

SCHMITT INDUSTRIES INC  
Form 10-K  
July 30, 2010

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

Washington, D.C. 20549

**FORM 10-K**

(Mark One)

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

For the fiscal year ended: May 31, 2010

or

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

For the transition period from            to

Commission File Number: 000-23996

**SCHMITT INDUSTRIES, INC.**

(Exact name of registrant as specified in its charter)

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**Oregon**  
(State or other jurisdiction of  
incorporation or organization)

**93-1151989**  
(IRS Employer  
Identification Number)

**2765 N.W. Nicolai Street**

**Portland, Oregon 97210**

(Address of principal executive offices) (Zip Code)

**(503) 227-7908**

(Registrant's telephone number, including area code)

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

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

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

Securities registered pursuant to Section 12(g) of the Act: None

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its Corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

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The aggregate market value of the voting stock held by non-affiliates of the registrant as of November 30, 2009, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$7,388,000 based upon the closing price of \$3.50 reported for such date on the NASDAQ Capital Market. For purposes of this disclosure, shares of Common Stock held by persons who hold more than 10% of the outstanding shares of Common Stock and shares held by officers and directors of the registrant, have been excluded because such persons may be deemed to be affiliates. This determination is not necessarily conclusive for other purposes.

As of July 29, 2010, the registrant had 2,894,802 outstanding shares of Common Stock.

### **Documents Incorporated by Reference**

Portions of the registrant's definitive Proxy Statement for its 2010 Annual Meeting of Shareholders are incorporated by reference into Part III hereof.

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**PART I**

**Item 1. Business**

*Forward-Looking Statements*

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

***Introduction***

Schmitt Industries, Inc. (the Company), an Oregon corporation incorporated in 1995, designs, manufactures and markets computer-controlled vibration detection and balancing equipment (the Balancer Segment) primarily to the machine tool industry. The predecessor to the Company was originally organized in 1984 under the laws of the Province of British Columbia. Through a statutory procedure, in 1995, the Company ceased to be domiciled in British Columbia and became an Oregon corporation. Through its wholly owned subsidiary, Schmitt Measurement Systems, Inc. (SMS), an Oregon corporation, the Company designs, manufactures and markets precision laser-based surface measurement products for a wide variety of commercial applications in addition to the disk drive, silicon wafer and optics industries; laser-based distance measurement products for a wide variety of industrial applications; and ultrasonic measurement products that accurately measure the fill levels of large liquefied propane tanks and transmit that data via satellite to a secure web site (the Measurement Segment). The Company also sells and markets its products in Europe through its wholly owned subsidiary, Schmitt Europe Ltd. (SEL), located in the United Kingdom. The Company's executive offices are located at 2765 N.W. Nicolai Street, Portland, Oregon 97210, and its telephone number is (503) 227-7908.

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

**Balancer Segment**

The Company's principal product line is the Schmitt Dynamic Balance System (the SBS System), consisting of a computerized control unit, vibration sensor, spindle-mounting adapter, and balance head. It is designed as an inexpensive yet highly accurate permanent installation on grinding machines. SBS products can detect and correct for vibration as small as 0.02 microns. The Company acquired its original balancing equipment technology pursuant to a series of agreements from 1987 through 1991, substantially enhancing and advancing the patented technology since that time. Since inception the targeted customer base has been manufacturers and operators of grinding machines for a variety of industries such as automotive, aerospace, medical and machine tools, where operating tolerances on manufactured parts are exceedingly precise.

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

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

Notable features of the SBS System include its ability to fit almost all machines, ease of installation, compact and modular construction, ability to balance a wheel while on a machine, virtual elimination of wheel vibration, automatic monitoring of balancing, display in both English and metric systems, instrument grade calibration, short balance process, measurement of both displacement and/or velocity and minimal user maintenance.

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

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

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

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

**Machine Tool Rebuilders** These customers, found in most, if not all, industrialized nations, develop their business by offering to completely update and refurbish older grinding machines. These rebuilders typically

tear the old machine apart and install new components, such as the SBS System. The Company currently sells its products directly to major machine rebuilders throughout the world.

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

For the years ended May 31, 2010, May 31, 2009 and May 31, 2008 (Fiscal 2010, 2009 and 2008), net sales of the Company's balancing products totaled \$4.7 million, \$7.0 million and \$8.4 million, respectively. Net sales of balancing products accounted for 69%, 73% and 74% of the Company's total sales in Fiscal 2010, 2009 and 2008, respectively. See Note 6 to Consolidated Financial Statements.

### ***Competition***

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

Competitive products come from European companies located in Switzerland, Germany, Spain and Italy. These competitors produce electromechanical and water balancers similar to the SBS System. The Company considers these companies, with their established European base, to be the major competitors. Competitors include Marposs S.p.A., Dittel Messtechnik GmbH, MPM Micro Prazision Marx GmbH and Balance Systems S.r.l.

Water balancers (hydrokompensers) are an older European design still on the market that can be supplied by the Company when specifically requested by users. They require plumbing and water chambers to be machined into the wheel hub. To install these systems, the grinding machines must be disassembled and parts remachined or replaced within the spindle assembly. The water system is tuned or calibrated to the machine by a factory service technician and are suitable for mid and high speed spindle environments.

Pricing of the SBS system is geared toward maintaining the status of the SBS system as the premier product in the industry, offering best quality, reliability and performance and superior economic value.

### **Measurement Segment**

Within the Measurement segment, the Company designs, manufactures and markets several laser-based precision test and measurement product lines and an ultrasonic product for measuring the fill levels of large liquid propane tanks and operates a precision laser light scatter measurement laboratory.

There are five specific product lines: laser-based surface roughness measurement, laser-based distance measurement and dimensional sizing, remote tank monitoring, laser light-scatter surface measurement and a laser light-scatter measurement laboratory.

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

These products use a patented laser light scatter technology to perform rapid, accurate, repeatable, non-destructive and non-contact surface measurement tests that quantify surface micro-roughness. The technology is extremely precise, measuring surface roughness at the molecular (Angstrom) level. Products are

sold to manufacturers of hard disk drives, silicon wafers and optical products and industries with fabrication processes that require precise and reliable measurements.

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

The following two products meet the challenges of disk drive manufacturers:

The TMS-2000-RC (Texture Measurement System) product is an accurate non-contact texture measurement system. The product (used on aluminum substrates) is currently used worldwide by most major disk drive manufacturers, providing fast, accurate and repeatable microroughness measurements while quadrupling production throughput when compared to other testing devices. Surface roughness can be measured to levels below 0.5 Angstroms (the point of a needle is one million Angstroms in diameter).

The TMS-2000-DUV-RC product measures the surface microroughness of ceramic/glass rather than aluminum substrates. Manufacturers require the technology and products to measure surface roughness of these ceramic/glass substrates to the same exact levels as those that measure aluminum. The Deep Ultra-violet light (DUV) technology and product use the patented light scatter technology to measure the surface roughness of glass substrates to levels less than 0.5 Angstroms.

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

The Company offers two products devoted to the silicon wafer industry, the TMS-2000W-RC and TMS-3000W-RC. Both products provide fast, accurate, repeatable measurements for manufacturers of silicon wafers, computer chips and memory devices. This industry demands manufacturing precision to increase performance and capacity and these products help achieve those goals. Silicon wafers are carefully cut and polished to provide the base upon which a computer or memory chip is produced. Therefore, chip manufacturing is extremely dependent on the beginning surface roughness of the wafer. Since all silicon wafers exhibit a microscopic level of surface roughness, stemming from chemical deposition, grinding, polishing, etching, or any number of other production techniques, some method of measuring these surface characteristics is required. The Company's wafer measurement products provide a way for customers in this industry to quantify and control their manufacturing process. The system provides measurements to less than 0.5 Angstroms, a level unachievable by competing devices.

The Company also recently acquired the Lasercheck line of surface measurement gauges. Lasercheck® is a unique laser-based non-contact roughness gauge incorporating patented laser light scatter technology that can make precise repeatable surface roughness measurements in the 0.01 to 10 micron (0.40 to 400 micro inches) range. Lasercheck provides high-speed in-process measurements in a fraction of a second and is optimized for surface measurements of ground, sanded, polished, hone, super-finished and shot-blasted surfaces. The Lasercheck line of surface measurements gauges is a complementary fit to the TMS surface measurement products for ultra-smooth (sub-Angstrom) surfaces, such as silicon wafers and hard disk drives.

#### ***Distance Measurement and Dimensional Sizing Products***

These laser-based products, utilizing both triangulation and time-of-flight methods of measurement, are used in a wide range of industrial applications including manufacturing, lumber production, steel casting, glass and paper production, medical imaging, crane control and micron-level part and surface inspection. Presently,

there are six AccuRange (AR) product lines: the AR1000, AR3000 and AR4000 distance measurement sensors, the AR4000 Line Scanner and the AR700 and AR200 series of triangulating laser displacement sensors.

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

The AR1000 and AR3000 distance measurement lasers utilize pulsed time of flight measurement principles to accurately measure distances of up to 30 meters (up to 300 meters with retro reflective tape) with the AR1000 and up to 300 meters (3000 meters with retro reflective tape) with the AR3000. Both products are highly versatile, able to measure distances both indoors and outdoors. Applications include load confirmation, lumber positioning, crane monitoring, fill level measurement, velocity measurement and laser altimeter.

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

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

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

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

The Company's primary product for this new market is called Xact. The Xact product utilizes ultrasonic technology to detect and measure the capacity and volume of large chemical storage tanks, such as liquid propane tanks. Each sensor, which is affixed to the exterior of the underside of each tank, produces a small electrical pulse, or a ping, through the tank's steel shell, which is reflected off the bottom surface of the liquid stored in the tank in the form of an echo that is detected. The time of flight between the ping and the echo is then calculated to determine, based upon additional data regarding tank size and shape, the volume of liquid the tank contains. This information is then remotely transmitted via a satellite transceiver that is affixed to the top of the tank to a secure website on the internet, processed using proprietary software and displayed on that website.

Each tank can be remotely monitored simultaneously anywhere in the world. The user has the ability to schedule when each tank is to be measured simply by adjusting the settings for each tank.

### ***Research and Other Measurement Products***

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

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

### ***Light-Scatter Measurement Laboratory***

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

In Fiscal 2010, 2009 and 2008, net sales of Measurement products totaled \$2.1 million, \$2.5 million and \$3.0 million, respectively, and accounted for 31%, 27% and 26% of the Company's total sales in Fiscal 2010, 2009 and 2008, respectively. See Note 6 to Consolidated Financial Statements.

### ***Competition***

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

The market for distance measurement and dimensional sizing products is extremely competitive, characterized by rapidly changing technology. The Company believes the principal elements of competition

include quality of ongoing technical support and maintenance coupled with responsiveness to customer needs, as well as price, product quality, reliability and performance. The differences between the Company's sensors and competitive products include pushbutton selection of output signals in certain models and sensors that can be programmed using serial commands through a PC computer. The AR200 displacement sensor cannot be overloaded and measures accurately even when a mirror reflects the entire light beam back to the detector.

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

**Sales by Geographic Area**

In Fiscal 2010, 2009 and 2008, the Company recorded net sales of its products in the United States, its country of domicile, of \$3.1 million, \$4.8 million and \$6.0 million, respectively. Net sales in the last three fiscal years by geographic areas are:

	North America	Europe	Asia	Others
Fiscal 2010	\$ 3,308,958	\$ 1,148,857	\$ 2,171,993	\$ 175,940
Fiscal 2009	\$ 5,075,254	\$ 1,370,388	\$ 2,722,762	\$ 332,804
Fiscal 2008	\$ 6,305,626	\$ 1,842,008	\$ 2,811,167	\$ 462,456

**Business and Marketing Strategy**

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

**Balancer Segment Products**

The Company markets and sells the Balancer segment products in a variety of ways. First are the channels provided by independent manufacturers' representatives and distributors. There are currently approximately 100 individuals and/or organizations throughout the world acting in one of these capacities, including approximately 25 in the United States and 30 in China.

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

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

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

### **Measurement Segment Products**

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

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

### **Backlog**

The Company does not generally track backlog. Normally, orders are shipped within a few days after receipt unless the customer requests otherwise.

### **Manufacturing**

There are no unique sources of supply or raw materials in any product lines. Essential electronic components, available in large quantities from various suppliers, are assembled into the Balancing and Measurement electronic control units under the Company's quality and assembly standards. Company-owned software and firmware are coupled with the electronic components to provide the basis of the Company's various electronic control units. Management believes several supply sources exist for all electronic components and assembly work incorporated into its electronic control systems. The primary outside supplier of electronic assemblies is Silicon Forest Electronics of Vancouver, Washington, a custom supplier of assembled electronic products for several Pacific Northwest companies. In the event of supply problems, the Company believes that two or three alternatives could be developed within thirty days.

Mechanical parts for the Company's products are produced by high quality machine shops. The Company is not dependent on any one supplier of mechanical components. Principal suppliers of components for the Company's products include Eagle Industries of Newberg, Oregon; Asco Machine, Inc. of Vancouver, Washington; Davis Tool of Portland, Oregon; and Forest City Gear of Roscoe, Illinois.

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

The Company's Quality Control Program first received full ISO 9001 certification in 1996. On November 4, 2005, the Company received its certification to the newer ISO 9001:2000 requirements and received its recertification in December 2008.

**Proprietary Technology**

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

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

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

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

**Product Development**

The Company maintains an ongoing research and development program to expand the product lines and capabilities of its business segments. The goal of this program is to expand the product base in historic markets and to enter new market areas so as to reduce reliance on historic market segments. For example, in the past fiscal year, the Company has developed and introduced the SB-5500, a new controller for the Balancer segment with new digital electronics, multi-language display and several communication options.

During Fiscal 2010, 2009 and 2008, the Company's research and development expense totaled \$585,000, \$1.0 million and \$628,000, respectively. The Fiscal 2009 increase in product development costs relates primarily to the acquisition of the Xact product technology and further development of that technology.

**Employees**

As of July 29, 2010, the Company employed 42 individuals worldwide on a full-time basis. There were no regular part-time employees. None of the Company's employees is covered by a collective bargaining agreement.

**Item 1A. RISK FACTORS**

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

*The general economic conditions and the global financial crisis may adversely affect the Company's business, operating results and financial condition*

The Company's operations and performance depend significantly on worldwide economic conditions, particularly in the manufacturing sector, and their impact on levels of capital investment, which have recently deteriorated significantly over the past two fiscal years and may remain depressed, or be subject to further deterioration. Economic factors that could adversely influence demand for the Company's products include uncertainty about global economic conditions leading to reduced levels of investment, customers' and suppliers' access to credit, unemployment and other macroeconomic factors affecting commercial and industrial spending behavior.

The past distress in the financial markets and global economy has resulted in reduced liquidity and a tightening of credit markets. As a result of these conditions, the Company could experience several potential adverse effects, including the inability of customers to obtain credit to finance purchases of the Company's products, the insolvency of customers resulting in reduced sales and bad debts, and the insolvency of key suppliers resulting in product development and production delays.

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

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

*The Xact tank monitoring system may not become commercially viable and satisfy expected demand*

On May 13, 2009, the Company announced the introduction of the Xact tank monitoring system for measuring fill levels of industrial liquefied propane tanks and communicating that data via satellite to a secure web site. Although the initial acquisition and further development of the Xact product has negatively impacted current operating results, the product should allow the Company to enter new measurement markets and is expected to add sales and profits to the Company in future years. However, the Xact product may not be successful, anticipated market demand for the product may not materialize and additional product or market opportunities may not be identified and developed and brought to market in a timely and cost-effective manner, each of which could continue to negatively impact future operating results and result in large and immediate write-offs of recorded intangible asset balances.

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

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

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

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

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

Competition in the markets for the Company's products is intense. The speed with which companies can identify new applications for the Company's various technologies, develop products to meet those needs and supply commercial quantities at low prices to those new markets are important competitive factors. The principal competitive factors in the Company's markets are product features, performance, reliability and price. Many of the Company's competitors have greater financial, technical, research and development and marketing resources. No assurance can be given that the Company will be able to compete effectively in the future, and the failure to do so would have a material adverse effect on the Company's business, financial condition and results of operations.

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

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

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

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

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

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

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

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

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

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

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

The Company's future effective tax rate may be adversely affected by a number of factors including: the jurisdictions in which profits are determined to be earned and taxed; the resolution of issues arising from future

potential tax audits with various tax authorities; changes in the valuation of our deferred tax assets and liabilities; adjustments to estimated taxes upon finalization of various tax returns; increases in expenses not deductible for tax purposes; changes in available tax credits; changes in stock-based compensation expense; changes in tax laws or the interpretations of such tax laws and changes in generally accepted accounting principles.

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

Changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules promulgated by the Securities and Exchange Commission, have increased and could continue to increase Company expenses as the Company devotes resources to ensure compliance with all applicable laws and regulations. In particular, the Company could incur significant additional administrative expense and a diversion of management's time in Fiscal 2011 to implement Section 404 of the Sarbanes-Oxley Act which requires management to report on, and the Company's independent registered public accounting firm to ultimately attest to, our internal control over financial reporting. The Company may also incur additional fees necessary for them to provide their attestation. In addition, the NASDAQ Capital Market, on which the Company's common stock is listed, has also adopted comprehensive rules and regulations relating to corporate governance. These laws, rules and regulations have increased the scope, complexity and cost of corporate governance, reporting and disclosure practices. The Company may be required to hire additional personnel and use outside legal, accounting and advisory services to address these laws, rules and regulations. The Company also expects these developments to make it more difficult and more expensive for the Company to obtain director and officer liability insurance in the future, and the Company may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Further, Company board members, Chief Executive Officer and Chief Financial Officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified board members and executive officers, which would adversely affect the Company.

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

The Company markets and sells its products worldwide and international sales have accounted for and are expected to continue to account for a significant portion of future revenue. International sales are subject to a number of risks, including: the imposition of governmental controls; trade restrictions; difficulty in collecting receivables; changes in tariffs and taxes; difficulties in staffing and managing international operations; political and economic instability; general economic conditions; and fluctuations in foreign currencies. No assurances can be given that these factors will not have a material adverse effect on future international sales and operations and, consequently, on business, financial condition and results of operations.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

The Company's design and assembly facilities and executive offices are located in Portland, Oregon in three company-owned buildings totaling approximately 40,500 square feet. SEL occupies a 755-square foot facility in Coventry, England pursuant to a two-year lease beginning May 7, 2009 with a basic monthly rent of £975 (approximately \$1,425 as of May 31, 2010).

**Item 3. Legal Proceedings**

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

**Item 4. (Remove and Reserved)**

## PART II

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

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

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

<b>Year Ended May 31, 2009</b>	<b>High</b>	<b>Low</b>
First Quarter	\$ 6.40	\$ 4.50
Second Quarter	\$ 7.08	\$ 4.25
Third Quarter	\$ 4.68	\$ 3.00
Fourth Quarter	\$ 3.75	\$ 2.55
<b>Year Ended May 31, 2010</b>	<b>High</b>	<b>Low</b>
First Quarter	\$ 5.53	\$ 2.95
Second Quarter	\$ 5.00	\$ 3.35
Third Quarter	\$ 4.00	\$ 3.37
Fourth Quarter	\$ 4.08	\$ 3.47

As of July 29, 2010, there were 2,894,802 shares of Common Stock outstanding held by approximately 175 holders of record. The number of holders does not include individual participants in security position listings; the Company believes that there are more than 1,750 individual holders of shares of Common Stock.

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

This table shows information about equity awards under the Company's equity compensation plans at May 31, 2010:

<b>Plan Category</b>	<b>Number of Securities to be issued upon exercise of outstanding options</b>	<b>Weighted-average exercise price of outstanding options</b>	<b>Number of Securities remaining available for future issuance under equity compensation plans (excluding securities in column a)</b>
	<b>a</b>	<b>b</b>	<b>c</b>
Equity compensation plans approved by security holders	218,609	\$ 3.32	238,875
Equity compensation plans not approved by security holders			
	218,609	\$ 3.32	238,875

**Recent Sales of Unregistered Securities**

On September 30, 2009, the Company completed an Asset Purchase Agreement with Optical Dimensions, a sole proprietorship, pursuant to which the Company acquired all of the assets and assumed certain liabilities of Optical Dimensions. As partial consideration for the assets, the Company issued 24,642 restricted shares of



common stock of the Company to Optical Dimensions. The number of shares issued was equal to \$100,000 in value based on the average closing price of the Company's common stock, as reported on the NASDAQ National Market, over the five-day period immediately prior to closing. The sale of shares to Optical Dimensions was effected pursuant to Section 4(2) of the Securities Act of 1933.

**Issuer Purchases of Equity Securities**

None.

**Item 6. Selected Financial Data**

*In thousands, except per share information*

**Year Ended**

	5/31/10	5/31/09	5/31/08	5/31/07	5/31/06
Sales	\$ 6,806	\$ 9,501	\$ 11,421	\$ 11,882	\$ 11,503
Net Income (Loss)	\$ (1,711)	\$ (2,154)	\$ 1,103	\$ 1,285	\$ 1,350
Net Income (Loss) Per Share, Basic	\$ (.59)	\$ (.75)	\$ .40	\$ .49	\$ .52
Weighted Average No. Shares, Basic	2,887	2,870	2,725	2,649	2,606
Net Income (Loss) Per Share, Diluted	\$ (.59)	\$ (.75)	\$ .39	\$ .47	\$ .49
Weighted Average No. Shares, Diluted	2,887	2,870	2,834	2,763	2,746
Stockholders' Equity	\$ 10,121	\$ 11,718	\$ 13,756	\$ 11,365	\$ 9,814
Total Assets	\$ 11,352	\$ 12,624	\$ 15,247	\$ 12,471	\$ 10,927
Long-term Debt (including current portion)	\$	\$	\$	\$	\$ 22

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

**Overview**

Schmitt Industries, Inc. designs, manufactures and markets computer controlled vibration detection and balancing equipment (the Balancer segment) to the worldwide machine tool industry and, through its wholly owned subsidiary, Schmitt Measurement Systems, Inc., precision laser-based surface roughness measurement products, laser-based distance measurement products and ultrasonic measurement systems (the Measurement segment) for a variety of industrial applications worldwide. The Company sells and markets its products in Europe through its wholly owned subsidiary, Schmitt Europe Ltd. (SEL) located in the United Kingdom. The Company is organized into two operating segments: the Balancer segment and the Measurement segment.

For the year ended May 31, 2010 (Fiscal 2010), total sales decreased \$2.7 million, or 28.4%, to \$6.8 million from \$9.5 million in the year ended May 31, 2009 (Fiscal 2009). Balancer segment sales focus throughout the world on end-users, rebuilders and original equipment manufacturers of grinding machines with the target geographic markets in North America, Asia and Europe. Balancer sales decreased \$2.3 million, or 33.0%, to \$4.7 million in Fiscal 2010 compared to \$7.0 million in Fiscal 2009. The Fiscal 2010 decrease in worldwide balancer sales is due to lower volumes of shipments as the worldwide automotive industry has been severely impacted by the global economic downturn. The Measurement segment product line consists of both laser-based light-scatter and distance measurement and dimensional sizing products. Total Measurement sales decreased \$395,000, or 15.6%, to \$2.1 million in Fiscal 2010 compared to \$2.5 million in Fiscal 2009. The decrease is primarily due to the lower volumes of shipments of laser-based measurement products.

In response to the significant decreases in revenues during the past year, the Company has been reducing its operating expenses. Operating expenses decreased \$1.3 million, or 21.2%, to \$4.8 million in Fiscal 2010 from \$6.1 million in Fiscal 2009. General, administrative and sales expenses decreased \$850,000, or 16.9%, in Fiscal 2010 to \$4.2 million as compared to \$5.0 million in the prior fiscal year. Research and development expenses decreased \$435,000, or 42.7%, to \$585,000 in Fiscal 2010 from \$1.0 million in Fiscal 2009.

Net loss was \$1.7 million, or \$0.59 per fully diluted share, for the year ended May 31, 2010 as compared to net loss of \$2.2 million, or \$0.75 per fully diluted share, for the year ended May 31, 2009.

**Acquisition**

On September 30, 2009, the Company completed an Asset Purchase Agreement (the Agreement) with Optical Dimensions, a sole proprietorship, pursuant to which the Company acquired all of the assets and assumed certain liabilities of Optical Dimensions. As a result, the Company now owns and operates Optical Dimensions' business, including its patented laser light scatter roughness measurement technology. The total purchase price for the acquisition was approximately \$200,000 which includes the value of the shares issued and the cash paid. The Agreement provided that the Company pay cash of \$100,000 and issue 24,642 shares of common stock of the Company. The number of shares issued was equal to \$100,000 in value based on the average closing price of the Company's common stock, as reported on the NASDAQ National Market, over the five-day period immediately prior to closing.

**Critical Accounting Policies**

**Revenue Recognition** The Company recognizes revenue for sales and billing for freight charges upon delivery of the product to the customer at a fixed or determinable price with a reasonable assurance of collection, passage of title to the customer as indicated by shipping terms and fulfillment of all significant obligations, pursuant to the guidance provided by Accounting Standards Codification Topic 605. For sales to all customers, including manufacturer representatives, distributors or their third-party customers, these criteria are met at the

time product is shipped. When other significant obligations remain after products are delivered, revenue is recognized only after such obligations are fulfilled. In addition, judgments are required in evaluating the credit worthiness of our customers. Credit is not extended to customers and revenue is not recognized until we have determined that collectability is reasonably assured.

**Allowance for Doubtful Accounts** Our policy is to maintain allowances for estimated losses resulting from the inability of our customers to make required payments. Credit limits for all customers are established based upon several factors, including but not limited to financial condition and stability, payment history, published credit reports and use of credit references. On a monthly basis, management performs various analyses to evaluate accounts receivable balances to ensure recorded amounts reflect estimated net realizable value. This review includes accounts receivable agings, other operating trends and relevant business conditions, including general economic factors, as they relate to the Company's domestic and international customers. When a customer's account balance becomes past due, we initiate dialogue with the customer to determine the cause. If it is determined that the customer will be unable to meet its financial obligation to us, such as in the case of a bankruptcy filing, we record a specific allowance to reduce the related receivable to the amount we expect to recover given all of the information presently available.

**Inventories** As a designer and manufacturer of high technology systems, we are exposed to a number of economic and industry factors that could result in portions of our inventories becoming either obsolete or in excess of anticipated usage. These factors include, but are not limited to, technological changes in our markets, our ability to meet changing customer requirements, competitive pressures in products and prices, and the availability of key components from our suppliers. Our policy is to record inventory write-downs when conditions exist that suggest our inventories may be in excess of anticipated demand for our products and market conditions. We regularly evaluate the ability to realize the value of our inventories based upon a combination of factors including the following: historical usage rates, forecasted sales or usage, product end of life dates, estimated current and future market values and new product introductions. Purchasing requirements and alternative usage avenues are explored within these processes to mitigate inventory exposure. When recorded, our write-downs are intended to reduce the carrying value of our inventories to their net realizable value and establish a new cost basis.

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

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

#### **Recently issued accounting pronouncements**

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

**Discussion of Operating Results**

	2010		Year Ended May 31, 2009		2008	
Balancer sales	\$ 4,670,723	68.6%	\$ 6,971,079	73.4%	\$ 8,414,120	73.7%
Measurement sales	2,135,025	31.4%	2,530,129	26.6%	3,007,137	26.3%
<b>Total sales</b>	<b>6,805,748</b>	<b>100.0%</b>	<b>9,501,208</b>	<b>100.0%</b>	<b>11,421,257</b>	<b>100.0%</b>
Cost of sales	3,763,756	55.3%	5,361,088	56.4%	5,305,144	46.4%
<b>Gross profit</b>	<b>3,041,992</b>	<b>44.7%</b>	<b>4,140,120</b>	<b>43.6%</b>	<b>6,116,113</b>	<b>53.6%</b>
Operating expenses:						
General, administration and sales	4,184,100	61.5%	5,033,617	53.0%	4,628,003	40.5%
Research and development	584,582	8.6%	1,019,440	10.7%	628,150	5.5%
<b>Total operating expenses</b>	<b>4,768,682</b>	<b>70.1%</b>	<b>6,053,057</b>	<b>63.7%</b>	<b>5,256,153</b>	<b>46.0%</b>
Operating income (loss)	(1,726,690)	(25.4%)	(1,912,937)	(20.1%)	859,960	7.5%
Other income	31,107	0.5%	49,682	0.5%	251,282	2.2%
Income (loss) before income taxes	(1,695,583)	(24.9%)	(1,863,255)	(19.6%)	1,111,242	9.7%
Provision for income taxes	15,430	0.2%	290,269	3.1%	8,138	0.1%
<b>Net income (loss)</b>	<b>\$ (1,711,013)</b>	<b>(25.1%)</b>	<b>\$ (2,153,524)</b>	<b>(22.7%)</b>	<b>\$ 1,103,104</b>	<b>9.7%</b>

**Sales** Sales in the Balancer segment decreased \$2.3 million, or 33.0%, to \$4.7 million for Fiscal 2010 compared to \$7.0 million for Fiscal 2009. This decrease is primarily due to lower unit sales volumes in Asia, North America and Europe during the year. North American sales decreased \$1.2 million, or 40.6%, in Fiscal 2010 compared to the prior year. Asia sales decreased \$601,000, or 23.3%, in Fiscal 2010 compared to Fiscal 2009. European sales decreased \$372,000, or 31.7%, in Fiscal 2010 compared to Fiscal 2009. The decreases across all geographies are primarily due to lower volumes of shipments caused by continuing weaknesses in the global economy and the softening of the worldwide automotive, bearing and aircraft industries which has impacted the machine tool industry. The levels of demand in our geographic markets cannot be forecasted with any certainty given the recent weaknesses in the global economy.

Sales in the Measurement segment decreased \$395,000, or 15.6%, to \$2.1 million in Fiscal 2010 compared to \$2.5 million in Fiscal 2009. Sales of laser-based dimensional sizing products decreased \$455,000, or 21.8%, primarily due to the lower unit sales volumes in North America. Sales of laser-based surface measurement products increased \$50,000, or 11.3%, primarily due to the September 30, 2009 acquisition of Optical Dimensions which resulted in product sales of \$114,000; these sales were partially offset by a decrease in sales to disk drive and silicon wafer manufacturers of \$64,000.

Sales in the Balancer segment decreased \$1.4 million, or 17.2%, to \$7.0 million for Fiscal 2009 compared to \$8.4 million for Fiscal 2008. This decrease is primarily due to decreased sales in North America and Europe during the year. North American sales decreased \$1.0 million, or 25.1%, in Fiscal 2009 compared to the prior year. European sales decreased \$411,000, or 25.9%, in Fiscal 2009 compared to Fiscal 2008. Market demand in Asia for the Balancer segment products was flat with that region showing a decrease of \$22,000, or 0.8%, for Fiscal 2009 compared to the prior year. The decreases in North America and Europe are primarily due to lower volumes of shipments caused by weaknesses in the global economy and softening of the worldwide automotive, bearing and aircraft industries and its impact on the machine tool industry. The European market is also negatively impacted by greater competition with other European companies. The global economic crisis has not impacted the Chinese market as much as other regions of the world resulting in relatively flat sales in Asia.

Sales in the Measurement segment decreased \$477,000, or 15.9%, to \$2.5 million in Fiscal 2009 compared to \$3.0 million in Fiscal 2008. The decrease is primarily due to the lower volumes of shipments of laser-based surface measurement products to disk drive and silicon wafer manufacturers. These industries have undergone



significant consolidation as manufacturers merged or exited the markets resulting in a redeployment of equipment rather than making additional investments in capital equipment. Fiscal 2009 sales of laser-based dimensional sizing products increased slightly, \$18,000 or 0.9%, as compared to Fiscal 2008.

**Gross margin** Gross margin for Fiscal 2010 increased to 44.7% compared to 43.6% for Fiscal 2009. This increase is primarily due to lower increases to reserves for excess and obsolete inventory in the current year offset by a shift in the sales product mix to lower margin products and the impact of significantly lower sales volumes. Gross margin for Fiscal 2009 decreased to 43.6% as compared to 53.6% for Fiscal 2008. This decrease is due to changes in the product sales mix shifting towards lower margin products and increases in reserves for excess and obsolete inventory. Balancer margins were also negatively impacted as a result of higher sales in foreign markets as a large portion of those sales are made through distributors who receive favorable pricing.

**Operating expenses** Operating expenses decreased \$1.3 million, or 21.2%, to \$4.8 million for Fiscal 2010 compared to \$6.1 million in Fiscal 2009. General, administrative and sales expenses decreased \$850,000, or 16.9%, to \$4.2 million in Fiscal 2010 compared to \$5.0 million in the prior year. This decrease is due primarily to lower personnel costs resulting from both salary reductions and mandatory furloughs and lower stock-based compensation, lower commissions related to the decrease in sales and the expense and spending controls put in place due to the significant decline in revenue, offset by higher bad debt expense in the current year. Research and development expenses decreased \$435,000, or 42.7%, to \$585,000 in Fiscal 2010 compared to \$1.0 million in Fiscal 2009. The decrease in research and development expense is primarily due to lower material costs associated with new product development related to technologies acquired from Xtero and to existing product lines and lower personnel costs associated with salary reductions. Operating expenses increased \$797,000, or 15.2%, to \$6.1 million for Fiscal 2009 as compared to \$5.3 million for Fiscal 2008. General, administrative and selling expenses increased \$406,000 or 8.8% for Fiscal 2009 as compared to Fiscal 2008. This increase is primarily due to higher personnel costs resulting from increased headcount, higher stock-based compensation and higher amortization expenses related to the identifiable intangible assets acquired from Xtero, offset by lower commissions related to the decrease in sales. Research and development expenses increased \$391,000 or 62.3% as compared to the prior year primarily due to new product development associated with the technologies acquired from Xtero and new product development related to existing product lines.

**Other income** Other income consists of interest income, foreign currency exchange gain (loss) and other income (expense). Interest income was \$11,000, \$74,000 and \$227,000 in Fiscal 2010, 2009 and 2008, respectively. Interest income has decreased due to lower investment balances and lower interest rates. Foreign currency exchange gain was \$19,000 and \$25,000 in Fiscal 2010 and 2008, respectively. Foreign currency exchange loss was \$24,000 in Fiscal 2009.

**Income tax provision** The effective tax rate in Fiscal 2010 was (0.9)%. The effective tax rate on consolidated net loss in Fiscal 2010 differs from the federal statutory tax rate primarily due to the amount of income from foreign jurisdictions, changes in the deferred tax valuation allowance and certain expenses not being deductible for income tax reporting, offset by tax credits related to research and experimentation expenses. The effective tax rate in Fiscal 2009 was 15.6%. The effective tax rate on consolidated net loss in Fiscal 2009 differs from the federal statutory tax rate primarily due to research and experimentation credits, lower effective tax rates on net income reported by SEL and the effect of changes in tax contingencies, offset by changes in the deferred tax valuation allowance, the expiration of capital loss carryforwards, a foreign jurisdiction statutory gain exclusion and certain expenses not being deductible for income tax reporting. The effective tax rate in Fiscal 2008 was 0.7%. The effective tax rate on consolidated net income in Fiscal 2008 differs from the federal statutory tax rate primarily due to export tax incentives claimed during the year related to prior years, domestic manufacturing deduction, lower effective tax rates on net income reported by the Company's wholly owned subsidiary, Schmitt Europe Ltd. (SEL), located in the United Kingdom, the net tax benefits related to a gain exclusion provision provided in Canada on the sale of technology from the Canadian subsidiary to a US subsidiary and a reduction in the valuation allowance, offset by certain expenses not deductible for income tax reporting.

**Net income** Net loss decreased \$443,000 to a net loss of \$1.7 million, or \$0.59 per diluted share, for Fiscal 2010 as compared to net loss of \$2.2 million, or \$0.75 per diluted share, for Fiscal 2009. Net loss decreased due primarily to lower sales and related gross profit, offset by lower general, administrative and selling expenses, lower research and development expenses and a lower effective tax rate during Fiscal 2010. Net income decreased \$3.3 million to a net loss of \$2.2 million, or \$0.75 per diluted share, for Fiscal 2009 as compared to net income of \$1.1 million, or \$0.39 per diluted share, for Fiscal 2008. Net income decreased due primarily to lower sales, lower gross profit and higher operating expenses during Fiscal 2009.

## **LIQUIDITY AND CAPITAL RESOURCES**

The Company's working capital decreased \$1.4 million to \$7.3 million as of May 31, 2010 compared to \$8.7 million as of May 31, 2009. Cash and cash equivalents decreased \$628,000 to \$3.5 million as of May 31, 2010 from \$4.2 million as of May 31, 2009.

Cash used in operating activities was \$417,000 in Fiscal 2010 as compared to \$1.2 million in Fiscal 2009. The decrease was primarily due to decreases in net loss, deferred taxes, depreciation and amortization, stock-based compensation, inventories, income taxes receivable, income taxes payable and other accrued liabilities, offset by increases in accounts receivable and accounts payable.

At both May 31, 2010 and 2009, we had accounts receivable of \$1.1 million. At May 31, 2010, inventories decreased \$222,000 to \$3.6 million compared to \$3.9 million at May 31, 2009 due to the timing of purchase and inventory receipts. At May 31, 2010, income taxes receivable decreased \$309,000 to \$22,000 compared to \$330,000 at May 31, 2009 due to the receipt of income tax refunds from the government. At May 31, 2010, total current liabilities increased \$322,000 to \$1.2 million as compared to \$906,000 at May 31, 2009. The increase is primarily due to the timing of accounts payable payments as compared to the prior year.

During the year ended May 31, 2010, net cash used in investing activities was \$160,000, which consisted of \$100,000 used for the acquisition of Optical Dimensions during the second quarter of Fiscal 2010 and by additions to property and equipment of \$55,000. Additions to property and equipment consisted primarily of new manufacturing and office equipment.

The Company has a \$1.0 million bank line of credit agreement secured by U.S. accounts receivable, inventories and general intangibles. Interest is payable at the bank's prime rate (3.25% as of May 31, 2010), or LIBOR plus 2.0%, (2.35% as of May 31, 2010). The agreement expires on March 1, 2011. There were no outstanding balances on the line of credit at May 31, 2010 and 2009.

We believe that our existing cash and investments combined with the cash we anticipate to generate from operating activities, and our available line of credit and financing available from other sources will be sufficient to meet our cash requirements for the foreseeable future. We do not have any significant commitments nor are we aware of any significant events or conditions that are likely to have a material impact on our liquidity or capital resources.

**QUARTERLY FINANCIAL DATA***In thousands, except per share information (unaudited)*

<b>2009 Quarter Ended</b>	<b>August 31</b>	<b>November 30</b>	<b>February 28</b>	<b>May 31</b>
Sales	\$ 3,193	\$ 2,989	\$ 1,761	\$ 1,557
Gross profit	\$ 1,657	\$ 1,403	\$ 808	\$ 272
Net income (loss)	\$ 34	\$ (114)	\$ (261)	\$ (1,813)
Net income (loss) per share, basic	\$ .01	\$ (.04)	\$ (.09)	\$ (.63)
Net income (loss) per share, diluted	\$ .01	\$ (.04)	\$ (.09)	\$ (.63)

<b>2010 Quarter Ended</b>	<b>August 31</b>	<b>November 30</b>	<b>February 28</b>	<b>May 31</b>
Sales	\$ 1,223	\$ 1,922	\$ 1,542	\$ 2,118
Gross profit	\$ 549	\$ 943	\$ 795	\$ 755
Net loss	\$ (575)	\$ (224)	\$ (443)	\$ (469)
Net loss per share, basic	\$ (.20)	\$ (.08)	\$ (.15)	\$ (.16)
Net loss per share, diluted	\$ (.20)	\$ (.08)	\$ (.15)	\$ (.16)

**Item 7A. Quantitative and Qualitative Disclosures about Market Risk**  
**Interest Rate Risk**

The Company did not have any derivative financial instruments as of May 31, 2010. However, the Company could be exposed to interest rate risk at any time in the future and, therefore, employs established policies and procedures to manage its exposure to changes in the market risk of its marketable securities.

The Company's interest income and expense are most sensitive to changes in the general level of U.S. and European interest rates. In this regard, changes in U.S. and European interest rates affect the interest earned on the Company's interest bearing cash equivalents and short term investments. The Company has a variable rate line of credit facility with a bank but there is no outstanding balance as of May 31, 2010. Also, there is no other long-term obligation whose interest rates are based on variable rates that may fluctuate over time based on economic changes in the environment. Therefore, at this time, the Company is not subject to interest rate risk on outstanding interest bearing obligations if market interest rates fluctuate and does not expect any change in the interest rates to have a material effect on the Company's results from operations.

**Foreign Currency Risk**

The Company markets and sells its products worldwide and international sales have accounted for and are expected to continue to account for a significant portion of future revenue. The Company operates a subsidiary in the United Kingdom and acquires certain materials and services from vendors transacted in foreign currencies. Therefore, the Company's business and financial condition is sensitive to currency exchange rates or any other restrictions imposed on their currencies. For Fiscal 2010, 2009 and 2008, results of operations included gains (losses) on foreign currency translation of \$19,000, (\$24,000) and \$25,000, respectively. The foreign exchange gains or losses in Fiscal 2010, 2009 and 2008 were primarily attributable to Company's United Kingdom subsidiary, Schmitt Europe, Ltd.

**Item 8. Financial Statements and Supplementary Data**  
**Schmitt Industries, Inc.**

**Consolidated Balance Sheets**

	May 31, 2010	May 31, 2009
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 3,545,986	\$ 4,174,335
Accounts receivable, net	1,144,420	1,110,850
Inventories	3,645,303	3,866,971
Prepaid expenses	192,167	171,178
Income taxes receivable	21,570	330,134
	8,549,446	9,653,468
<b>Property and equipment</b>		
Land	299,000	299,000
Buildings and improvements	1,564,880	1,564,880
Furniture, fixtures and equipment	1,059,496	1,037,346
Vehicles	90,452	90,452
	3,013,828	2,991,678
Less accumulated depreciation and amortization	(1,720,880)	(1,563,840)
	1,292,948	1,427,838
<b>Other assets</b>		
Intangible assets, net	1,509,711	1,542,694
<b>TOTAL ASSETS</b>	<b>\$ 11,352,105</b>	<b>\$ 12,624,000</b>
<b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b>		
<b>Current liabilities</b>		
Accounts payable	\$ 665,044	\$ 335,609
Accrued commissions	170,614	172,755
Accrued payroll liabilities	231,390	228,887
Other accrued liabilities	160,717	168,325
<b>Total current liabilities</b>	<b>1,227,765</b>	<b>905,576</b>
<b>Long-term liabilities</b>	<b>3,591</b>	
<b>Stockholders equity</b>		
Common stock, no par value, 20,000,000 shares authorized, 2,894,802 and 2,870,160 shares issued and outstanding at May 31, 2010 and May 31, 2009, respectively	9,739,391	9,545,678
Accumulated other comprehensive loss	(264,004)	(183,629)
Retained earnings	645,362	2,356,375
<b>Total stockholders equity</b>	<b>10,120,749</b>	<b>11,718,424</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 11,352,105</b>	<b>\$ 12,624,000</b>

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



## Schmitt Industries, Inc.

## Consolidated Statements of Operations

	Year Ended May 31,		
	2010	2009	2008
<b>Net sales</b>	\$ 6,805,748	\$ 9,501,208	\$ 11,421,257
Cost of sales	3,763,756	5,361,088	5,305,144
<b>Gross profit</b>	3,041,992	4,140,120	6,116,113
Operating expenses:			
General, administration and sales	4,184,100	5,033,617	4,628,003
Research and development	584,582	1,019,440	628,150
Total operating expenses	4,768,682	6,053,057	5,256,153
<b>Operating income (loss)</b>	(1,726,690)	(1,912,937)	859,960
Other income	31,107	49,682	251,282
<b>Income (loss) before income taxes</b>	(1,695,583)	(1,863,255)	1,111,242
Provision for income taxes	15,430	290,269	8,138
<b>Net income (loss)</b>	\$ (1,711,013)	\$ (2,153,524)	\$ 1,103,104
<b>Net income (loss) per common share, basic</b>	\$ (0.59)	\$ (0.75)	\$ 0.40
Weighted average number of common shares, basic	2,886,633	2,870,160	2,725,086
<b>Net income (loss) per common share, diluted</b>	\$ (0.59)	\$ (0.75)	\$ 0.39
Weighted average number of common shares, diluted	2,886,633	2,870,160	2,834,158

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

## Schmitt Industries, Inc.

## Consolidated Statements of Cash Flows

	2010	Year Ended May 31, 2009	2008
<b>Cash flows relating to operating activities</b>			
Net income (loss)	\$ (1,711,013)	\$ (2,153,524)	\$ 1,103,104
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	362,027	410,653	238,984
(Gain) loss on disposal of property and equipment	(1,200)		703
Deferred taxes		353,253	(405,895)
Stock based compensation	93,420	175,326	52,957
Tax benefit related to stock options			10,175
Excess tax benefit from stock-based compensation			(10,202)
(Increase) decrease in:			
Accounts receivable	(21,075)	416,604	(127,611)
Inventories	247,986	20,554	(220,068)
Prepaid expenses	(18,257)	(72,462)	(29,354)
Income taxes receivable	308,425	(330,134)	
Increase (decrease) in:			
Accounts payable	324,569	(183,508)	184,331
Accrued liabilities and customer deposits	(1,394)	485,037	(62,357)
Income taxes payable		(304,201)	155,598
Net cash provided by (used in) operating activities	(416,512)	(1,182,402)	890,365
<b>Cash flows relating to investing activities</b>			
Purchase of short-term investments	(1,000,000)	(1,019,199)	(10,059,693)
Maturities of short-term investments	1,000,000	3,519,062	11,524,479
Purchase of property and equipment	(54,838)	(171,733)	(386,016)
Advances and payments on asset acquisition	(100,000)		(484,158)
Proceeds from sale of property and equipment	1,200		100
Other long-term assets	(6,039)		
Net cash provided by (used in) investing activities	(159,677)	2,328,130	594,712
<b>Cash flows relating to financing activities</b>			
Common stock issued on exercise of stock options			13,104
Excess tax benefit from stock-based compensation			10,202
Net cash provided by financing activities			23,306
Effect of foreign exchange translation on cash	(52,160)	8,476	(1,313)
<b>Increase (decrease) in cash and cash equivalents</b>	<b>(628,349)</b>	<b>1,154,204</b>	<b>1,507,070</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>4,174,335</b>	<b>3,020,131</b>	<b>1,513,061</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 3,545,986</b>	<b>\$ 4,174,335</b>	<b>\$ 3,020,131</b>

**Supplemental Disclosure of Cash Flow Information**

Cash paid (received) during the year for income taxes	\$ (293,876)	\$ 92,190	\$ 247,842
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*The accompanying notes are an integral part of these consolidated financial statements*



## Schmitt Industries, Inc.

## Consolidated Statements of Changes in Stockholders Equity And Comprehensive Income

	Shares	Amount	Accumulated other comprehensive loss	Retained earnings	Total	Total comprehensive income (loss)
<b>Balance, May 31, 2007</b>	2,664,419	\$ 8,114,251	\$ (122,050)	\$ 3,372,331	\$ 11,364,532	
Adoption of FIN 48				34,464	34,464	
Stock options exercised and related tax benefit of \$10,175	5,764	23,279			23,279	
Stock based compensation		52,957			52,957	
Common stock issued in connection with asset acquisition	199,977	1,179,865			1,179,865	
Net income				1,103,104	1,103,104	\$ 1,103,104
Other comprehensive loss			(1,738)		(1,738)	(1,738)
<b>Balance, May 31, 2008</b>	2,870,160	9,370,352	(123,788)	4,509,899	13,756,463	
<b>Comprehensive income, year ended May 31, 2008</b>						\$ 1,101,366
Stock based compensation		175,326			175,326	
Net loss				(2,153,524)	(2,153,524)	\$ (2,153,524)
Other comprehensive loss			(59,841)		(59,841)	(59,841)
<b>Balance, May 31, 2009</b>	2,870,160	9,545,678	(183,629)	2,356,375	11,718,424	
<b>Comprehensive loss, year ended May 31, 2009</b>						\$ (2,213,365)
Stock based compensation		93,420			93,420	
Common stock issued in connection with asset acquisition	24,642	100,293			100,293	
Net loss				(1,711,013)	(1,711,013)	\$ (1,711,013)
Other comprehensive loss			(80,375)		(80,375)	(80,375)
<b>Balance, May 31, 2010</b>	2,894,802	\$ 9,739,391	\$ (264,004)	\$ 645,362	\$ 10,120,749	
<b>Comprehensive loss, year ended May 31, 2010</b>						\$ (1,791,388)

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

**Schmitt Industries, Inc.**

**Notes to Consolidated Financial Statements**

**For The Years Ended May 31, 2010, 2009 and 2008**

**NOTE 1**

**SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Operations**

Schmitt Industries, Inc. (the Company) designs, manufactures, and markets computer controlled vibration detection and balancing equipment primarily to the machine tool industry. Through its wholly owned subsidiary, Schmitt Measurement Systems, Inc., the Company designs, manufactures and markets precision laser-based surface measurement systems for the disk drive, silicon wafer and optics industries; laser-based distance measurement and dimensional sizing products for a wide variety of commercial and industrial applications; and ultrasonic measurement products that accurately measure the fill levels of large liquefied propane tanks and transmit that data via satellite to a secure web site.

**Principles of Consolidation**

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

**Revenue Recognition**

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

**Cash Equivalents**

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

**Short-Term Investments**

At both May 31, 2010 and 2009, short-term investments were \$0. The carrying amount of short-term investments is stated at cost, which approximates fair market value because of their short maturities. There were no related unrealized holding gains or losses at May 31, 2010 and 2009.

## Schmitt Industries, Inc.

## Notes to Consolidated Financial Statements (Continued)

## For The Years Ended May 31, 2010, 2009 and 2008

**Accounts Receivable**

The Company maintains credit limits for all customers based upon several factors, including but not limited to payment history, published credit reports and use of credit references. Management performs various analyses to evaluate accounts receivable balances to ensure recorded amounts reflect estimated net realizable value. This review includes using accounts receivable agings, other operating trends and relevant business conditions, including general economic factors, as they relate to each of the Company's domestic and international customers. If these analyses lead management to the conclusion that potential significant accounts are uncollectible, a reserve is provided. The allowance for doubtful accounts was \$23,387 and \$38,233 as of May 31, 2010 and 2009, respectively.

**Inventory**

Inventory is valued at the lower of cost or market with cost determined on the average cost basis. Costs included in inventories consist of materials, labor and manufacturing overhead, which are related to the purchase or production of inventories. Write-downs, when required, are made to reduce excess inventories to their net realizable values. Such estimates are based on assumptions regarding future demand and market conditions. If actual conditions become less favorable than the assumptions used, an additional inventory write-down may be required. As of May 31, 2010 and 2009, inventories consisted of:

	May 31, 2010	May 31, 2009
Raw materials	\$ 1,070,902	\$ 1,525,618
Work-in-process	980,971	730,609
Finished goods	1,593,430	1,610,744
	\$ 3,645,303	\$ 3,866,971

**Property and Equipment**

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

**Foreign Currency Translation**

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

**Advertising**

Advertising costs included in general, administrative and selling, are expensed when the advertising first takes place. Advertising expense was \$56,463, \$82,512 and \$107,539 for the fiscal years ended May 31, 2010, 2009 and 2008, respectively.

**Schmitt Industries, Inc.**

**Notes to Consolidated Financial Statements (Continued)**

**For The Years Ended May 31, 2010, 2009 and 2008**

**Research and Development Costs**

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

**Stock-Based Compensation**

Stock-based compensation includes expense charges for all stock-based awards to employees and directors granted under the Company's stock option plan. The Company has adopted ASC Topic 718, which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options based on estimated fair values.

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

**Income Taxes**

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

**Intangible Assets**

Amortizable intangible assets, purchased technology and patents, are amortized over their estimated useful lives ranging from five to seventeen years. As of May 31, 2010 and 2009, amortizable intangible assets were \$2,200,883 and \$2,085,363 and accumulated amortization was \$697,212 and \$542,669, respectively. Amortization expense is expected to be approximately \$162,000 in Fiscal 2011 and 2012, \$129,000 in Fiscal 2013, \$128,000 in Fiscal 2014 and \$113,000 in Fiscal 2015.

Intangible and other long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. Recoverability is determined by comparing the forecasted future net cash flows from the operations to which the assets relate, based on management's best estimates using the appropriate assumptions and projections at the time, to the carrying amount of the assets. If the carrying value is determined to be in excess of future operating cash flows, the asset is considered impaired and a loss is recognized equal to the amount by which the carrying amount exceeds the estimated fair value of the assets. As of May 31, 2010, management did not believe impairment, as defined above, existed.

**Earnings (Loss) Per Share**

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

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**Schmitt Industries, Inc.**

**Notes to Consolidated Financial Statements (Continued)**

**For The Years Ended May 31, 2010, 2009 and 2008**

outstanding, adjusted for dilutive incremental shares attributed to outstanding options to purchase common stock. Common stock equivalents for stock options are computed using the treasury stock method. In periods in which a net loss is incurred, no common stock equivalents are included since they are antidilutive and as such all stock options outstanding are excluded from the computation of diluted net loss in those periods. 78,241 and 86,187 potentially dilutive common shares from outstanding stock options have been excluded from diluted earnings (loss) per share for the years ended May 31, 2010 and 2009, respectively.

**Concentration of Credit Risk**

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

**Financial Instruments**

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

**Shipping and Handling Charges**

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

**Use of Estimates**

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

**Recently Issued Accounting Pronouncements**

In June 2009, the FASB issued SFAS No.168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles - a Replacement of FASB Statement No.162*, which establishes the FASB Accounting Standards Codification (the Codification or ASC) as the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of this guidance, the Codification superseded all then-existing non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the codification will become non-authoritative. The Company adopted ASC Topic 105 in the second quarter of Fiscal 2010. The adoption of ASC Topic 105 did not have a material impact on the Company's financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*, which was incorporated into the Codification with ASC Topic 805 *Business Combinations*. This guidance establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest;

## Schmitt Industries, Inc.

## Notes to Consolidated Financial Statements (Continued)

## For The Years Ended May 31, 2010, 2009 and 2008

recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This guidance is to be applied prospectively to business combinations for which the acquisition date is after May 31, 2009.

In May 2009, the FASB issued SFAS No 165, *Subsequent Events*. The provisions of this standard were incorporated into the Codification with ASC Topic 855, *Subsequent Events*. This guidance is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. This guidance is effective for interim or annual financial periods ending after June 15, 2009. The Company has adopted this guidance.

**NOTE 2****LINE OF CREDIT**

In February 2009, the Company renewed its \$1.0 million bank line of credit agreement secured by U.S. accounts receivable, inventories and general intangibles which expires on March 1, 2011. Interest is payable at the bank's prime rate (3.25% as of May 31, 2010) or LIBOR plus 2.0%, (2.35% as of May 31, 2010). There were no outstanding balances on the line of credit at May 31, 2010 and 2009.

**NOTE 3****LONG-TERM OBLIGATIONS**

As of May 31, 2010, there were no outstanding obligations under capital leases or purchase contracts. The Company leases certain facilities and equipment to support operations under non-cancelable operating leases and other contractual obligations. Total rent expense for the years ended May 31, 2010, 2009 and 2008 amounted to \$36,348, \$36,394 and \$32,370, respectively.

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

Years ending May 31,	
2011	\$ 28,250
2012	1,788
2013	1,788
2014	1,788
2015	447
Thereafter	

**NOTE 4****INCOME TAXES**

The provision for income taxes is as follows:

	Years ended May 31,		
	2010	2009	2008
Current	\$ 18,573	\$ (62,984)	\$ 590,761
Deferred	(661,882)	144,858	(507,623)

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Change in valuation allowance	665,025	208,395	(75,000)
Total provision for income taxes	\$ 15,430	\$ 290,269	\$ 8,138

## Schmitt Industries, Inc.

## Notes to Consolidated Financial Statements (Continued)

## For The Years Ended May 31, 2010, 2009 and 2008

Deferred tax assets are comprised of the following components:

	2010	2009
Depreciation and amortization	\$ 378,140	\$ 352,934
Inventory related items	251,228	202,475
Other reserves and liabilities	62,056	53,976
Net operating loss carryforward	676,249	72,055
General business and other credit carryforward	194,980	213,054
Other deferred items, net	5,463	8,597
Gross deferred tax assets	1,568,116	903,091
Deferred tax asset valuation allowance	(1,568,116)	(903,091)
Net deferred tax asset	\$	\$

Deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the deferred tax asset will not be realized. The Company has recorded a substantial deferred tax asset related to temporary differences between book and tax bases of assets and liabilities. During Fiscal 2010, the Company increased its valuation allowance \$665,025 as a result of the write-down of deferred tax assets. During Fiscal 2009, the Company increased its valuation allowance \$903,091 as a result of the write-down of deferred tax assets. This increase was partially offset by a decrease of \$694,696 due to the expiration of the related capital losses. The Company has provided a full valuation allowance against all of its deferred tax assets as the recent losses have been given more weight than projected future income when determining the need for a valuation allowance.

The Company has federal net operating loss carryforwards of approximately \$1.7 million which expire in 2029 and 2030 along with the federal general business and other credit carryforwards. The Company has state net operating loss carryforwards of approximately \$2.5 million which expire in 2024 and 2025.

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

	Years ended May 31,		
	2010	2009	2008
Statutory federal tax rate	(34.0)%	(34.0)%	34.0%
State taxes, net of federal benefit	(4.4)	(4.4)	4.4
Change in deferred tax valuation allowance	39.2	11.2	
Expiration of capital loss carryforward		37.3	
Stock-based compensation	1.9	3.2	1.6
Domestic production incentives			(1.0)
Export tax incentives			(8.2)
R&E tax credits	(3.6)	(6.4)	
Effect of foreign income tax rates	0.3	(1.6)	(12.0)
Foreign jurisdiction statutory gain exclusion		18.0	(25.0)
Effect of tax rate changes			5.6
Effect of changes in tax contingencies		(7.0)	
Permanent and other differences	1.5	(0.7)	1.3

Effective tax rate

0.9%

15.6%

0.7%

## Schmitt Industries, Inc.

## Notes to Consolidated Financial Statements (Continued)

## For The Years Ended May 31, 2010, 2009 and 2008

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

On June 1, 2007, the Company adopted the provisions of ASC Topic 740. The adoption of ASC Topic 740 resulted in a \$34,464 decrease in the Company's liability for unrecognized tax benefits, which was accounted for as an increase to the June 1, 2007 retained earnings balance. At June 1, 2007, the gross amount of unrecognized tax benefits was approximately \$586,000, which included approximately \$150,000 of net unrecognized tax benefits that, if recognized, would reduce the Company's effective income tax rate. During the third quarter of Fiscal 2009, the Company completed an examination of its federal tax returns for the years ended May 31, 2005 through 2007. The Company recognized tax benefits of approximately \$150,000 including interest and penalties during Fiscal 2009.

A reconciliation of the beginning and ending amount of unrecognized income tax benefits is as follows:

	2010	2009	2008
Balance at beginning of year	\$	\$ 450,833	\$ 489,599
Decrease for tax positions taken (payment of tax)			(38,766)
Decrease for tax positions settled		(450,833)	
Balance at end of year	\$	\$	\$ 450,833

Interest and penalties associated with uncertain tax positions are recognized as components of the Provision for income taxes. The Company's accrual for interest and penalties was \$96,500 upon adoption of ASC Topic 740. The liability for interest and penalties decreased to \$0 due to the completion of the federal examination. The liability for payment of interest and penalties was \$0 as of May 31, 2010 and 2009, respectively.

Several tax years are subject to examination by major tax jurisdictions. In the United States, federal tax years for Fiscal 2007 and after are subject to examination. In the United Kingdom, tax years for Fiscal 2006 and after are subject to examination. In Canada, tax years for 2005 and after are subject to examination. In the United States, returns related to an acquired subsidiary for the year ended October 31, 1994 and final return for the period ended May 19, 1995 are also subject to examination.

**NOTE 5****COMMITMENTS AND CONTINGENCIES**

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

## Schmitt Industries, Inc.

## Notes to Consolidated Financial Statements (Continued)

## For The Years Ended May 31, 2010, 2009 and 2008

pool agreement, each former shareholder and debt holder released TMA from any claims with regard to the acquisition except their rights to future royalties. Royalty expense applicable to the years ended May 31, 2010, 2009 and 2008 amounted to \$16,358, \$19,352 and \$47,344, respectively.

## NOTE 6

## SEGMENT INFORMATION

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

	2010		Year Ended May 31, 2009		2008	
	Balancer	Measurement	Balancer	Measurement	Balancer	Measurement
Gross sales	\$ 5,203,773	\$ 2,225,083	\$ 7,689,975	\$ 2,573,139	\$ 9,192,824	\$ 3,039,809
Intercompany sales	(533,050)	(90,058)	(718,896)	(43,010)	(778,704)	(32,672)
Net sales	\$ 4,670,723	\$ 2,135,025	\$ 6,971,079	\$ 2,530,129	\$ 8,414,120	\$ 3,007,137
Operating income (loss)	\$ (990,867)	\$ (735,823)	\$ (922,199)	\$ (990,738)	\$ 1,053,310	\$ (193,350)
Depreciation expense	\$ 147,775	\$ 59,709	\$ 143,084	\$ 52,591	\$ 122,353	\$ 36,968
Amortization expense	\$	\$ 154,543	\$	\$ 214,978	\$	\$ 79,663
Capital expenditures	\$ 46,201	\$ 8,637	\$ 134,476	\$ 37,257	\$ 119,927	\$ 266,089

*Geographic Information*

	Year Ended May 31,		
	2010	2009	2008
North America	\$ 3,308,958	\$ 5,075,254	\$ 6,305,626
Europe	1,148,857	1,370,388	1,842,008
Asia	2,171,993	2,722,762	2,811,167
Other markets	175,940	332,804	462,456
Total Net Sales	\$ 6,805,748	\$ 9,501,208	\$ 11,421,257

	2010		Year Ended May 31, 2009		2008	
	United States	Europe	United States	Europe	United States	Europe

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Operating income (loss)	\$ (1,746,621)	\$ 19,931	\$ (2,104,070)	\$ 191,133	\$ 495,483	\$ 364,477
Depreciation expense	\$ 207,484	\$	\$ 195,518	\$ 157	\$ 152,916	\$ 6,405
Amortization expense	\$ 154,543	\$	\$ 214,978	\$	\$ 79,663	\$
Capital expenditures	\$ 54,838	\$	\$ 171,733	\$	\$ 386,016	\$

## Schmitt Industries, Inc.

## Notes to Consolidated Financial Statements (Continued)

## For The Years Ended May 31, 2010, 2009 and 2008

*Segment and Geographic Assets*

	May 31, 2010	May 31, 2009
Segment assets to total assets		
Balancer	\$ 4,425,280	\$ 4,674,279
Measurement	3,359,269	3,445,253
Corporate assets	3,567,556	4,504,468
<b>Total assets</b>	<b>\$ 11,352,105</b>	<b>\$ 12,624,000</b>
Geographic assets to long-lived assets		
United States	\$ 1,292,948	\$ 1,427,838
Europe		
<b>Total assets</b>	<b>\$ 1,292,948</b>	<b>\$ 1,427,838</b>
Geographic assets to total assets		
United States	\$ 10,947,605	\$ 12,042,035
Europe	404,500	581,965
<b>Total assets</b>	<b>\$ 11,352,105</b>	<b>\$ 12,624,000</b>

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

**NOTE 7****STOCK OPTIONS AND STOCK BASED COMPENSATION**

The Board of Directors adopted the 2004 Stock Option Plan (2004 Plan) in August 2004 and the 1995 Stock Option Plan (1995 Plan) in December 1995, which plan was amended in August 1996 and restated in August 1998. An option granted under the 2004 Plan and/or 1995 Plan (the Plans) might be either an incentive stock option (ISO), or a nonstatutory stock option (NSO). ISOs may be granted only to employees and members of the Board of Directors of the Company and are subject to certain limitations, in addition to restrictions applicable to all stock options under the Plan. Options not meeting these limitations will be treated as NSOs. The purchase price of ISOs is fair market value on the date of grant; the purchase price of NSOs may vary from fair market value. Vesting is at the discretion of the compensation committee of the Board of Directors, but is either 50% at grant date and 16.7% on each anniversary thereafter or 25% at grant date and 25% on each anniversary thereafter. The Company initially reserved 400,000 shares for issuance under the 1995 Plan and 300,000 shares for issuance under the 2004 Plan. The 1995 Plan expired in December 2005 and no additional options may be issued under the 1995 Plan, although expiration of the 1995 Plan did not affect the rights of persons who received stock grants under the 1995 Plan. Stock-based compensation recognized in the Company's Consolidated Financial Statements for the years ended May 31, 2010, 2009 and 2008 includes compensation cost for stock-based awards granted prior to, but not fully vested as of, May 31, 2006. All outstanding options will expire no later than 2018.

Upon adoption of ASC Topic 718, the Company continued to use the Black-Scholes option pricing model as its method of valuation for stock-based awards. The Company's determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. Although the fair value of stock-based awards is determined in accordance with ASC Topic 718, the Black-Scholes option pricing model requires the input of



Schmitt Industries, Inc.

Notes to Consolidated Financial Statements (Continued)

For The Years Ended May 31, 2010, 2009 and 2008

highly subjective assumptions, and other reasonable assumptions could provide differing results. These variables include, but are not limited to:

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

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

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

*Expected Dividend Yield.* The Company does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero.

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

The Company has computed, to determine stock-based compensation expense recognized for the years ended May 31, 2010, 2009 and 2008, the value of all stock options granted using the Black-Scholes option pricing model as prescribed by ASC Topic 718 using the following assumptions:

	Year ended May 31, 2010	Year ended May 31, 2009	Year ended May 31, 2008
Risk-free interest rate		4.0%	3.6%
Expected life		4.8 years	4.8 years
Expected volatility		54.4%	56.7%

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

The total stock-based compensation expense recognized under ASC Topic 718 was \$93,420, \$175,326 and \$52,957 during Fiscal 2010, 2009 and 2008, respectively. All stock-based compensation expense has been recorded as General, administration and sales expense in the Consolidated Financial Statements.

## Schmitt Industries, Inc.

## Notes to Consolidated Financial Statements (Continued)

## For The Years Ended May 31, 2010, 2009 and 2008

At May 31, 2010, the Company had a total of 218,609 outstanding stock options (187,359 vested and exercisable and 31,250 non-vested) with a weighted average exercise price of \$3.32. The Company estimates that a total of approximately \$36,561 will be recorded as additional stock-based compensation expense during the fiscal year ending May 31, 2011, for all options which were outstanding as of May 31, 2010, but which were not yet vested.

Outstanding Options			Exercisable Options		
Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining	Number of Shares	Weighted Average Exercise Price	
		Contractual Life (yrs)			
76,110	\$1.20	1.8	76,110	\$1.20	
62,499	2.30	4.0	62,499	2.30	
5,000	5.80	5.4	5,000	5.80	
75,000	6.16	8	43,750	6.13	
218,609	\$3.32	4.6	187,359	\$2.84	

Options granted, exercised, canceled and expired under the Company's stock option plan during the years ended May 31, 2010, 2009 and 2008 are summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Options outstanding May 31, 2007	175,871	\$ 2.57
Options granted	25,000	5.98
Options exercised	(5,764)	2.27
Options forfeited/cancelled	(6,623)	6.58
Options outstanding May 31, 2008	188,484	2.89
Options granted	50,000	6.25
Options exercised		
Options forfeited/cancelled	(19,875)	6.58
Options outstanding May 31, 2009	218,609	3.32
Options granted		
Options exercised		
Options forfeited/cancelled		
Options outstanding May 31, 2010	218,609	3.32

The total intrinsic value of outstanding and exercisable options at May 31, 2010 was \$726,080 and \$532,455, respectively. The total intrinsic value of options exercised during the years ended May 31, 2010, 2009 and 2008 was \$0, \$0 and \$34,242, respectively.

## NOTE 8

**EARNINGS PER SHARE**

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

## Schmitt Industries, Inc.

## Notes to Consolidated Financial Statements (Continued)

## For The Years Ended May 31, 2010, 2009 and 2008

reconciliation of the numerators and denominators of the basic and diluted per share computations for each of the three years in the period ended May 31, 2010:

	Income (Numerator)	Weighted Average Shares (Denominator)	Per Share Amount
<b>Year ended May 31, 2010</b>			
Basic earnings per share			
Loss available to common stockholders	\$ (1,711,013)	2,886,633	\$ (0.59)
Effect of dilutive securities stock options			
Diluted earnings per share			
Loss available to common stockholders	\$ (1,711,013)	2,886,633	\$ (0.59)
<b>Year ended May 31, 2009</b>			
Basic earnings per share			
Loss available to common stockholders	\$ (2,153,524)	2,870,160	\$ (0.75)
Effect of dilutive securities stock options			
Diluted earnings per share			
Income available to common stockholders	\$ (2,153,524)	2,870,160	\$ (0.75)
<b>Year ended May 31, 2008</b>			
Basic earnings per share			
Income available to common stockholders	\$ 1,103,104	2,725,086	\$ 0.40
Effect of dilutive securities stock options		109,072	
Diluted earnings per share			
Income available to common stockholders	\$ 1,103,104	2,834,158	\$ 0.39

**NOTE 9****EMPLOYEE BENEFIT PLANS**

The Company adopted the Schmitt Industries, Inc. 401(k) Profit Sharing Plan & Trust effective June 1, 1996. Employees must meet certain age and service requirements to be eligible. Participants may contribute up to 15% of their eligible compensation which may be partially matched by the Company. The Company may further make either a profit sharing contribution or a discretionary contribution. The Company made matching contributions in conjunction with employee contributions to the plan totaling \$56,532, \$55,122 and \$49,252 during Fiscal 2010, 2009 and 2008, respectively.

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

Effective June 1, 2004, the Company entered into a contract to provide consulting services to PulverDryer USA, Inc., ( PulverDryer ) pursuant to which PulverDryer paid the Company \$8,000 a month from June 2004 through October 2004. PulverDryer also buys certain products from the Company at normal prevailing rates. The Company and PulverDryer extended the contract from November 1, 2004 forward at that same

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monthly fee of \$8,000. The contract was terminated in February 2010. Product sales to PulverDryer during the fiscal years ended May 31, 2010, 2009 and 2008 totaled \$1,408, \$2,367 and \$16,468, respectively.

In connection with the contract, the Board authorized Wayne Case, the Company's Chief Executive Officer, to provide advisory services to PulverDryer, and permitted Mr. Case to receive as compensation the total consulting

## Schmitt Industries, Inc.

## Notes to Consolidated Financial Statements (Continued)

## For The Years Ended May 31, 2010, 2009 and 2008

fees paid by PulverDryer from June 2004 through October 2004. From November 2004 to February 2010, Mr. Case received 40% of the ongoing consulting fee from PulverDryer, which percentage was determined by the Compensation Committee. Mr. Case also served on the board of directors of PulverDryer through the termination of the contract.

## NOTE 11

## ACQUISITIONS

## Optical Dimensions

On September 30, 2009, the Company completed an Asset Purchase Agreement (the Agreement) with Optical Dimensions, a sole proprietorship, pursuant to which the Company acquired all of the assets and assumed certain liabilities of Optical Dimensions. As a result, the Company now owns and operates Optical Dimensions' business, including its patented laser light scatter roughness measurement technology. The total purchase price for the acquisition was \$200,293 which includes the value of the shares issued and the cash paid. The Agreement provided that the Company pay cash of \$100,000 and issue 24,642 shares of common stock of the Company. The number of shares issued was equal to \$100,000 of value based on the average closing price of the Company's common stock, as reported on the NASDAQ National Market, over the five-day period immediately prior to closing. Based upon the closing price on September 30, 2009, as reported on the NASDAQ Capital Market, the aggregate non-cash value of the Company's 24,642 shares issued was \$100,293.

The following table summarizes the estimated fair values of the assets acquired and the liabilities assumed at the date of acquisition:

Tangible assets and liabilities assumed:	
Receivables	\$ 33,434
Inventory	40,000
Property and equipment	17,757
Prepaid expenses	2,955
Accounts payable	(9,374)
Intangible assets	
Purchased technology	115,521
	<b>\$ 200,293</b>

The allocation process requires an analysis and valuation of acquired assets, including technologies, customer contracts and relationships and trade names, and liabilities assumed, including contractual commitments and legal contingencies. The values assigned to certain acquired assets and liabilities are preliminary, are based upon information available as November 30, 2009, and may be adjusted as further information becomes available. Additional information that may become available subsequently and may result in changes in the values allocated to various assets and liabilities includes, but is not limited to, unidentified claims from suppliers or other contingent obligations and the amounts required to settle them. Any changes in the values allocated to tangible and specifically identified intangible assets acquired and liabilities assumed during the allocation period may result in an adjustment to intangible assets.

Purchased technology relates to Optical Dimensions' patented laser light scatter roughness measurement technology that has reached technological feasibility. The fair value of the purchased technology is being amortized over the expected useful life of five years.

## Schmitt Industries, Inc.

## Notes to Consolidated Financial Statements (Continued)

## For The Years Ended May 31, 2010, 2009 and 2008

**Xtero Datacom Inc**

On February 20, 2008, the Company, through its newly formed wholly owned subsidiary, Schmitt Industries (Canada) Limited, a British Columbia corporation ( SICL ), acquired all of the issued and outstanding common shares of Xtero Datacom Inc., a British Columbia corporation ( Xtero ). As consideration for the Xtero shares, the Company issued 199,977 shares of Company common stock to the Xtero shareholders. In addition, Xtero shareholders will be eligible to receive shares of SICL stock that are exchangeable for shares of Schmitt common stock on a one-for-one basis based on 50% of the after-tax earnings derived from Xtero products during a five-year earn-out program ending on May 31, 2013. The issuance of the 199,977 shares was not registered, and was made with reliance upon Section 3(a) (10) of the Securities Act of 1933 (the Act), which exempts judicially approved share exchanges from the Act's registration requirements. On January 29, 2008, the Supreme Court of British Columbia granted a final order approving the transaction. Based upon the closing price of the Company's common stock of \$5.90 on February 20, 2008 as reported on the NASDAQ Capital Market, the aggregate value of the Company's 199,977 shares issued to the Xtero shareholders was approximately \$1,179,865. The aggregate purchase price for the acquisition was \$1,797,367 which includes the value of shares issued, advances of \$500,000 to Xtero prior to February 20, 2008 on a convertible promissory note and other transaction costs.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition:

Tangible assets and liabilities assumed:	
Receivables	\$ 182,000
Accounts payable and other current liabilities	(248,657)
Deferred tax liabilities	(842,280)
Intangible assets	
Purchased technology	2,706,304
	<b>\$ 1,797,367</b>

The allocation process requires an analysis and valuation of acquired assets, including deferred tax assets, technologies, customer contracts and relationships, trade names and liabilities assumed, including contractual commitments and legal contingencies. The values assigned to certain acquired assets and liabilities are preliminary, are based on information available as of May 31, 2008, and may be adjusted as further information becomes available. Additional information that may become available subsequently and may result in changes in the values allocated to various assets and liabilities includes, but is not limited to, unidentified claims from suppliers or other contingent obligations, the amounts required to settle them, and the value of deferred tax assets and liabilities. Any changes in the values allocated to tangible and specifically identified intangible assets acquired and liabilities assumed during the allocation period may result in adjustments to intangible assets. During the fourth quarter of Fiscal 2009, the Company filed tax returns in Canada related to this acquisition which resulted in changes to the preliminary values assigned to the deferred tax liabilities and the intangible asset. Based on the tax return filings and elections available to treat the Xtero acquisition as a purchase of assets for tax purposes, the tax basis of the underlying assets was increased which eliminated the deferred tax liability originally recognized at the acquisition date. As a result of the elimination of the deferred tax liability originally recorded, the value of the intangible asset decreased to \$1,663,539.

Purchased technology relates to Xtero's remote satellite sensing of large chemical storage tanks that have reached technological feasibility. The fair value of the purchased technology is being amortized over the original useful life of 15 years.

*Report of Independent Registered Public Accounting Firm*

Board of Directors and Shareholders

Schmitt Industries, Inc.

We have audited the accompanying consolidated balance sheet of Schmitt Industries, Inc. and its subsidiaries as of May 31, 2010, and the related consolidated statement of operations, changes in stockholders' equity and comprehensive income and cash flows for the year ended May 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Schmitt Industries, Inc. as of May 31, 2010 and the results of its operations and its cash flows for the year ended May 31, 2010 in conformity with accounting principles generally accepted in the United States of America.

/s/ MOSS-ADAMS LLP

Portland, Oregon

July 30, 2010

*Report of Independent Registered Public Accounting Firm*

Board of Directors and Shareholders

Schmitt Industries, Inc.

We have audited the accompanying consolidated balance sheet of Schmitt Industries, Inc. and its subsidiaries as of May 31, 2009 and the related consolidated statements of operations, changes in stockholders' equity and comprehensive income and cash flows for each of the two years in the period ended May 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Schmitt Industries, Inc. as of May 31, 2009 and the results of its operations and its cash flows for each of the two years in the period ended May 31, 2009 in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP

Portland, Oregon

July 31, 2009

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

None.

**Item 9A(T). Controls and Procedures**

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

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934, as amended (Exchange Act), is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. Our disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosures. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives, and management necessarily is required to use its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

An evaluation was carried out under the supervision and with the participation of the Company's management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the CEO and CFO have concluded that the Company's disclosure controls and procedures are effective.

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

Our management is responsible for establishing and maintaining adequate internal controls over financial reporting (as defined in Exchange Act Rules 13a-15(f) or 15d-15(f)). Under the supervision and with the participation of our management, including our CEO and CFO, we conducted an evaluation of the effectiveness of our internal controls over financial reporting based on the framework in *Internal Controls - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control - Integrated Framework*, our management concluded that our internal controls over financial reporting were effective as of May 31, 2010.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the SEC that permit the Company to provide only management's report in the annual report.

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

There were no changes in our internal control over financial reporting (as defined in Exchange Rules 13a-15(f) and 15d-15(f)) that occurred during the quarter ended May 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information**

None.

**PART III**

Certain information required by Part III is included in the Company's definitive Proxy Statement for its 2010 Annual Meeting of Shareholders (Proxy Statement) and is incorporated herein by reference. The Proxy Statement will be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934 not later than 120 days after the end of the fiscal year covered by this Report.

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

The information required by this item is included in the Company's Proxy Statement relating to the 2010 Annual Meeting of Shareholders and is incorporated herein by reference.

**Item 11. Executive Compensation**

The information required by this item is included in the Company's Proxy Statement relating to the 2010 Annual Meeting of Shareholders and is incorporated herein by reference.

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

The information required by this item is included in the Company's Proxy Statement relating to the 2010 Annual Meeting of Shareholders and is incorporated herein by reference.

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

The information required by this item is included in the Company's Proxy Statement relating to the 2010 Annual Meeting of Shareholders and is incorporated herein by reference.

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

The information required by this item is included in the Company's Proxy Statement relating to the 2010 Annual Meeting of Shareholders and is incorporated herein by reference.

**PART IV**

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

(a) *Financial Statements:*

- (1) Consolidated Balance Sheets as of May 31, 2010 and 2009  
Consolidated Statements of Operations for the years ended May 31, 2010, 2009 and 2008  
Consolidated Statements of Cash Flows for the years ended May 31, 2010, 2009 and 2008  
Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income for the years ended May 31, 2010, 2009 and 2008  
Notes to Consolidated Financial Statements for the years ended May 31, 2010, 2009 and 2008  
Reports of Independent Registered Public Accounting Firms
- (2) *Financial Statement Schedules:* All financial statement schedules are omitted either because they are not applicable, not required, or the required information is included in the financial statements or notes thereto.
- (3) *Exhibits:* Reference is made to the list on page 44 of the Exhibits filed with this report.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**SCHMITT INDUSTRIES, INC.**

By: */s/ WAYNE A. CASE*  
**Wayne A. Case**  
*Chairman of the Board  
and Chief Executive Officer*

Date: July 30, 2010

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on July 30, 2010.

<b>Signature</b>	<b>Title</b>
<i>/s/ WAYNE A. CASE</i> <b>Wayne A. Case</b>	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)
<i>/s/ JAMES A. FITZHENRY</i> <b>James A. Fitzhenry</b>	Director and President
<i>/s/ JEFFREY T SIEGAL</i> <b>Jeffrey T Siegal</b>	Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)
<i>/s/ MAYNARD BROWN</i> <b>Maynard Brown</b>	Director
<i>/s/ TIMOTHY D.J. HENNESSY</i> <b>Timothy D.J. Hennessy</b>	Director
<i>/s/ DAVID M. HUDSON</i> <b>David M. Hudson</b>	Director
<i>/s/ MICHAEL J. ELLSWORTH</i> <b>Michael J. Ellsworth</b>	Director

**INDEX TO EXHIBITS**

**Exhibits Description**

Exhibits marked with an asterisk (\*) are incorporated by reference to exhibits or appendices previously filed with the Securities and Exchange Commission, as indicated by the references in brackets. All other exhibits are filed herewith.

\*2.1 Arrangement Agreement by and among Schmitt Industries, Inc., Schmitt Industries (Canada) Limited, and Xtero Datacom Inc. dated December 14, 2007.

**[Form 10-Q for the fiscal quarter ended February 29, 2008, Exhibit 2.1]**

\*2.2 Amending Agreement to Arrangement Agreement by and among Schmitt Industries, Inc., Schmitt Industries (Canada) Limited, and Xtero Datacom Inc. dated February 7, 2008.

**[Form 10-Q for the fiscal quarter ended February 29, 2008, Exhibit 2.2]**

\*2.3 Asset Purchase Agreement between Schmitt Industries, Inc., and Glenn Valliant, an individual doing business as Optical Dimensions, dated September 30, 2009.

**[Form 10-Q for the fiscal quarter ended November 30, 2009, Exhibit 2.1]**

\*3.1 Second Restated Articles of Incorporation of Schmitt Industries, Inc.

**[Form 10-K for the fiscal year ended May 31, 1999, Exhibit 3(i)]**

\*3.2 Second Restated Bylaws of Schmitt Industries, Inc.

**[Form 10-K for the fiscal year ended May 31, 1999, Exhibit 3(ii)]**

\*4.1 See exhibits 3.1 and 3.2 for provisions of the Articles of Incorporation and Bylaws defining the rights of security holders.

\*10.1 Schmitt Industries, Inc. Amended & Restated Stock Option Plan.

**[Form 10-K for the fiscal year ended May 31, 1999, Exhibit 10.1]**

\*10.2 Schmitt Industries, Inc. 2004 Stock Option Plan.

**[Appendix B to Schedule 14A filed on August 23, 2004]**

\*14.1 Code of Ethics and Business Conduct.

**[Form 10-K for the fiscal year ended May 31, 2004, Exhibit 14.1]**

21.1 Subsidiaries of Schmitt Industries, Inc. as of May 31, 2010.

23.1 Consent of Independent Registered Public Accounting Firm.

23.2 Consent of Independent Registered Public Accounting Firm.

31.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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

