

STARRETT L S CO  
Form 10-Q  
May 04, 2011

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 26, 2011

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 1-367

THE L. S. STARRETT COMPANY  
(Exact name of registrant as specified in its charter)

MASSACHUSETTS  
(State or other jurisdiction of incorporation or organization)

04-1866480  
(I.R.S. Employer Identification No.)

121 CRESCENT STREET, ATHOL,  
MASSACHUSETTS  
(Address of principal executive offices)

01331-1915  
(Zip Code)

Registrant's telephone number, including area code 978-249-3551

Former name, address and fiscal year, if changed since last report

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

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Smaller Reporting Company

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

Common Shares outstanding April 30, 2011  
as of

Class A Common Shares 5,914,376

Class B Common Shares 788,925

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THE L. S. STARRETT COMPANY

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Part I. Financial Information  
Item 1. Condensed Consolidated Unaudited Financial Statements

THE L. S. STARRETT COMPANY  
Consolidated Balance Sheets  
(in thousands of dollars except share data)

|                                                                                                                                 | March 26<br>2011<br>(unaudited) | June 26<br>2010<br>(audited) |
|---------------------------------------------------------------------------------------------------------------------------------|---------------------------------|------------------------------|
| <b>ASSETS</b>                                                                                                                   |                                 |                              |
| Current assets:                                                                                                                 |                                 |                              |
| Cash                                                                                                                            | \$21,834                        | \$20,478                     |
| Investments                                                                                                                     | -                               | 1,250                        |
| Accounts receivable (less allowance for doubtful accounts of \$1,092 and \$607)                                                 | 40,078                          | 33,707                       |
| Inventory                                                                                                                       | 55,837                          | 46,156                       |
| Deferred income tax asset                                                                                                       | 3,589                           | 3,300                        |
| Prepaid expenses, taxes and other current assets                                                                                | 7,854                           | 5,510                        |
| Total current assets                                                                                                            | 129,192                         | 110,401                      |
| Property, plant and equipment, at cost (less accumulated depreciation of \$130,654 and \$120,943)                               |                                 |                              |
|                                                                                                                                 | 55,072                          | 56,529                       |
| Property held for sale                                                                                                          | 788                             | 2,699                        |
| Intangible assets (less accumulated amortization of \$5,910 and \$4,973)                                                        | 367                             | 1,303                        |
| Other assets                                                                                                                    | 692                             | 280                          |
| Taxes receivable                                                                                                                | 2,807                           | 2,807                        |
| Deferred income tax asset, net                                                                                                  | 26,101                          | 26,115                       |
| Total assets                                                                                                                    | \$215,019                       | \$200,134                    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                     |                                 |                              |
| Current liabilities:                                                                                                            |                                 |                              |
| Short-term debt and current maturities                                                                                          | \$6,277                         | \$2,696                      |
| Accounts payable and accrued expenses                                                                                           | 15,937                          | 17,740                       |
| Accrued salaries and wages                                                                                                      | 5,381                           | 5,037                        |
| Total current liabilities                                                                                                       | 27,595                          | 25,473                       |
| Long-term taxes payable                                                                                                         | 9,290                           | 9,132                        |
| Deferred income tax liabilities                                                                                                 | 2,341                           | 2,436                        |
| Long-term debt                                                                                                                  | 532                             | 706                          |
| Postretirement benefit liability                                                                                                | 32,971                          | 30,005                       |
| Total liabilities                                                                                                               | 72,729                          | 67,752                       |
| Stockholders' equity:                                                                                                           |                                 |                              |
| Class A Common \$1 par (20,000,000 shares authorized) 5,910,263 outstanding on 3/26/2011 and 5,858,700 outstanding on 6/26/2010 | 5,910                           | 5,859                        |
| Class B Common \$1 par (10,000,000 shares authorized) 788,825 outstanding on 3/26/2011 and 821,204 outstanding on 6/26/2010     | 789                             | 821                          |
| Additional paid-in capital                                                                                                      | 50,597                          | 50,373                       |
| Retained earnings reinvested and employed in the business                                                                       | 125,086                         | 122,724                      |
| Accumulated other comprehensive loss                                                                                            | (40,092)                        | (47,395)                     |

|                                            |           |           |
|--------------------------------------------|-----------|-----------|
| Total stockholders' equity                 | 142,290   | 132,382   |
| Total liabilities and stockholders' equity | \$215,019 | \$200,134 |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY  
 Consolidated Statements of Operations  
 (in thousands of dollars except per share data)(unaudited)

|                                                                           | 13 Weeks Ended |           | 39 Weeks Ended |            |
|---------------------------------------------------------------------------|----------------|-----------|----------------|------------|
|                                                                           | 3/26/2011      | 3/27/2010 | 3/26/2011      | 3/27/2010  |
| Net sales                                                                 | \$58,763       | \$48,643  | \$173,592      | \$139,751  |
| Cost of goods sold                                                        | 39,821         | 33,110    | 117,300        | 98,285     |
| Gross margin                                                              | 18,942         | 15,533    | 56,292         | 41,466     |
| % of Net sales                                                            | 32.2           | % 31.9    | % 32.4         | % 29.7     |
| Selling and general expense                                               | 18,049         | 14,600    | 51,801         | 43,312     |
| Gain on sale of building                                                  | (1,350 )       | -         | (1,350 )       | -          |
| Operating income (loss)                                                   | 2,243          | 933       | 5,841          | (1,846 )   |
| Other income (expense)                                                    | (44 )          | 108       | 493            | (534 )     |
| Earnings (loss) before income taxes                                       | 2,199          | 1,041     | 6,334          | (2,380 )   |
| Income tax expense                                                        | 494            | 862       | 2,500          | 884        |
| Net earnings (loss)                                                       | \$1,705        | \$179     | \$3,834        | \$(3,264 ) |
| Basic and diluted earnings (loss) per share                               | \$0.25         | \$0.03    | \$0.57         | \$(0.49 )  |
| Average outstanding shares used in per share calculations (in thousands): |                |           |                |            |
| Basic                                                                     | 6,698          | 6,673     | 6,691          | 6,663      |
| Diluted                                                                   | 6,724          | 6,687     | 6,712          | 6,663      |
| Dividends per share                                                       | \$0.08         | \$0.06    | \$0.22         | \$0.24     |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY  
Consolidated Statements of Cash Flows  
(in thousands of dollars)(unaudited)

|                                                                          | 39 Weeks Ended |            |
|--------------------------------------------------------------------------|----------------|------------|
|                                                                          | 3/26/2011      | 3/27/2010  |
| Cash flows from operating activities:                                    |                |            |
| Net earnings (loss)                                                      | \$3,834        | \$(3,264 ) |
| Gain in sale of building                                                 | (1,350 )       | -          |
| Non-cash operating activities:                                           |                |            |
| Depreciation                                                             | 7,010          | 6,795      |
| Amortization                                                             | 936            | 902        |
| Fixed asset impairment                                                   | -              | 130        |
| Net long-term tax payable                                                | 107            | (453 )     |
| Deferred taxes                                                           | (12 )          | (623 )     |
| Unrealized transaction (gains)/losses                                    | (137 )         | (222 )     |
| Retirement benefits                                                      | 2,727          | 2,229      |
| Equity method loss on investment in private software development company | 541            | -          |
| Working capital changes                                                  |                |            |
| Receivables                                                              | (3,308 )       | (4,441 )   |
| Inventories                                                              | (7,076 )       | 13,855     |
| Other current assets                                                     | (2,298 )       | 510        |
| Other current liabilities                                                | (2,887 )       | 2,474      |
| Prepaid pension cost and other                                           | 77             | (116 )     |
| Net (used in) by operating activities                                    | (1,836 )       | 17,776     |
| Cash flows from investing activities:                                    |                |            |
| Additions to property, plant and equipment                               | (4,051 )       | (5,914 )   |
| Decrease in investments                                                  | 1,250          | 618        |
| Investment in private software development company                       | (950 )         | -          |
| Proceeds from sale of building                                           | 3,262          | -          |
| Earn-out paid for Kinemetric Engineering                                 | -              | (110 )     |
| Net cash (used in) investing activities                                  | (489 )         | (5,406 )   |
| Cash flows from financing activities:                                    |                |            |
| Proceeds from short-term borrowings                                      | 4,887          | 13,982     |
| Short-term debt repayments                                               | (1,303 )       | (19,233 )  |
| Proceeds from long-term borrowings                                       | -              | 129        |
| Long-term debt repayments                                                | (202 )         | (523 )     |
| Proceeds from common stock issued                                        | 196            | 305        |
| Dividends paid                                                           | (1,472 )       | (1,599 )   |
| Net cash provided by (used in) financing activities                      | 2,106          | (6,939 )   |
| Effect of exchange rate changes on cash                                  | 1,575          | (450 )     |
| Net increase in cash                                                     | 1,356          | 4,981      |
| Cash, beginning of period                                                | 20,478         | 10,248     |
| Cash, end of period                                                      | \$21,834       | \$15,229   |

Supplemental cash flow information:

|                 |         |         |
|-----------------|---------|---------|
| Interest paid   | \$245   | \$1,537 |
| Taxes paid, net | \$3,357 | \$880   |

See Notes to Unaudited Consolidated Financial Statements



THE L. S. STARRETT COMPANY  
Consolidated Statements of Stockholders' Equity  
For the Thirty-nine Weeks Ended March 26, 2011 and March 27, 2010  
(in thousands of dollars except per share data)(unaudited)

|                                                                          | Common Stock                         |         | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total     |
|--------------------------------------------------------------------------|--------------------------------------|---------|----------------------------------|----------------------|-----------------------------------------------|-----------|
|                                                                          | Out-standing<br>(\$1 Par)<br>Class A | Class B |                                  |                      |                                               |           |
| Balance June 27, 2009                                                    | \$5,770                              | \$869   | \$49,984                         | \$127,707            | \$ (41,452 )                                  | \$142,878 |
| Comprehensive income (loss):                                             |                                      |         |                                  |                      |                                               |           |
| Net loss                                                                 |                                      |         |                                  | (3,264 )             |                                               | (3,264 )  |
| Unrealized net gain on investments                                       |                                      |         |                                  |                      | 5                                             | 5         |
| Translation loss, net                                                    |                                      |         |                                  |                      | 2,615                                         | 2,615     |
| Total comprehensive loss                                                 |                                      |         |                                  |                      |                                               | (644 )    |
| Dividends (\$.24 per share)                                              |                                      |         |                                  | (1,599 )             |                                               | (1,599 )  |
| Treasury shares:                                                         |                                      |         |                                  |                      |                                               |           |
| Issued                                                                   | 33                                   |         | 261                              |                      |                                               | 294       |
| Issuance of stock under ESPP                                             |                                      | 2       | 59                               |                      |                                               | 61        |
| Conversion                                                               | 32                                   | (32 )   |                                  |                      |                                               | -         |
| Balance March 27, 2010                                                   | \$5,835                              | \$839   | \$50,304                         | \$122,844            | \$ (38,832 )                                  | \$140,990 |
| Balance June 26, 2010                                                    | \$5,859                              | \$821   | \$50,373                         | \$122,724            | \$ (47,395 )                                  | \$132,382 |
| Comprehensive income:                                                    |                                      |         |                                  |                      |                                               |           |
| Net income                                                               |                                      |         |                                  | 3,834                |                                               | 3,834     |
| Minimum pension liability, net                                           |                                      |         |                                  |                      | 118                                           | 118       |
| Translation gain, net                                                    |                                      |         |                                  |                      | 7,185                                         | 7,185     |
| Total comprehensive income                                               |                                      |         |                                  |                      |                                               | 11,137    |
| Dividends (\$0.22 per share)                                             |                                      |         |                                  | (1,472 )             |                                               | (1,472 )  |
| Treasury shares:                                                         |                                      |         |                                  |                      |                                               |           |
| Issued                                                                   | 17                                   |         | 156                              |                      |                                               | 173       |
| Issuance of stock under ESPP                                             |                                      | 2       | 68                               |                      |                                               | 70        |
| Conversion                                                               | 34                                   | (34 )   |                                  |                      |                                               | -         |
| Balance March 26, 2011                                                   | \$5,910                              | \$789   | \$50,597                         | \$125,086            | \$ (40,092 )                                  | \$142,290 |
| Cumulative Balance:                                                      |                                      |         |                                  |                      |                                               |           |
| Translation loss                                                         |                                      |         |                                  |                      | \$ (4,386 )                                   |           |
| Amounts not recognized as a<br>component of net periodic benefit<br>cost |                                      |         |                                  |                      | (35,706 )                                     |           |
|                                                                          |                                      |         |                                  |                      | \$ (40,092 )                                  |           |

See Notes to Unaudited Consolidated Financial Statements

THE L. S. STARRETT COMPANY  
Notes to Unaudited Consolidated Financial Statements

Note 1: Basis of Presentation

In the opinion of management, the accompanying unaudited, consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position of the Company as of March 26, 2011 and June 26, 2010; the results of operations for the thirteen and thirty-nine weeks ended March 26, 2011 and March 27, 2010, the cash flows for the thirty-nine weeks ended March 26, 2011 and March 27, 2010; and changes in stockholders' equity for the thirty-nine weeks ended March 26, 2011 and March 27, 2010.

The Company follows the same accounting policies in the preparation of interim statements as described in the Company's Annual Report filed on Form 10-K for the year ended June 26, 2010, and these financial statements should be read in conjunction with said Annual Report on Form 10-K.

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect amounts reported in the consolidated financial statements and accompanying notes. The second footnote to the Company's Consolidated Financial Statements included in the Annual Report on Form 10-K for the fiscal year ended June 26, 2010 describes the significant accounting policies and methods used in the preparation of the consolidated financial statements.

Note 2: Investments

The Company has categorized its financial assets, based on the priority of the inputs to the valuation technique, into a three-level fair value hierarchy. If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

Financial assets recorded on the balance sheets are categorized based on the inputs to the valuation techniques as follows:

- o Level 1 – Financial assets whose values are based on unadjusted quoted prices for identical assets or liabilities in an active market which the company has the ability to access at the measurement date (examples include active exchange-traded equity securities and most U.S. Government and agency securities).

As of March 26, 2011 and June 26, 2010, the Company's Level 1 financial assets were as follows (in thousands):

|                                                   | Level 1   |           |
|---------------------------------------------------|-----------|-----------|
|                                                   | 3/26/2011 | 6/26/2010 |
| International Bonds Puerto Rican debt obligations | -         | 1,250     |
|                                                   | -         | 1,250     |

As of March 26, 2011 and June 26, 2010, the Company did not have any level 2 or 3 assets.

## Note 3: Inventory

Inventory consists of the following:

|                                        | March 26<br>2011 | June 26<br>2010 |
|----------------------------------------|------------------|-----------------|
| Raw Material and Supplies              | \$ 30,632        | \$ 27,251       |
| Goods in Process and Finished<br>Parts | 23,862           | 19,136          |
| Finished Goods                         | 26,707           | 24,960          |
|                                        | 81,201           | 71,347          |
| LIFO Reserve                           | (25,364 )        | (25,191 )       |
| Net Inventory                          | \$ 55,837        | \$ 46,156       |

LIFO inventories were \$14.4 million and \$12.3 million at March 26, 2011 and June 26, 2010, respectively, such amounts being approximately \$25.4 million and \$25.2 million respectively, less than if determined on a FIFO basis. The use of LIFO, as compared to FIFO, on a year-to-date third quarter basis resulted in a \$0.1 million increase in cost of sales in fiscal 2011 compared to a \$6.9 million reduction in cost of sales in fiscal 2010.

## Note 4: Pension and Post Retirement Benefits

Net periodic benefit costs for the Company's defined benefit pension plans consist of the following (in thousands):

|                                                | Thirteen Weeks<br>Ended March |          | Thirty-nine Weeks<br>Ended March |          |
|------------------------------------------------|-------------------------------|----------|----------------------------------|----------|
|                                                | 2011                          | 2010     | 2011                             | 2010     |
| Service cost                                   | \$575                         | \$484    | \$1,724                          | \$1,457  |
| Interest cost                                  | 1,618                         | 1,567    | 4,847                            | 4,720    |
| Expected return on plan assets                 | (1,867 )                      | (1,775 ) | (5,594 )                         | (5,346 ) |
| Amortization of prior service cost             | 158                           | 95       | 472                              | 288      |
| Amortization of unrecognized<br>actuarial loss | 680                           | 701      | 2,040                            | 2,104    |
|                                                | \$1,164                       | \$1,072  | \$3,489                          | \$3,223  |

Net periodic benefit costs for the Company's postretirement medical plan consists of the following (in thousands):

|                                                | Thirteen Weeks<br>Ended March |        | Thirty-nine Weeks<br>Ended March |        |
|------------------------------------------------|-------------------------------|--------|----------------------------------|--------|
|                                                | 2011                          | 2010   | 2011                             | 2010   |
| Service cost                                   | \$92                          | \$85   | \$276                            | \$254  |
| Interest cost                                  | 151                           | 169    | 453                              | 508    |
| Amortization of prior service benefit          | (226 )                        | (226 ) | (679 )                           | (679 ) |
| Amortization of unrecognized<br>actuarial loss | 7                             | -      | 21                               | -      |
|                                                | \$24                          | \$28   | \$71                             | \$83   |

## Note 5: Debt

Debt, including capitalized lease obligations, is comprised of the following (in thousands):

|                                          | March 26,<br>2011 | June 26,<br>2010 |
|------------------------------------------|-------------------|------------------|
| <b>Short-term and current maturities</b> |                   |                  |
| Loan and Security Agreement              | \$6,000           | \$1,700          |
| Short-term foreign credit facility       | 41                | 738              |
| Capitalized leases                       | 236               | 258              |
|                                          | \$6,277           | \$2,696          |
| <b>Long-term debt</b>                    |                   |                  |
| Capitalized leases                       | \$532             | \$706            |
|                                          | \$6,809           | \$3,402          |

The material financial covenants of the Loan and Security Agreement are 1) achieve a minimum EBITDA of \$3.5 million on a trailing twelve month basis, 2) achieve a minimum Tangible Net Worth of \$130 million excluding any pension liability, 3) incur no more than \$10.0 million for capital expenditures on a fiscal year basis, and 4) maintain a Debt Service Coverage Ratio of a minimum of 1:25 to 1. As of March 26, 2011, the Company was in compliance with each of these financial covenants. The effective interest rate on the Loan and Security agreement through March 26, 2011 was 2.3%.

## Note 6: Income Tax

The Company is subject to U.S. federal income tax and various state, local and international income taxes in numerous jurisdictions. The Company's domestic and international tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues and expenses. Additionally, the amount of income taxes paid is subject to the Company's interpretation of applicable tax laws in the jurisdictions in which it files.

The Company has substantially concluded all U.S. federal income tax matters for years through fiscal 2006. As of March 26, 2011, we do not have any income tax audits in progress in the various federal, local and international jurisdictions in which we operate. We do have one state audit in process. In international jurisdictions including Argentina, Australia, Brazil, Canada, China, UK, Germany, New Zealand, and Mexico, which comprise a significant portion of the Company's operations, the years that may be examined vary, with the earliest year being 2004.

The effective tax rate through the third quarter of fiscal 2011 was 39.5%. Discrete items included in the effective tax rate were an Argentinean valuation allowance of \$462,000 recorded in the second quarter and a United Kingdom tax rate differential of \$112,000 recorded in the first quarter partially offset by a favorable adjustment related to state net operating loss of \$261,000 recorded in the third quarter.

The Company has identified no new uncertain tax positions during the thirty-nine week period ended March 26, 2011 for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next twelve months.

No valuation allowance has been recorded for the domestic federal net operating losses (NOL) as the Company continues to believe that based on forecasted future taxable income and certain tax planning strategies available, it is more likely than not that it will be able to utilize the federal NOL

Note 7: Fair Value

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate value.

- o Cash and short term instruments  
The carrying amount approximates fair value because of the short maturity of those investments

o Investments

The fair value of some investments are estimated on quoted market prices for those or similar investments.

o Short and long-term debt

The fair value of the Company's short and long term debt is estimated based on quoted market prices for corporate debt having similar characteristics or on the current rates offered to the Company for debt of the same remaining maturities.

The estimated fair value of the Company's financial instruments is as follows in thousands (000):

|                 | March 26, 2011     |            | June 26, 2010      |            |
|-----------------|--------------------|------------|--------------------|------------|
|                 | Carrying<br>Amount | Fair Value | Carrying<br>Amount | Fair Value |
| Cash            | \$21,834           | \$21,834   | \$20,478           | \$20,478   |
| Short-term debt | 6,277              | 6,277      | 2,696              | 2,696      |
| Investments     | -                  | -          | 1,250              | 1,250      |
| Long-term debt  | 532                | 532        | 706                | 706        |

Note 8: Investments

The Company entered into an investment agreement with a private software development company in the fourth quarter of fiscal 2010. Under the agreement the Company is scheduled to invest \$1.5 million over twelve to eighteen months and will receive 36% equity in the software development company. The Company has invested \$1.2 million through the third quarter of fiscal 2011 and has recorded a \$0.5 million loss under the equity method of accounting, which is included in other income (expense) in the Consolidated Statement of Operations. The \$0.7 million net carrying value of the investment as of March 26, 2011 is included in other long term assets in the Consolidated Balance Sheet.

Note 9: Subsequent Events

The Company has evaluated events occurring subsequent to March 26, 2011 through the date of issuance of the financial statements and determined there were no material subsequent events to be disclosed.

Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

THREE MONTHS ENDED March 26, 2011 and March 27, 2010

Overview

Net sales increased \$10.1 million or 21% from \$48.7 million to \$58.8 million. A weaker U. S. dollar translated into a \$1.5 million of the revenue increase. Operating income improved \$1.3 million due to the gain on the sale of a building. A \$3.4 million improvement in gross margin was offset by a \$3.4 million increase in selling and general expenses. Net income for fiscal 2011 was \$1.7 million, \$0.25 per share, compared to \$0.2 million, \$0.03 per share in fiscal 2010, primarily due to improved profits and a lower effective tax rate.

Net Sales

Net sales in North America increased \$4.0 million or 15% from \$26.3 million to \$30.3 million as strong gains in the industrial sector, particularly in precision tools, saws and capital equipment, more than offset declines in the construction markets. International net sales increased \$6.1 million or 27% from \$22.4 million to \$28.5 million, with gains in Latin America, Europe and Asia.

Gross Margin

Gross margin improved \$3.4 million from \$15.5 (31.9% of revenue) million to \$18.9 (32.2% of revenue) million, with North America and International posting gains of \$0.3 million and \$3.1 million, respectively. North American gross margins as a percentage of revenue declined 3.2% from 31.6% to 28.4% due to the comparative impact of LIFO inventory levels, which reduced cost of sales in fiscal 2010 while increasing cost of sales in fiscal 2011. International gross margins improved 4.5% from 32.1% to 36.6% as a result of improved pricing and efficiencies in Brazil.

Selling and General Expenses

Selling and general expenses increased \$3.4 million or 23% from \$14.6 million to \$18.0 million with North America and International posting increases of \$1.6 million and \$1.8 million, respectively. The North American increase reflects increased wages related to the restoration of a 10% reduction in management salaries; higher commissions based upon revenue improvement; higher employee benefits costs; and the amortization expense of the new ERP system. Higher selling expenses were the key factor in the International increase.

Earnings Before Taxes

Earnings before taxes increased \$1.2 million from \$1.0 million in fiscal 2010 to \$2.2 million in fiscal 2011. The improvement was primarily the result of the gain on the building sale as an improvement in gross margins was offset by an increase in selling and general expenses.

NINE MONTHS ENDED March 26, 2011 and March 27, 2010

#### Overview

Net sales increased \$33.8 million or 24% from \$139.8 million to \$173.6 million. A weaker U. S. dollar translated into \$3.8 million or 11% of the revenue gain. Operating income increased \$7.7 million as an increase in gross margins of \$14.8 million offset an increase in selling and general expenses of \$8.5 million, contributing \$6.3 million. The gain on the sale of the building represented an additional \$1.4 million. Net income for fiscal 2011 was \$3.8 million, \$0.57 per share, compared to a \$3.3 million net loss, \$(0.49) per share, in fiscal 2010 as a result of improved profits and a lower effective tax rate.

#### Net Sales

Net sales in North America increased \$15.4 million or 22% as a continued recovery in the industrial sector mitigated a decline in the construction market. Increased demand for precision tools, saws and metrology equipment from our Tru Stone and Kinematic divisions led the North American performance. International net sales increased \$18.4 million or 27% with Latin America and Europe posting gains of 30% and 22%, respectively.

#### Gross Margin

Gross margin increased \$14.8 million or 36% with volume representing \$10.0 million and improved margins accounting for \$4.9 million. North American margins improved 2.2% from 26.4% to 28.6% largely due to a favorable product mix led by a strong recovery by the Tru Stone division. International margins improved 3.3% from 32.9% to 36.2% led by a 3.0% improvement in Latin America.

#### Selling and General Expenses

Selling and general expenses increased \$8.5 million or 20% with North America and International each posting increases of \$4.2 million. The North American increase reflects higher wages related to the restoration of a 10% reduction in management salaries; higher commissions based upon revenue growth; increased employee benefits costs; and the amortization expense of the new ERP system. Higher selling expenses were the prime factor resulting in the International expense increase.

#### Other Income/(Expense)

Other income/(expense) increased \$1.0 million from a \$0.5 million expense in fiscal 2010 to income of \$0.5 million in fiscal 2011 due to higher interest income, including \$0.5 million related to settlement of a non-income tax lawsuit with the Brazilian government recorded in the second quarter of fiscal 2011. The fiscal 2011 interest income of \$1.0 million more than offset a \$0.5 million equity loss in a private software company.

#### Earnings Before Taxes

Earnings before taxes increased \$8.7 million from a loss of \$2.4 million in fiscal 2010 to a profit of \$6.3 million in fiscal 2011. The improvement was the result of a \$7.7 million gain in operating income and a \$1.0 million favorable swing in other income.



## LIQUIDITY AND CAPITAL RESOURCES

| Cash flows (in thousands)                       | Thirty-nine Weeks |           |
|-------------------------------------------------|-------------------|-----------|
|                                                 | 3/26/2011         | 3/27/2010 |
| Cash (used in) operations                       | \$(1,836 )        | \$17,776  |
| Cash (used in) investing activities             | (489 )            | (5,406 )  |
| Cash provided by (used in) financing activities | 2,106             | (6,939 )  |
| Effect of exchange rates changes on cash        | 1,575             | (450 )    |
| Net increase in cash                            | \$1,356           | \$4,981   |

Cash increased \$1.4 million as increased borrowings and favorable foreign exchange more than offset higher working capital requirements. The \$19.6 million swing in cash provided by operations from a \$17.8 million gain in fiscal 2010 to \$1.8 million deficit in fiscal 2011 was primarily due to the economic recovery resulting in a net increase in inventories of \$20.9 million between fiscal years. Cash used in investing activities declined \$4.9 million principally reflecting the expenditures for the new ERP system in fiscal 2010 and proceeds from the building sale in fiscal 2011. The cash provided from financing activities increased \$9.1 million reflecting a net \$5.3 million in short-term debt repayments in fiscal 2010 versus a net increase in debt of \$3.6 million in fiscal 2011. The change in debt position between fiscal years is a function of the economic conditions from recession in fiscal 2010 to recovery in fiscal 2011.

## Liquidity and credit arrangements

The Company believes it maintains sufficient liquidity and has the resources to fund its operations in the near term. If the Company is unable to maintain consistent profitability, additional steps will be taken in order to maintain liquidity, including plant consolidations, work force and dividend reductions. In addition to its cash, the Company maintains a \$23 million Loan and Security agreement, of which, \$6.0 million was outstanding as of March 26, 2011. This Loan and Security agreement matures as of April 30, 2012.

## INFLATION

The Company has experienced modest inflation relative to its material cost, much of which cannot be passed on to the customer through increased prices.

## OFF-BALANCE SHEET ARRANGEMENTS

The Company does not have any material off-balance sheet arrangements.

## Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

There have been no material changes in qualitative and quantitative disclosures about market risk from what was reported in our Annual Report on Form 10-K for the fiscal year ended June 26, 2010.

Item 4.

#### CONTROLS AND PROCEDURES

The Company's management, under the supervision and with the participation of the Company's President and Chief Executive Officer and Chief Financial Officer, has evaluated the Company's disclosure controls and procedures as of March 26, 2011, and they have concluded that our disclosure controls and procedures were effective as of such date. All information required to be filed in this report was recorded, processed, summarized and reported within the time period required by the rules and regulations of the Securities and Exchange Commission, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. There have been no changes in internal control over financial reporting that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Management's remediation efforts related to the material weakness that existed as of June 26, 2010, and noted in Item 9A of the Company's 2010 Annual Report on Form 10-K filed on September 21, 2010, are not complete as of March 26, 2011. The plan includes recruiting additional financial resources and correcting the reporting and control problems associated with the fourth quarter fiscal 2010 ERP implementation. An update as to the status of managements' efforts is listed below.

- o The Company completed the development of an improved financial reporting framework which will facilitate a uniform approach to consolidated and subsidiary financial reporting and analysis. This project was completed in the second quarter of fiscal 2011.
- o The Company has added experienced financial resources to its staff and will continue to evaluate further requirements. The plan to correct the major financial reporting and control problems began in October of 2010 and is expected to be completed by the fourth quarter fiscal 2011.

PART II.

OTHER INFORMATION

Item 1A.

Risk Factors

SAFE HARBOR STATEMENT

UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Quarterly Report on Form 10-Q contains forward-looking statements about the Company's business, competition, sales, expenditures, foreign operations, plans for reorganization, interest rate sensitivity, debt service, liquidity and capital resources, and other operating and capital requirements. In addition, forward-looking statements may be included in future Company documents and in oral statements by Company representatives to securities analysts and investors. The Company is subject to risks that could cause actual events to vary materially from such forward-looking statements. You should carefully review and consider the information regarding certain factors which could materially affect our business, financial condition or future results set forth under Item 1A. "Risk Factors" in our Form 10-K for the year ended June 26, 2010. There have been no material changes from the factors disclosed in our Form 10-K for the year ended June 26, 2010.

In addition to the risk factors outlined in Form 10-K, management has developed a plan to remediate material weaknesses over financial reporting, which is described in Item 4 in this Form 10-Q. We may disclose changes to such factors or disclose additional factors from time to time in our future filings with the Securities and Exchange Commission.

Item 6.

Exhibits

31a Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.

31b Certification of Principal Financial Officer pursuant to Section 202 of the Sarbanes-Oxley Act of 2002, filed herewith.

32 Certifications of the Principal Executive Officer and the Principal Financial Officer pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

THE L. S. STARRETT COMPANY  
(Registrant)

Date May 4, 2011

S/R. Douglas A. Starrett  
Douglas A. Starrett - President and CEO

Date May 4, 2011

S/R. Francis J. O'Brien  
Francis J. O'Brien - Treasurer and CFO

