 million in the same period in the previous year, an increase of 10%. For the six months ended August 31, 2006, general and administrative expenses were \$10.1 million as compared to \$9.2 million in the same period in the previous year, an increase of 10%. Included in both the three and six month periods ended August 31, 2006, was approximately \$1.0 million of expenses related to the sale of assets and obligations in Holland as discussed below. Excluding the amounts related to the Holland transaction, general administrative expense decreased to \$4.1 million for the three months ended August 31, 2006 compared to the same period in fiscal 2006. The reduction in the quarter is primarily due to investments made in sales infrastructure and corporate expenses in our domestic segment made in fiscal 2006 that were not repeated in fiscal 2007. After taking into account the Holland transaction, general and administrative expenses were 7% and 8% of sales, respectively, in the three and six months ended August 31, 2006 compared with 9% in the same periods in fiscal 2006.

Selling and marketing expenses in both the three months ended August 31, 2006 and 2005 were \$3.7 million. In the six months ended August 31, 2006, selling and marketing expenses were \$7.3 million compared to \$7.1 million in the same period in the previous fiscal year, an increase of 3%. The primary reason for the increase was an increase in the marketing expenses associated with our home center customers in our domestic and Canadian segment related to additional sales volume. As a percent of sales, selling and marketing expenses were consistent in all periods presented at approximately 7%.

We sold our carpet tape seaming business in the first quarter of fiscal 2006. In connection with the sale, operating expenses in the first quarter of fiscal 2006 included a gain on sale of our carpet tape seaming business of \$1.1 million, which was recorded in our domestic segment.

#### *Impairment Loss on Goodwill and Other Intangibles*

During the second quarter of fiscal 2007, we completed our annual impairment test on the goodwill and other intangible assets currently recorded. Earnings forecasts for each of our divisions were updated in support of the fair value estimates used in the initial impairment tests. The valuations were based on market approaches, the present value of future cash flows and closing price of our stock as at August 31, 2006. These tests indicated that the carrying amount of the goodwill exceeded fair value in our Mexico, UK and domestic operating entities, and led us to conclude that goodwill was impaired. As of the time of the filing, we have not finalized the second step of the impairment analysis due to the timing of the 10-Q filing relative to the occurrence of the events of impairment and other issues. The second step of the impairment analysis will be finalized in the third quarter of fiscal 2007. However, we have determined that an impairment loss is probable and could be reasonably estimated. Therefore, as permitted under the provisions of FASB Statement No. 142, we recorded an estimated non-cash impairment charge of \$7.6 million to reduce the carrying value of goodwill and other intangibles to its implied fair value. The implied fair value of goodwill and other intangible assets was determined through the allocation of the fair value to the underlying assets and liabilities. The non-cash charge was recorded at our domestic (\$6.3 million), Europe (\$1.0 million) and Other (\$0.3 million) segments.

After the non-cash charge for impairment, \$6.9 million of goodwill remains recorded on our domestic segment, \$0.9 million in our Canada segment, \$0.3 million in our Europe segment and \$1.4 million in our Australia/New Zealand segment. No balance remains in our Other segment.

We will continue to assess the potential of impairment of goodwill and other indefinite-lived intangibles in accordance with SFAS No. 142 in future periods. Should our business prospects change, and our expectations for acquired business be further reduced, or other circumstances that affect our business dictate, we may be required to recognize additional impairment charges in accordance with SFAS No. 142.

*Disposition of Assets and Obligations in Holland*

On August 31, 2006, we entered into a license and royalty agreement with Estillon B.V. , a European supplier of carpet specialty tools, granting Estillon rights to manufacture, market and distribute products using our Roberts® and Smoothedge® brands to customers, other than mass merchants, in certain European Union countries. At the same time, an additional agreement was executed with Estillon whereby Estillon purchased inventory and accounts receivable from us in exchange for cash.

As a result of this license and royalty agreement and the sale agreement, we will no longer conduct direct operations in Holland. All future obligations related to the employee and the facilities in Holland have been accrued as of August 31, 2006. For additional information, please review the pro forma results for the most recent period and fiscal year excluding the results of operations in Holland and the transaction to sell the assets and obligations in Footnote M.

Related to the transaction in Holland, we recorded a loss on the sale of the assets and obligations of \$0.4 million in the second quarter of fiscal 2007. This loss resulted from the write-off of fixed assets and future obligations related to the employees and facilities. In addition, we realized a translation loss related to the assets and obligations sold under the provisions of Statement of Financial Accounting Standards No. 52, *Foreign Currency Translation*. The realization resulted in the reclassification of \$0.4 million from comprehensive income to operating expenses. Both amounts were recorded in General and Administrative Expenses in the Europe segment in the second quarter of fiscal 2007.

*Changes in the Put Warrant Liability*

As of August 31, 2006, we reported a liability of \$1.0 million relating to the valuation of the put warrants as Other Current Liabilities, as compared to a \$2.3 million liability reported at the end of fiscal 2006. The amounts were classified as liabilities in accordance with Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. Changes to the fair value of the put warrant liability are recognized in the earnings, as a result, we recognized income of \$1.2 million and \$1.3 million for the three and six months ended August 31, 2006, respectively. In the same periods in fiscal 2006, we recognized expense of \$0.4 million and income of \$1.0 million. The put warrants will continue to be revalued on a quarterly basis as long as they remain outstanding which could result in either significant increases or reductions in our quarterly net income depending on fluctuations in the price of our stock. For a more detailed discussion regarding the put warrants and management's estimates of the associated liability, see Liquidity and Capital Resources .

*Interest Expense*

Interest expense for the three and six months ended August 31, 2006 was approximately \$0.7 million and \$1.5 million, respectively. These amounts compare to \$0.6 million and \$1.1 million in the same periods in the previous year. Interest expense increased as a result of increased borrowings to fund acquisitions and working capital needs, as well as increased interest rates.

*Income Taxes*

We recorded a provision for income taxes in the three and six months ended August 31, 2006 of approximately \$0.1 million and \$0.3 million, respectively. This compares with a provision for \$0.2 million and \$0.9 million in the same periods in fiscal 2006. In all periods presented, the change in the put warrant liability is non-deductible for tax purposes. In the jurisdictions that have been affected by the impairment loss on goodwill, a valuation allowance has been recorded for any deferred tax benefit associated with the loss. After removing the put warrant expense, the non-taxable accumulated foreign currency translation related to our disposition of assets in Holland and the impairment loss on goodwill from the

calculation, the effective tax rate in the three and six months ended August 31, 2006 was 60% and 45%, respectively. The effective rate was in excess of our statutory rate due to an adjustment to a prior year tax assessment in the second quarter of fiscal 2007. This rate compares with 97% and 40% in the three and six months ended August 31, 2005. The fiscal 2006 provision was based upon the statutory tax rates available in every jurisdiction in which we operate as adjusted for tax contingencies.

*Net Income*

The net loss for the second quarter of fiscal 2007 was \$6.7 million, or \$1.94 per diluted share compared with a net loss of \$0.4 million or \$0.11 per diluted share in the second quarter of fiscal 2006. In the six months ended August 31, 2006, the net loss was \$6.4 million or \$1.85 per diluted share compared to net income of \$2.2 million or \$0.58 per diluted share in the same period in fiscal 2006.

*Reconciliation of Net Income to Net Income Adjusted for the Change in the Put Warrant Liability and Other Non-Recurring Items*

While Net Income Adjusted for the Change in the Put Warrant Liability and Non-Recurring Items is not a measure of financial performance under generally accepted accounting principles, we believe that the measure provides meaningful comparisons of our current and projected operating performance with its historical results. We use Net Income Adjusted for the Change in the Put Warrant Liability and Non-Recurring Items as an internal measure of our business and believe it is utilized as an important measure of performance by the investment community. Net Income Adjusted for the Change in the Put Warrant Liability and Non-Recurring Items is not meant to be considered a substitute or replacement for Net Income as prepared in accordance with generally accepted accounting principles.

Edgar Filing: QEP CO INC - Form 10-Q

The reconciliation of Net Income to Net Income Adjusted for the Change in the Put Warrant Liability and Non-Recurring Items is as follows (in thousands except for per share amounts):

	For the Three Months Ended August 31,		For the Six Months Ended August 31,	
	2006	2005 (As Restated)	2006	2005 (As Restated)
Net income (loss), as reported (a)	\$ (6,731)	\$ (375)	\$ (6,401)	\$ 2,242
Add back (deduct):				
Impairment loss on goodwill and other intangible assets	7,598		7,598	
Realization of currency translation loss related to the disposition of certain assets and obligations of the Holland subsidiary	447		447	
Loss related to the disposition of certain assets and obligations of the Holland subsidiary, net of tax benefit	354		354	
Gain on sale of carpet seaming tape business, net of tax				(708)
Change in put warrant liability	(1,231)	381	(1,316)	(962)
Net income adjusted for the change in the put warrant liability and non-recurring items (b)	\$ 437	\$ 6	\$ 682	\$ 572
Earnings (loss) per share, as reported:				
Basic ((a)/(c))	\$ (1.94)	\$ (0.11)	\$ (1.85)	\$ 0.65
Diluted ((a)/(d))	\$ (1.94)	\$ (0.11)	\$ (1.85)	\$ 0.58
Weighted average number of shares outstanding, as reported:				
Basic (c)	3,474	3,458	3,468	3,458
Diluted (d)	3,474	3,458	3,468	3,834
Earnings per share adjusted for the change in the put warrant liability and non-recurring items:				
Basic ((b)/(e))	\$ 0.13	\$ 0.00	\$ 0.20	\$ 0.17
Diluted ((b)/(f))	\$ 0.12	\$ 0.00	\$ 0.18	\$ 0.15
Weighted average number of shares outstanding as adjusted for the change in the put warrant liability and non-recurring items:				
Basic (e)	3,473	3,458	3,468	3,458
Diluted (f)	3,728	3,820	3,783	3,834

**Liquidity and Capital Resources**

Working capital was approximately \$8.1 million as of August 31, 2006 as compared to approximately \$7.9 million at February 28, 2006, an increase of approximately \$0.2 million.

Net cash provided by operating activities during the first six months of fiscal 2007 period was approximately \$0.1 million compared to approximately \$0.3 million for the comparable fiscal 2006 period. In the current fiscal year, net income as adjusted for depreciation, amortization, non-cash charges and changes in deferred taxes was \$1.8 million as compared with \$2.3 million in the same period in the previous year. In addition, \$3.6 million in cash flow was provided by reductions in inventory and accounts receivable during the first half of fiscal 2007. In the same period in fiscal 2006, increases in inventory and accounts receivable were a use of cash of \$3.2 million. In the fiscal 2007 period, these amounts were offset by a reduction of accounts payable and accrued liabilities of \$6.0 million. This compares with cash provided by an increase in accounts payable and accrued liabilities of \$1.1 million in the previous fiscal year. The reduction in inventory and accounts payable is the result of resource management programs put in place during fiscal 2006 and fiscal 2007.

Net cash used in investing activities was approximately \$0.2 million in the first six months in fiscal 2007, which is exclusively made up of capital expenditures in the period. Cash used in investing activities in the first six months of fiscal 2006 was \$3.1 million, and included the cash paid for the acquisition of Capitol USA in May 2006.

Net cash used by financing activities was approximately \$0.5 million in the first six months of fiscal 2007





as compared to a cash provided of approximately \$1.7 million in the same period in the previous year. During the fiscal 2007 period, we borrowed an additional \$2.2 million on our lines of credit offset by payments of \$2.8 million (\$1.4 for long-term debt, \$1.4 million in acquisition related debt) on other debt instruments during the period. These amounts were net borrowings of \$1.7 million during fiscal 2006.

We have a loan agreement with two domestic financial institutions to provide a revolving credit facility, mortgage and term note financing. In March 2005, we amended the facility to consolidate our term notes and increase the amount of borrowing capacity to \$27 million through February 2006 and \$29 million thereafter under the revolving facility under the same formula for eligible accounts receivable and inventory that previously existed. In addition, we received approximately \$3.0 million of additional term financing under the amendment. The amendment provided for repayment of this facility at a rate of \$0.2 million per month at an interest rate of Libor plus 2.125% to Libor plus 2.625%. The amendment also formally released our Chairman and Chief Executive Officer of his guaranty of one of the term loans. The balance on this term note was \$3.3 million at August 31, 2006. The revolving facility was also extended to July 2008. In June 2005 and December 2005, certain financial covenants of the loan agreement were amended and, in March 2006 and June 2006, we received a waiver of compliance with certain financial covenants. As of August 31, 2006, the term loan had an interest rate that ranged from Libor plus 2.13% to Libor plus 2.88%, while the revolver bears an interest rate that ranges from Libor plus 1.50% to Libor plus 2.25%. These loans are collateralized by substantially all of our assets. The agreement also prohibits us from incurring certain additional indebtedness, limits certain investments, advances or loans, restricts substantial asset sales and capital expenditures and prohibits the payment of dividends, except for dividends due on our Series A and C preferred stock. At August 31, 2006 the rate was Libor (5.41%) plus 2.5% and we had borrowed approximately \$24.9 million and had \$3.7 million available for future borrowings under our revolving loan facility net of approximately \$0.4 million in outstanding letters of credit.

As of February 28, 2006, we determined we were in violation of financial covenants under our credit facility that required us to maintain a certain senior debt to trailing EBITDA ratio and a certain fixed charge coverage ratio. On March 20, 2006 we were granted a waiver of the non-compliance of these covenants. Further, it was subsequently determined that we were in violation of an additional financial covenant under the credit facility that required us to maintain a certain liabilities to tangible net worth ratio. On June 1, 2006, we received a waiver of the non-compliance with this covenant and the loan agreement was amended. Pursuant to the amendment, we (i) modified several of the financial covenants in the loan agreement, including covenants that require us to maintain a certain senior debt to trailing EBITDA ratio, a certain fixed charge coverage ratio and a certain liabilities to tangible net worth ratio (all as defined in the loan agreement); (ii) amended the loan agreement to require that lockbox deposits will be applied against the revolving loan on a daily basis; and (iii) amended the interest rate applicable to our term loan and the revolving loan. As amended, interest accrues on the term loan at a rate per annum equal to, at our option, (a) the Prime rate; or (b) Libor plus 2.13 % to Libor plus 2.88 %, while the revolving loan accrues interest at a rate per annum equal to, at our option, (a) the Prime Rate; or (b) Libor plus 1.5 % to Libor plus 2.25 %.

The credit agreement was further amended on October 23, 2006 to exclude from the covenant calculations the effect of the goodwill impairment charge, described in Footnote F above, and the losses recorded related to the Holland transaction. Both the disposition of assets and obligations and the realization of the foreign currency translation as discussed in Footnote M related to Holland were excluded. Without this amendment the excluded items recorded in the second quarter of fiscal 2007 would have caused us to be in violation as of August 31, 2006 of the same EBITDA and fixed charge coverage covenants discussed above.

Our Australian subsidiary has entered into three term loan facilities with an Australian financial institution to provide financing of up to AUD 1.7 million (approximately US \$1.3 million). These facilities expire between April 2007 and October 2008. The loans require quarterly payments of AUD 0.2 million (approximately US \$0.1 million) and a final balloon payment. The balance of these term notes was approximately \$1.0 million at August 31, 2006.

In May 2005, in connection with the acquisition of the adhesives manufacturing assets, we issued a four-year, non-interest-bearing \$4.0 million note due in annual installments of \$1.0 million. The principle balance of the note is discounted at an imputed interest rate of 5.20%; the unamortized discount at August 31, 2006 was \$0.3 million.

In November 2005, in connection with the acquisition of the distributor of tools and flooring installation products, we issued a three-year, AUD 0.5 million note (approximately US \$0.3 million) bearing interest at the Australian 180-day commercial bill rate due in semi-annual installments totaling approximately AUD 0.2 million per year.

We believe our existing cash balances, internally generated funds from operations and our available bank lines of credit will provide the liquidity necessary to satisfy our working capital needs, including changes in working capital balances, and will be adequate to finance anticipated capital expenditures and debt obligations for the next twelve months. There can be no assurance, however, that the assumptions upon which we base our future working capital and capital expenditure requirements and the assumptions upon which we base our belief that funds will be available to satisfy such requirements will prove to be correct. If these assumptions are not correct, we may be required to raise additional capital through loans or the issuance of debt securities that would require the consent of our current lenders, or through the issuance of equity securities.

To the extent we raise additional capital by issuing equity securities or obtaining borrowings convertible into equity, ownership dilution to existing stockholders may result, and future investors may be granted rights superior to those of existing stockholders. Moreover, additional capital may be unavailable to us on acceptable terms, or may not be available at all.

In connection with the subordinated loan agreement between ourselves and HillStreet Fund, L.P., entered into on April 5, 2001 (which was paid in full on May 12, 2003), we issued 325,000 10-year warrants at an exercise price of \$3.63 per share. The put warrants continue to remain outstanding and since April 5, 2006 can be put to us at any time, based on criteria set forth in the warrant agreement. In addition, we may call these warrants on and after April 5, 2007, based on the same criteria. In the event the warrant is put, we will be required to pay the holder of the warrants in cash in accordance with the warrant agreement. We cannot determine the actual amount of the liability until such time as the warrant holder elects to exercise the put or such time as we call the warrant. The liability is based on the determination of our entity value, which is defined in the warrant agreement as the greatest of: (1) the fair market value of the Company established as of a capital transaction or public offering; or, (2) a formula value based on a multiple of the trailing twelve month EBITDA; or (3) an appraised value as if the Company was sold as a going concern.

Prior to our fiscal year ended February 28, 2006, we estimated the value of the put warrant liability using methods and valuation techniques required by the warrant agreement.

After discussions with the SEC, we have determined to value the put warrant liability by calculating the difference between our closing stock price at the end of a reporting period and the exercise price of \$3.63 per share multiplied by the 325,000 warrants outstanding. We believe this methodology provides an appropriate estimate of entity value. The other methodologies described above may be utilized to value the liability if they yield a higher entity value than the stock price method. Based on this methodology, management determined that a liability of \$1.0 million should be reported for the put warrants at the as of August 31, 2006, compared to a liability of \$2.3 million at the end of fiscal 2006. The decrease in the liability is included as a \$1.2 million and a \$1.3 million, respectively, reduction of expense on the income statement in the three and six months ended August 31, 2006. In the same periods in fiscal 2006, we recognized expense of \$0.4 million and income of \$1.3 million. Changes in the value of the liability are recorded in net income of the period.

It is likely that the fair value of the put liability will continue to fluctuate in the future depending on changes in our stock price. In addition, the actual settlement amount for the put warrant liability could differ materially from the value determined based on our closing stock price as of the end of any reporting period. Management does not believe that it can estimate our maximum potential liability under the warrant agreement due to the fact that each of the methodologies contemplated under the warrant agreement for determining the put price is based upon a measurement of our fair value at a specific moment in time.

#### Impact of Inflation and Changing Prices

During fiscal 2006 and continuing during fiscal 2007, we have experienced significant price increases in

certain key commodities and components related to the purchase of raw materials and finished goods. We believe that our level of gross profit as a percent of net sales is affected by these increases. Other than the changes described, the effect of inflation on our operations has been minimal.

#### Recently Issued Accounting Standards

In February 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments*. Which amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS No. 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. We adopted the standard as of March 1, 2006 and the standard did not have an impact on our financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Income Tax Uncertainties*. FIN 48 defines the threshold for recognizing the benefits of tax return positions in the financial statements as *more-likely-than-not* to be sustained by the taxing authority. The recently issued literature also provides guidance on the de-recognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. FIN 48 also includes guidance concerning accounting for income tax uncertainties in interim periods and increases the level of disclosures associated with any recorded income tax uncertainties.

FIN 48 is effective for fiscal years beginning after December 15, 2006 (our fiscal year ending February 28, 2008). The differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption will be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. We are still evaluating the impact, if any, of adopting the provisions of FIN 48 on its financial position, results of operations and liquidity.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB No. 108 is effective for fiscal years ending after November 15, 2006 (our fiscal year ending February 28, 2007). We are currently assessing the impact, if any, the adoption of SAB No. 108 will have on our operating income or net earnings. The cumulative effect, if any, of applying the provisions of SAB No. 108 will be reported as an adjustment to beginning-of-year retained earnings.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning after December 15, 2007 (our fiscal year ending February 28, 2008). We are currently evaluating the impact, if any, the adoption of SFAS No. 157 will have on our operating income or net earnings.

A variety of proposed or otherwise potential accounting standards are currently under study by standard-setting organizations and various regulatory agencies. Because of the tentative and preliminary nature of these proposed standards, management has not determined whether implementation of such proposed standards would be material to our consolidated financial statements.

#### Forward-Looking Statements

This report contains certain forward-looking statements that are made pursuant to the safe harbor

provisions of the Securities Litigation Reform Act of 1995. Forward-looking statements present our expectations or forecasts of future events. These statements can be identified by the fact that they do not relate strictly to historical or current facts. They are frequently accompanied by words such as believe, intend, expect, anticipate, plan, or estimate and other words of similar meaning, and include statements relating to adequacy of our liquidity sources to meet our working capital needs and anticipated expenditures; our ability to increase the amount of sales of our products and expected sales levels of our products, our ability to increase prices and maintain or improve our gross margins; our ability to maintain good relationships with our suppliers and major customers; our ability to pass cost increases on to our customers; our ability to continue to do business around the world; our ability to successfully expand our market share, capitalize on new customers and cross-sell our products; our ability to introduce new and innovative products, expand existing product lines, and increase our sales and marketing penetration; our ability to continue our performance and that of our products and to increase stockholder returns; our ability to enhance our position as a worldwide manufacturer and distributor of specialty tools; expectations regarding the growth in sales of the largest home improvement retailers as compared to the rate of sales growth in the overall market; expectations regarding growth trends in the flooring segment of the home improvement market; and expectations that we will continue to penetrate more foreign markets.

These forward-looking statements are based on currently available information and are subject to risks and uncertainties which could cause actual results to differ materially from those discussed in the forward-looking statements and from historical results of operations (See Risk Factors). Among the risks and uncertainties which could cause such a difference are the assumptions upon which we base our assessments of our future working capital and capital expenditures; our ability to satisfy our working capital needs and to finance our anticipated capital expenditures; our dependence upon a limited number of customers for a substantial portion of our sales and the continued success of initiatives with those customers; the success of our marketing and sales efforts; improvements in productivity and cost reductions; increased pricing pressures from customers and competitors and the ability to defend market share in the face of price competition; our ability to maintain and improve our brands; our reliance upon certain major foreign suppliers; our reliance upon suppliers and sales agents for the purchase of finished products which we then resell; the level of demand for our products among existing and potential new customers; our ability to successfully integrate our acquired businesses; our dependence upon the efforts of Mr. Lewis Gould, our Chief Executive Officer and certain other key personnel; our ability to successfully integrate new management personnel; our ability to accurately predict the number and type of employees required to conduct our operations and the compensation required to be paid to such personnel; our ability to manage our growth, and the risk of economic and market factors affecting us or our customers; the impact of new accounting standards and the impact of the restatement of our financial results; our belief that there will be no future adverse effect on the fair value of our goodwill or other intangible assets; decisions by management related to accounting issues, and regulation and litigation matters; the general economic conditions in North America and the world; and other risks and uncertainties described elsewhere herein and in other reports we have filed with the SEC.

All forward looking statements included herein are made only as of the date such statements are made and we do not undertake any obligation to publicly update or correct any forward-looking statements to reflect events or circumstances that subsequently occur or of which we hereafter become aware. Subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements set forth above and elsewhere in this report and in other reports filed with the Securities and Exchange Commission.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

International revenues from our non-North American operations accounted for approximately 21% and 22% of total revenues during the second quarter and first half of fiscal 2007. International revenues are generated from foreign subsidiaries and are typically denominated in the local currency of each country. Generally, these subsidiaries incur most of their expenses in local currency and, accordingly, use the local currency as their functional currency.

Our international operations are subject to risks, including, but not limited to differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions, and foreign exchange rate volatility when compared to the United States. Accordingly, our future results may be materially adversely impacted by changes in these or other factors. We currently do not utilize currency forward exchange contracts or any other instrument to hedge currency denominated transactions.

We averaged \$35.0 million of variable rate debt during the first quarter of fiscal 2007. If interest rates would have increased by 10%, the effect on our financial statements would have been an increase in interest expense of approximately \$0.1 million for the three and six month periods ended August 31, 2006.

We issued 325,000 warrants associated with certain of our previously existing subordinated debt. These warrants contain put and call provisions as defined in the agreement (See Liquidity and Capital Resources) If the fair value of the warrant changes by \$0.10, the effect would be an adjustment to earnings of less than \$0.1 million.

#### **Item 4. Controls and Procedures.**

- (a) We have carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report pursuant to Exchange Act Rule 13a-15(b). Based upon the evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that as a result of the material weaknesses in our internal control over financial reporting described more fully below, our disclosure controls and procedures were not effective in alerting them in a timely manner to material information relating to us and our consolidated subsidiaries required to be included in our periodic filings.

In connection with the audit for our fiscal years ending February 28, 2005 and 2006, we, along with our independent auditors, identified material weaknesses in our internal control over financial reporting relating to our procedures for (i) reconciling intercompany balances, and (ii) ensuring proper documentation and review of consolidating adjusting journal entries.

During the second quarter of fiscal 2007, we implemented and continue to implement various measures to address the material weaknesses and to improve overall internal control over financial reporting, including, (a) hiring of additional personnel to respond to the financial reporting and control complexities associated with our expanding operations; (b) developing and implementing additional control procedures over the recording of intercompany transactions, reconciliation of intercompany balances, and monitoring of compliance with those procedures; and (c) developing and implementing additional control procedures over the initiation and review of adjusting journal entries.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Management necessarily applied its judgment in assessing the benefits of controls relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. Because of the inherent limitations in a control system, misstatements due to error or fraud may occur and may not be detected.

- (b) Except as described above, there were no significant changes to our internal controls over financial reporting or in other factors that could significantly affect such internal controls during the three months ended August 31, 2006.

---

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

We are involved in litigation from time to time in the course of our business. In the opinion of management, no material legal proceedings are pending to which we or any of our property is subject.

### Item 1A. Risk Factors

We are subject to the following risk factors. While we believe our expectations are reasonable, they are not guarantees of future performance. Our results could differ substantially from its expectations if any of the events described in these risks occur.

*We may be unable to pass on to our customers increases in the costs of raw materials.*

The prices of many of the raw materials we use vary with market conditions. In addition, the price of many of our finished goods is impacted by changes in currency, freight costs and raw materials at the point of production. Our cost of raw materials and fuel-related costs are currently higher than historical averages and may remain so indefinitely due to the high price of oil and gas. Although we generally attempt to pass on increases in the costs of raw materials and fuel-related costs to our customers, our ability to pass these increases on varies depending on the product line, rate and magnitude of any increase. There may be periods of time during which increases in these costs cannot be recovered as occurred in fiscal 2006. During such periods of time, our profitability may be materially adversely affected.

*Our largest customers may seek to purchase product directly from foreign suppliers.*

Certain of our larger customers have in the past contacted one or more of our foreign suppliers to discuss purchasing home improvement products directly from these suppliers. Although we believe that our diversified product line, brand recognition and customer service will continue to offer benefits not otherwise available to our customers from foreign manufacturers, we could experience competition from one or more foreign manufacturers which now serve as our suppliers.

*We depend on a limited number of customers, and the loss of one or more of these customers could adversely affect our business.*

In particular, we are substantially dependent on two customers, Home Depot and Lowe's, for a large percentage of our revenues. We expect that we will continue to rely upon these customers for a significant portion of our revenues. Any significant reduction in business with Home Depot or Lowe's as a customer would have a material adverse effect on our financial position and results of operations.

*We may be required to record a significant charge to earnings if we must reassess our goodwill or other intangible assets arising from acquisitions.*

We are required to review our goodwill and intangible assets for impairment in accordance with SFAS No. 142 at least annually or when events or changes in circumstances indicate the carrying value may not be recoverable. If we determine that significant impairment has occurred in the future, we would be required to write off goodwill or other intangible assets. Our annual impairment assessment date is August 31<sup>st</sup>. Any future impairment charges could have a material adverse effect on our financial condition, earnings and results of operations and could cause our stock price to decline.

During the second quarter of fiscal 2007, we completed our annual impairment test on the goodwill and other intangible assets currently recorded. These tests indicated that the carrying amount of the goodwill exceeded fair value in our Mexico, UK and domestic operating entities, and led us to conclude that goodwill and other intangibles were impaired. Therefore, under the provisions of Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, we recorded a non-cash impairment charge of \$7.1 million to reduce the carrying value of goodwill and other intangibles to their implied fair value.

*We have foreign currency exposures related to buying, selling, and financing in currencies other than the local currencies in which we operate.*

Because a portion of our business is conducted in foreign currencies, fluctuations in currency prices can have a material impact on our results of operations. The effect on revenue of changes in the foreign currency exchange rates was between \$0.4 million and \$0.5 million for the three and six months ended August 31, 2006. Although we finance certain foreign operations utilizing debt denominated in the currency of the local operating unit in order to mitigate our foreign currency exposure, we cannot predict the effect foreign currency fluctuations will have on our results of operations in future periods.

We estimate that a 10% change of the U.S. dollar against local currencies would have changed our operating income by approximately \$0.5 million in the second quarter of fiscal 2007. However, this quantitative measure has inherent limitations. The sensitivity analysis disregards the possibility that rates can move in opposite directions and that changes in currency may or may not be offset by losses from another currency.

The translation of the assets and liabilities of international operations is made using the currency exchange rates as of the end of current period. Translation adjustments are not included in determining net income but are disclosed as *Accumulated Other Comprehensive Income* within shareholders' equity. In certain markets, we could recognize a significant gain or loss related to unrealized cumulative translation adjustments if we were to exit the market and liquidate our net investment. As of August 31, 2006, the net foreign currency translation adjustments reduced shareholders' equity by \$2.7 million.

*Failure to identify suitable acquisition candidates, to complete acquisitions and to integrate successfully the acquired operations.*

As part of our business strategy, we continue to evaluate acquisitions that could enhance our current product line, manufacturing capabilities and distribution channels either in the United States or around the world. Although we regularly evaluate acquisition opportunities, we may not be able to successfully identify suitable acquisition candidates, obtain sufficient financing on acceptable terms to fund acquisitions, or profitably manage the acquired businesses. In addition, we may not be able to successfully integrate the acquired operations and the acquired operations may not achieve the expected results.

*We have been, and in the future may be, subject to claims and liabilities under environmental, health and safety laws and regulations, which could be significant.*

We are subject to federal, state and local laws, regulations and ordinances governing activities or operations that may have adverse environmental effects, such as discharges to air and water, and handling and disposal practices for solid, special and hazardous wastes. Our activities, including our manufacturing operations at our leased facilities, are subject to the requirements of Environmental Laws. We have received various notices from state and federal agencies that we may be responsible for certain environmental remediation activities and we are, or have been, a defendant in environmental litigation. Although we are not currently aware of any situation requiring remedial or other action that would involve a material expense or expose us to material liability under Environmental Laws, we cannot provide assurance that we will not incur any material liability under Environmental Laws in the future or that it will not be required to expend funds in order to effect compliance with applicable Environmental Laws, either of which could have a material adverse effect on our business.



*We face intense competition in our industry, which could decrease demand for our products and could have a material adverse effect on our profitability.*

Our industry is highly competitive. We face competition from a large number of manufacturers and independent distributors. Many of our competitors are larger and have greater resources and access to capital than we do. In order to maintain our competitive position, we will need to continue to develop new products and expand its customer base both domestically and internationally. Competitive pressures may also result in decreased demand for our products. Any of these factors could have a material adverse effect on our operations.

*Recent management changes may disrupt our operations, and we may not be able to retain key personnel or replace them when they leave.*

During the past year, we have experienced a number of changes in our management. On April 26, 2005, our controller and principal accounting officer was relieved of his duties and subsequently terminated. On October 10, 2005, we appointed James Brower as Executive Vice President and Chief Operating Officer. On December 2, 2005, our Chief Financial Officer resigned effective January 15, 2006. On July 21, 2006, we appointed Stuart F. Fleischer to serve as Chief Financial Officer. These and other senior management changes could disrupt our ability to manage our business, and any such disruption could adversely affect our operations, growth, financial condition and results of operations. Our success is also dependent upon our ability to hire and retain qualified finance and accounting, operations, and other personnel. We cannot assure you that we will be able to hire or retain the personnel necessary for our planned operations or that the loss of any such personnel will not have a material impact on our financial condition and results of operation.

*Our inability to maintain access to the debt and capital markets may adversely affect our business and financial results.*

Our ability to invest in our business, refinance maturing debt obligations and make strategic acquisitions may require access to sufficient bank credit lines and capital markets to support short-term borrowings and cash requirements. If our current level of cash flow is insufficient and we are unable to access additional resources, we could experience a material adverse affect on our business and financial results.

*We have debt service obligations which are subject to restrictive covenants that limit our flexibility to manage our business and could trigger an acceleration of our outstanding indebtedness.*

Our credit facilities require that we maintain specific financial ratios and comply with certain covenants, including various financial covenants that contain numerous restrictions on our ability to incur additional debt, pay dividends or make other restricted payments, sell assets, or take other actions. Furthermore, our existing credit facilities are, and future financing arrangements are likely to be, secured by substantially all of our assets. If we breach any of these covenants, a default could result under one or more of these agreements. We have in the past violated certain covenants under our credit facilities. A default, if not waived by our lenders, could result in the acceleration of outstanding indebtedness and cause our debt to become immediately due and payable.

*Along with our independent auditors, we have identified material weaknesses in our internal control over financial reporting and we cannot assure you that additional material weaknesses will not be identified in the future.*

Along with our independent auditors, we have identified material weaknesses in our internal control over financial reporting relating to our procedures for (i) reconciling intercompany balances, and (ii) ensuring proper documentation and review of consolidating adjusting journal entries. Under current standards of the Public Company Accounting Oversight Board, a material weakness is a control deficiency, or a combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Although we have implemented, and continue to implement, various measures to improve our internal

control over financial reporting, there can be no assurance that we will be able to remedy the material weaknesses that have been identified or that additional material weaknesses will not be identified. Any failure to remediate the material weaknesses identified or to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results, cause us to fail to meet our reporting obligations or result in material misstatements in our financial statements. Any such failure could also affect the ability of our management to certify that our internal controls are effective when we provide an assessment of internal control over financial reporting pursuant to rules of the Securities and Exchange Commission under Section 404 of the Sarbanes-Oxley Act of 2002, when they become applicable beginning with the Annual Report on Form 10-K for the year ending February 29, 2008, and could affect the results of our independent registered public accounting firm's attestation report regarding management's assessment pursuant to those rules. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock.

*We have restated our financial results for a change in the value of the put warrant liability and cannot predict the consequences the restatement of our financial results will have in the future.*

As previously disclosed, on June 16, 2006, the SEC issued a comment letter (the "Comment Letter") to us regarding our Form 10-K for the year ended February 28, 2006. In the Comment Letter, the SEC raised questions about several matters contained in the Form 10-K including the amount of the put warrant liability that was recorded in connection with the warrants that were issued to HillStreet with respect to the subordinated loan agreement between ourselves and HillStreet, entered into on April 5, 2001 (which was paid in full on May 12, 2003). We had issued 325,000 10-year warrants at an exercise price of \$3.63 per share. The put warrants continue to remain outstanding and since April 5, 2006, the put feature may be exercised by the Holder at any time or from time to time, based on criteria set forth in the Warrant Agreement. In the event the put is exercised, we are required to pay cash to the Holder of the warrants for the excess value of the warrants. We cannot determine the actual amount of the liability until such time as the put warrant is exercised, as the liability is based on the determination of our entity value, which is defined in the Warrant Agreement as the greatest of: (1) the fair market value of the Company established as of a capital transaction or public offering; or, (2) a formula value based on a multiple of six times trailing twelve month EBITDA; or (3) an appraised value as if the Company was sold as a going concern.

Prior to our fiscal year ended February 28, 2006, we had estimated the amount of the liability using a formula based on EBITDA as contemplated under the Warrant Agreement or an internal appraisal value based on a multiple of projected EBITDA. For the fiscal year ended February 28, 2006, we hired an independent appraiser to perform a comprehensive appraisal which served as the basis for recording the put warrant liability for such fiscal period. After discussion with the SEC, we determined to value the put warrant liability at any reporting date by calculating the difference between our closing stock price on the last day of the reporting period and the exercise price of \$3.63 per share multiplied by the 325,000 warrants granted. We believe this methodology provides an appropriate estimate of entity value. The other methodologies described above may be utilized to value the liability if they yield a higher entity value than the stock price method.

We have restated our consolidated financial statements as of and for the years ended February 28 or 29, 2006, 2005, and 2004. In addition, we have also restated and provided additional disclosures for our unaudited quarterly financial data for certain interim periods of fiscal 2006 and fiscal 2005. At this time, we cannot predict what consequences the restatement of our financial results will have, if any, including the possibility of litigation. The filing of our restated financials may not resolve the SEC's comments on our Form 10-K and 10-Q filings and it is possible that we may in the future be required to adopt different accounting for our put warrant liability that could require further restatement of our financial statements. Any such restatements could be costly and time consuming, and there are no assurances that they would not have a material negative consequence. Considerable legal and accounting expenses related to this matter have already been incurred to date and significant expenditures may continue to be incurred in the future. The above and similar matters could divert management's attention from other business concerns and may have a material impact on our business, results of operations, and financial position. Furthermore, the actual settlement amount of the put warrant liability could differ materially from the value determined by marking the warrants to market at the end of any particular fiscal period.

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

The Annual Meeting of Shareholders was held on July 27, 2006. The following matters were voted upon at the Annual Meeting:

(i) The election of the following five members to the Company's Board of Directors:

Leonard Gould	Votes for: 2,673,904	Votes withheld: 64,214
Lewis Gould	Votes for: 2,673,904	Votes withheld: 64,214
Laura M. Holm	Votes for: 2,718,719	Votes withheld: 19,399
David W. Kreilein	Votes for: 2,718,719	Votes withheld: 19,399
Robert W. Muir Jr.	Votes for: 2,718,719	Votes withheld: 19,399
Emil Vogel	Votes for: 2,718,719	Votes withheld: 19,399

(ii) The ratification of the appointment of Grant Thornton LLP as the Company's independent certified public accountants for the fiscal year ending February 28, 2007.

For:	2,691,003
Against:	47,115

**Item 6. Exhibits**

- 3.1 Certificate of Incorporation of the Company <sup>(1)</sup>
- 3.2 By-Laws of the Company, as amended through August 20, 2004 <sup>(2)</sup>
- 4.1 Form specimen Certificate for Common Stock of the Company <sup>(1)</sup>
- 4.2 Form of Warrant issued by the Company to the representative of the underwriters of the Company's initial public offering <sup>(1)</sup>
- 4.3 Form of Warrant issued to the following persons in the following amounts: RCI Holdings, Inc. (100,000) and Marlborough Capital Fund, Ltd. (100,000) <sup>(3)</sup>
- 4.4 Form of 8% Convertible Subordinated Debenture issued to the following persons in the following amounts: RCI Holdings, Inc. (\$1,911,673.30), Marlborough Capital Fund, Ltd. (\$5,088,326.70), and IBJ Schroeder as Escrow Agent (\$500,000) <sup>(3)</sup>
- 10.1 Letter Agreement between the Company and Stuart F. Fleischer dated July 14, 2006.
- 31.1 Certification of Principal Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

<sup>(1)</sup> Filed with the Company's Registration Statement on Form S-1 (Reg. No. 333-07477) filed with the Securities and Exchange Commission on July 2, 1996, and incorporated herein by reference.

<sup>(2)</sup> Filed with the Company's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on October 14, 2004, and incorporated herein by reference.

<sup>(3)</sup> Filed with the Company's Report on Form 8-K filed with the Securities and Exchange Commission on November 3, 1997, and incorporated herein by reference.



SIGNATURES

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

Q.E.P. CO., INC.

By: /s/ Stuart F. Fleischer  
Stuart F. Fleischer  
Chief Financial Officer  
October 23, 2006

Exhibit Index

- 10.1 Letter Agreement between the Company and Stuart F. Fleischer dated July 14, 2006.
- 31.1 Certification of Principal Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.