SCHMITT INDUSTRIES INC
Form 10-K
July 31, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended: May 31, 2007

or

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

For the transition period from to

Commission File Number: 000-23996

SCHMITT INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

Oregon	**93-1151989**
(State or other jurisdiction of incorporation or organization)	(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	**Name of each exchange on which registered**
Common Stock - no par value	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 o No x

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 o No x

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 x No o

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. x

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

The aggregate market value of the voting stock held by non-affiliates of the registrant as of November 30, 2006, the last business day of the registrant s most recently completed second fiscal quarter, was approximately $14,370,000 based upon the closing price of $7.18 reported for such date on the NASDAQ Capital Market. For purposes of this disclosure, shares of Common Stock held by persons who hold more than 10% of the outstanding shares of Common Stock and shares held by officers and directors of the registrant, have been excluded because such persons may be deemed to be affiliates. This determination is not necessarily conclusive for other purposes.

As of July 24, 2007, the registrant had 2,668,933 outstanding shares of Common Stock.

Documents Incorporated by Reference

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

PART I

Item 1. Business

Introduction

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

Balancer Segment

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

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

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

Benefits to the system user include improved quality of finished parts, ease of product adaptation, minimal downtime, complete and ready installation, elimination of static balancing, longer life of the grinding wheel, diamond dressings and spindle bearings, the ability to balance within 0.02 microns and its adaptability to all types of machines.

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

Machine Tool Builders - These companies design and manufacture a variety of cylindrical, surface and specialty application grinding machines. SBS Systems are distributed to a variety of world markets through OEM (original equipment manufacturer) accounts, where a special pricing (20% discount) is offered to the machine builder incorporating the SBS System into its machine.

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

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

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

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

Competition

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

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

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

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

Measurement Segment

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

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

Surface measurement products

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

with fabrication processes that require precise and reliable measurements.

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

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

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

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

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

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

Dimensional sizing products

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

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

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

The AR600 series is a family of triangulating laser displacement sensors with excellent accuracy and sensitivity. The sensor projects a beam of visible laser light that creates a spot on the target surface. Reflected light from the surface is viewed from an angle by a line scan camera and the target s distance is computed from the image pixel data. The line includes 11 models measuring displacements from 1/8 to 50 and accuracy s down to .00015 (4 microns). They can operate on all types of surfaces at speeds up to 1250 samples/second. The product is extremely sensitive and can detect glass and liquid surfaces and also detect multiple surfaces of transparent materials, allowing great flexibility in specialized applications.

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

The AR200 line is the most compact series of triangulating laser displacement sensors. Four models cover metric measurement ranges from six to fifty millimeters. All models boast a 1/500 accuracy rating for measurements within twelve microns. The AR200 sensor is the only sensor of its kind to feature pushbutton selection of output signals. All models are standard with analog, limit switch and serial outputs. The AR200 sensors, much like the longer-range AR600 sensors, project a beam of visible laser light that creates a spot on the target surface. Reflected light from the surface is viewed from an angle by a line scan camera and the target s distance is computed from the image pixel data. The AR200-6M, -12M, -25M and -50M have ranges in millimeters that match their model number. The AR200 displacement sensor cannot be overloaded and measures accurately even when a mirror reflects the entire light beam back to the detector.

Research and other measurement products

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

The µScan 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 µScan can store 700 measurements in 255 files and provides the capability to program pass/fail criteria. Software is available for control, analysis and file conversion. From a single measurement, a user can determine RMS surface roughness, reflectance and scatter light levels (BRDF) on flat or curved surfaces under any lighting conditions.

Light-scatter measurement laboratory

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

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

Competition

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

The market for dimensional sizing products is extremely competitive, characterized by rapidly changing technology. The Company believes the principal elements of competition include quality of ongoing technical support and maintenance coupled with responsiveness to customer needs, as well as price, product quality, reliability and performance. The differences between our sensors and competitive products we feature pushbutton selection of output signals in certain models and our sensors can be programmed using serial commands through a PC computer. The AR200 displacement sensor can not be overloaded and measures accurately even when a mirror reflects the entire light beam back to the detector.

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

Sales by Geographic Area

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

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

Business and Marketing Strategy

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

Balancer Segment Products

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

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

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

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

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

Measurement Segment Products

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

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

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

Backlog

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

Manufacturing

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

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

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

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

Proprietary Technology

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

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

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

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

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

Product Development

The Company maintains an ongoing research and development program to expand the product lines and capabilities of both product segments. The goal of this program is to expand the product base in historic markets and to enter new market areas so as to reduce reliance on historic market segments. In the past fiscal year, the Company has developed the following new product:

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

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

Employees

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

Item 1A. Risk Factors

Business Risks

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

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

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

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

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

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

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

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

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

Demand for Company products may change:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Company faces risks from international sales and currency fluctuations:

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

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Company s design and assembly facilities and executive offices are located in Portland, Oregon in three company-owned buildings with total approximate square footage of 40,500 square feet. SEL occupies a 755-square foot facility in Coventry, England pursuant to a two year lease beginning May 7, 2007 with a basic monthly rent of £1,360 (approximately $2,690 as of May 31, 2007).

Item 3. Legal Proceedings

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

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

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

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PART II

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

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

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

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

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

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

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

Issuer Purchases of Equity Securities

None.

Item 6. Selected Financial Data

In thousands, except per share information

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

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

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

RESULTS OF OPERATIONS

Overview

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

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

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

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

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

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

Critical Accounting Policies

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

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

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

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

Deferred Taxes The Company applies the asset and liability method in recording income taxes, under which deferred income tax assets and liabilities are determined, based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using currently enacted tax rates and laws. Additionally, deferred tax assets are evaluated and a valuation allowance is established if it is more likely than not that all or a portion of the deferred tax asset will not be realized. In Fiscal 2005 and Fiscal 2006, management concluded future operations would produce sufficient earnings so that a portion of this asset could be used in future periods to reduce federal and state tax liabilities. Management continues to review the level of the valuation allowance on a quarterly basis. There can be no assurance that the Company s future operations will produce sufficient earnings so that the deferred tax asset can be fully utilized.

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

Recently issued accounting pronouncements

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

Discussion of operating results

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

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

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

Worldwide sales of Balancer products increased 1.3% in the year ended May 31, 2007 compared to the year ended May 31, 2006 as sales to the Asian markets increased by 33.7% offset by a decline in t