

STARRETT L S CO  
Form 10-Q  
February 03, 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

December 25, 2010

OR

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

For the transition period  
from

to

Commission file number

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):

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

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

YES  NO

Common Shares outstanding January 31, 2011  
as of

Class A Common Shares 5,896,317

Class B Common Shares 802,871

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)

|  | Dec. 25<br>2010<br>(unaudited) | June 26<br>2010<br>(audited) |
|--|--------------------------------|------------------------------|
| <b>ASSETS</b>  |                                |                              |
| <b>Current assets:</b>   |                                |                              |
| Cash   | \$21,625                       | \$20,478                     |
| Investments  | -                              | 1,250                        |
| Accounts receivable (less allowance for doubtful accounts of \$634 and \$607)  | 37,313                         | 33,707                       |
| Inventory  | 51,478                         | 46,156                       |
| Deferred income tax asset  | 3,396                          | 3,300                        |
| Prepaid expenses, taxes and other current assets   | 8,226                          | 5,510                        |
| Total current assets   | 122,038                        | 110,401                      |
| Property, plant and equipment, at cost (less accumulated depreciation of \$127,122 and \$120,943)                                  | 55,333                         | 56,529                       |
| Property held for sale   | 2,699                          | 2,699                        |
| Intangible assets (less accumulated amortization of \$5,597 and \$4,973)   | 679                            | 1,303                        |
| Other assets   | 474                            | 280                          |
| Long-term taxes receivable   | 2,807                          | 2,807                        |
| Long-term deferred income tax asset  | 26,048                         | 26,115                       |
| Total assets   | \$210,078                      | \$200,134                    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                |                              |
| <b>Current liabilities:</b>  |                                |                              |
| Notes payable and current maturities   | \$5,306                        | \$2,696                      |
| Accounts payable and accrued expenses  | 17,502                         | 17,740                       |
| Accrued salaries and wages   | 4,404                          | 5,037                        |
| Total current liabilities  | 27,212                         | 25,473                       |
| Long-term taxes payable  | 9,281                          | 9,132                        |
| Deferred income taxes  | 2,464                          | 2,436                        |
| Long-term debt   | 587                            | 706                          |
| Postretirement benefit liability   | 31,723                         | 30,005                       |
| Total liabilities  | 71,267                         | 67,752                       |
| <b>Stockholders' equity:</b>   |                                |                              |
| Class A Common \$1 par (20,000,000 shares authorized)<br>5,890,309 outstanding on 12/25/10 and<br>5,858,700 outstanding on 6/26/10 | 5,890                          | 5,859                        |
| Class B Common \$1 par (10,000,000 shares authorized)<br>803,913 outstanding on 12/25/10 and<br>821,204 outstanding on 6/26/10     | 804                            | 821                          |
| Additional paid-in capital   | 50,531                         | 50,373                       |
| Retained earnings reinvested and employed in the business  | 123,917                        | 122,724                      |

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|  |           |           |
|--|-----------|-----------|
| Accumulated other comprehensive loss       | (42,331 ) | (47,395 ) |
| Total stockholders' equity                 | 138,811   | 132,382   |
| Total liabilities and stockholders' equity | \$210,078 | \$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 |            | 26 Weeks Ended |            |
|---|----------------|------------|----------------|------------|
|   | 12/25/2010     | 12/26/2009 | 12/25/2010     | 12/26/2009 |
| Net sales   | \$57,290       | \$50,535   | \$114,829      | \$91,108   |
| Cost of goods sold  | 38,612         | 34,634     | 77,479         | 65,175     |
| Gross margin  | 18,678         | 15,901     | 37,350         | 25,933     |
| % of Net Sales  | 32.6           | % 31.5     | % 32.5         | % 28.5     |
| Selling and general expense   | 16,365         | 14,359     | 33,752         | 28,712     |
| Operating income (loss)   | 2,313          | 1,542      | 3,598          | (2,779 )   |
| Other income (expense)  | 354            | (254 )     | 537            | (642 )     |
| Earnings (loss) before income taxes                                       | 2,667          | 1,288      | 4,135          | (3,421 )   |
| Income tax expense  | 1,361          | 1,600      | 2,006          | 22         |
| Net earnings (loss)   | \$1,306        | \$(312 )   | \$2,129        | \$(3,443 ) |
| Basic earnings (loss) per share   | \$0.20         | \$(0.05 )  | \$0.32         | \$(0.52 )  |
| Diluted earnings (loss) per share   | \$0.19         | \$(0.05 )  | \$0.32         | \$(0.52 )  |
| Average outstanding shares used in per share calculations (in thousands): |                |            |                |            |
| Basic   | 6,691          | 6,666      | 6,687          | 6,658      |
| Diluted   | 6,714          | 6,666      | 6,706          | 6,658      |
| Dividends per share   | \$.08          | \$.06      | \$.14          | \$.18      |

See Notes to Unaudited Consolidated Financial Statements

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

|   | 26 Weeks Ended |            |
|---|----------------|------------|
|   | 12/25/2010     | 12/26/2009 |
| Cash flows from operating activities:                             |                |            |
| Net earnings (loss)   | \$2,129        | \$(3,443 ) |
| Non-cash items included:  |                |            |
| Depreciation  | 4,659          | 4,532      |
| Amortization  | 624            | 590        |
| Fixed asset impairment  | -              | 72         |
| Net long-term tax payable   | 104            | (454 )     |
| Deferred taxes  | 201            | (1,448 )   |
| Unrealized transaction (gains) losses                             | (113 )         | (303 )     |
| Retirement benefits   | 1,727          | 1,451      |
| Equity loss on investment in private software development company | 418            | —          |
| Working capital changes   |                |            |
| Receivables   | (1,617 )       | (2,727 )   |
| Inventories   | (3,489 )       | 10,900     |
| Other current assets  | (2,763 )       | 1,270      |
| Other current liabilities   | (1,851 )       | 1,556      |
| Prepaid pension cost and other                                    | 230            | (329 )     |
| Net cash provided by operating activities                         | 259            | 11,667     |
| Cash flows from investing activities:                             |                |            |
| Additions to plant and equipment                                  | (2,433 )       | (4,132 )   |
| Decrease in investments   | 1,250          | 618        |
| Earn out paid for Kinemetric Engineering                          | -              | (110 )     |
| Investment in private software development company                | (600 )         | -          |
| Net cash (used in) by investing activities                        | (1,783 )       | (3,624 )   |
| Cash flows from financing activities:                             |                |            |
| Proceeds from short-term borrowings                               | 3,385          | 14,049     |
| Short-term debt repayments  | (788 )         | (18,127 )  |
| Proceeds from long-term borrowings                                | -              | 129        |
| Long-term debt repayments   | (130 )         | (361 )     |
| Proceeds from common stock issued                                 | 139            | 260        |
| Dividends paid  | (936 )         | (1,199 )   |
| Net cash provided by (used in) financing activities               | 1,670          | (5,249 )   |
| Effect of exchange rate changes on cash                           | 1,001          | 295        |
| Net increase in cash  | 1,147          | 3,089      |
| Cash, beginning of period   | 20,478         | 10,248     |
| Cash, end of period   | \$21,625       | \$13,337   |

See Notes to Unaudited Consolidated Financial Statements



THE L. S. STARRETT COMPANY  
Consolidated Statements of Stockholders' Equity  
For the Twenty-six Weeks Ended December 25, 2010 and December 26, 2009  
(in thousands of dollars except per share data)(unaudited)

|  | Common Stock<br>Outstanding<br>(\$1 Par) |         | Addi-<br>tional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Com-prehensive<br>Loss | Total     |
|--|--|---------|---------------------------------------|----------------------|--|-----------|
|  | Class A                                  | Class B |                                       |                      |  |           |
| Balance June 27, 2009  | \$5,770                                  | \$869   | \$49,984                              | \$127,707            | \$ (41,452 )                                   | \$142,878 |
| Comprehensive income:  |  |         |                                       |                      |  |           |
| Net loss   |  |         |                                       | (3,443 )             |  | (3,443 )  |
| Unrealized net gain on<br>investments                                    |  |         |                                       |                      | 6  | 6         |
| Translation gain, net  |  |         |                                       |                      | 5,894  | 5,894     |
| Total comprehensive income   |  |         |                                       |                      |  | 2,457     |
| Dividends (\$.18 per share)  |  |         |                                       | (1,199 )             |  | (1,199 )  |
| Treasury shares:   |  |         |                                       |                      |  |           |
| Issued   | 29                                       |         | 222                                   |                      |  | 251       |
| Issuance of stock under ESPP   |  | 1       | 40                                    |                      |  | 41        |
| Conversion   | 13                                       | (13 )   |                                       |                      |  | 0         |
| Balance December 26, 2009  | \$5,812                                  | \$857   | \$50,246                              | \$123,065            | \$ (35,552 )                                   | \$144,428 |
| Balance June 26, 2010  | \$5,859                                  | \$821   | \$50,373                              | \$122,724            | \$ (47,395 )                                   | \$132,382 |
| Comprehensive income:  |  |         |                                       |                      |  |           |
| Net earnings   |  |         |                                       | 2,129                |  | 2,129     |
| Minimum pension liability  |  |         |                                       |                      | 78   | 78        |
| Translation gain, net  |  |         |                                       |                      | 4,986  | 4,986     |
| Total comprehensive income   |  |         |                                       |                      |  | 7,193     |
| Dividends (\$.14 per share)  |  |         |                                       | (936 )               |  | (936 )    |
| Treasury shares:   |  |         |                                       |                      |  |           |
| Issued   | 12                                       |         | 104                                   |                      |  | 116       |
| Issuance of stock under ESPP   |  | 2       | 54                                    |                      |  | 56        |
| Conversion   | 19                                       | (19 )   |                                       |                      |  |           |
| Balance December 25, 2010  | \$5,890                                  | \$804   | \$50,531                              | \$123,917            | \$ (42,331 )                                   | \$138,811 |
| Cumulative Balance:  |  |         |                                       |                      |  |           |
| Translation loss   |  |         |                                       |                      | (6,585 )                                       |           |
| Amounts not recognized as a<br>component of net periodic<br>benefit cost |  |         |                                       |                      | (35,746 )                                      |           |
|  |  |         |                                       |                      | \$ (42,331 )                                   |           |

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 financial statements contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position of the Company as of December 25, 2010 and June 26, 2010; the results of operations for the thirteen and twenty-six weeks ended December 25, 2010 and December 26, 2009; the cash flows for the twenty-six weeks ended December 25, 2010 and December 26, 2009; and changes in stockholders' equity for the twenty-six weeks ended December 25, 2010 and December 26, 2009.

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: Cash and 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 as set forth below. 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).
- o Level 2 - Financial assets whose values are based on quoted market prices in markets where trading occurs infrequently or whose values are based upon quoted prices of instruments with similar attributes in active markets.
- o Level 3 – Financial assets whose values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs reflect management's own view about the assumptions a market participant would use in pricing the asset.

As of December 25, 2010 and June 26, 2010, the Company's Level 1 financials assets were as follows (in thousands):

|   | Level 1    |           |
|---|------------|-----------|
|   | 12/25/2010 | 6/26/2010 |
| International Bonds (Puerto Rican Debt Obligations) | -          | \$1,250   |
|   | -          | \$1,250   |

As of December 25, 2010 and June 26, 2010, the Company did not have any Level 2 or 3 financial assets.



## Note 3: Inventory (in thousands)

|                                     | Dec 25<br>2010 | June 26<br>2010 |
|-------------------------------------|----------------|-----------------|
| Raw Material & Supplies             | \$ 32,011      | \$ 27,251       |
| Goods in Process and Finished Parts | 21,216         | 19,136          |
| Finished Goods                      | 22,943         | 24,960          |
|                                     | 76,170         | 71,347          |
| LIFO Reserve                        | (24,692 )      | (25,191 )       |
| Net Inventory                       | \$ 51,478      | \$ 46,156       |

LIFO inventories were \$12.7 million and \$12.3 million at December 25, 2010 and June 26, 2010, respectively, such amounts being approximately \$24.7 million and \$25.2 million, respectively, less than if determined on a FIFO basis. The impact of LIFO on a year-to-date second quarter basis was a \$0.5 million reduction in cost of sales in fiscal 2011 compared to a \$2.1 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 December |          | Twenty-six Weeks<br>Ended December |          |
|------------------------------------|----------------------------------|----------|------------------------------------|----------|
|                                    | 2010                             | 2009     | 2010                               | 2009     |
| Service cost                       | \$575                            | \$486    | \$1,149                            | \$973    |
| Interest cost                      | 1,618                            | 1,574    | 3,229                              | 3,154    |
| Expected return on plan assets     | (1,866 )                         | (1,783 ) | (3,727 )                           | (3,571 ) |
| Amortization of prior service cost | 157                              | 96       | 314                                | 192      |
| Amortization of unrecognized loss  | 680                              | 701      | 1,360                              | 1,403    |
|                                    | \$1,164                          | \$1,074  | \$2,325                            | \$2,151  |

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

|                                       | Thirteen Weeks<br>Ended December |        | Twenty-six Weeks<br>Ended December |        |
|---------------------------------------|----------------------------------|--------|------------------------------------|--------|
|                                       | 2010                             | 2009   | 2010                               | 2009   |
| Service cost                          | \$92                             | \$85   | \$184                              | \$169  |
| Interest cost                         | 151                              | 169    | 302                                | 339    |
| Amortization of prior service benefit | (226 )                           | (226 ) | (453 )                             | (453 ) |
| Amortization of unrecognized loss     | 7                                | -      | 14                                 | -      |
|                                       | \$24                             | \$28   | \$47                               | \$55   |

## Note 5: Notes payable and current maturities

Notes payable and current maturities are comprised of the following (in thousands):

|                                    | December 25,<br>2010 | June 26,<br>2010 |
|------------------------------------|----------------------|------------------|
| Loan and Security Agreement        | \$5,000              | \$1,700          |
| Short-term foreign credit facility | 47                   | 730              |
| Other                              | 259                  | 266              |
|                                    | \$5,306              | \$2,696          |

## 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 December 25, 2010, the Company did not have any income tax audits in progress in the numerous federal, state, local and international jurisdictions in which we operate. In international jurisdictions including Argentina, Australia, Brazil, Canada, China, UK, Germany, New Zealand, Dominican Republic 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 Company has identified no new uncertain tax positions during the twenty six week period ended December 25, 2010 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 its tax operating loss carry forward assets.

The effective tax rate for fiscal 2011 second quarter was 51%. Excluding the valuation allowance for Argentina of \$463 thousand, which is discussed below, the effective tax rate would have been 34%.

Based upon government regulations and updated business conditions in Argentina, the company recorded a \$463 thousand valuation allowance against a deferred tax asset in the second quarter of fiscal 2011.

## 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 Long term 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 on quoted market prices for the same or similar issues or on the current rates offered to the Company for debt of the same remaining maturities.

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

|                 | December 25, 2010 |            | June 26, 2010   |            |
|-----------------|-------------------|------------|-----------------|------------|
|                 | Carrying Amount   | Fair Value | Carrying Amount | Fair Value |
| Cash            | \$21,625          | \$21,625   | \$20,478        | \$20,478   |
| Short term debt | 5,306             | 5,306      | 2,696           | 2,696      |
| Investments     | -                 | -          | 1,250           | 1,250      |
| Long term debt  | 587               | 587        | 706             | 706        |

#### Note 8: Investment

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 will invest \$1.5 million over twelve to eighteen months and will receive 36% equity in the software development company. The Company has invested \$0.85 million and, in the second quarter of fiscal 2011, recorded a \$0.4 million loss under the equity method of accounting, such loss is included in other income (expense) in the Consolidated Statement of Operations. The \$0.45 million net carrying value of the investment as of December 25, 2010 is included in other long term assets in the Consolidated Balance Sheet.

#### Note 9: Subsequent Events

The Company has evaluated events occurring subsequent to December 25, 2010 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 DECEMBER 25, 2010 AND DECEMBER 26, 2009

##### Overview

Net sales increased \$6.8 million or 13.4% from \$50.5 million to \$57.3 million. A weaker U. S. dollar translated into a \$0.5 million of the revenue increase. Operating income improved \$0.8 million as a \$2.8 million improvement in gross margin more than offset a \$2.0 million increase in selling and general expenses. Net income increased \$1.6 million from a loss of \$0.3 million (\$0.05 per share) in the fiscal 2010 quarter compared to a profit of \$1.3 million (\$0.20 per share) in the fiscal 2011 quarter, principally due to aforementioned reasons and a lower effective tax rate.

##### Net Sales

Net sales in North America increased \$4.4 million or 19% from \$23.4 million to \$27.8 million as strong gains in the industrial sector more than offset declines in the construction markets. International net sales increased \$2.4 million or 9% from \$27.1 million to \$29.5 million, led by Southeast Asia and South America.

##### Gross Margin

Gross margin improved \$2.8 million from \$15.9 million (31.5% of revenue) to \$18.7 million (32.6% of revenue) with North America and International posting gains of \$0.9 million and \$1.9 million, respectively. North American gross



margins as a percentage of revenue declined 1.5% from 29.9% to 28.4% as a \$1.3 million volume increase was offset by a \$0.4 million margin erosion. This decrease in margin was the result of an unfavorable product mix and increased labor costs. International gross margins improved 3.8% from 32.8% to 36.6% principally as a result of improved efficiencies driven by increased sales revenue.

#### Selling and General Expenses

Selling and general expenses increased \$2.0 million or 14% from \$14.4 million to \$16.4 million with North America and International posting increases of \$1.4 and \$0.6 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 driver in the International increase.

#### Earnings Before Taxes

Earnings before taxes increased \$1.4 million from \$1.3 million in fiscal 2010 to \$2.7 million in fiscal 2011. In the second quarter of fiscal 2011, the Company prevailed on an outstanding non-income tax lawsuit with the Brazilian government resulting in a \$0.9 million gain. This gain has been recorded in the second quarter as a \$0.4 million reduction in selling and general expenses and \$0.5 million increase in interest income, which is included in other income (expense). The improvement was the result of a \$0.8 million gain in operating income and a \$0.6 million favorable swing in other income. The primary factors influencing the improved other income were lower interest expense and lower foreign exchange losses offsetting a \$0.4 million equity loss in a private software development company.

#### SIX MONTHS ENDED DECEMBER 25, 2010 AND DECEMBER 26, 2009

#### Overview

Net sales increased \$23.7 million or 26% from \$91.1 million to \$114.8 million. A weaker U. S. dollar translated into \$2.4 million or 10% of the revenue gain. Operating income increased \$6.4 million as an increase in gross margins more than offset higher selling and general expenses.

#### Net Sales

Net sales in North America increased \$11.8 million or 27% as a continued recovery in the industrial sector mitigated a decline in the construction market. Increased demand for precision tools and capital equipment from our Tru-Stone and Kinematic divisions led the North American performance. International net sales increased \$11.9 million or 25% due to the relative strength of the South American and Southeast Asia regions.

#### Gross Margin

Gross margins increased \$11.4 million or 44% with volume representing \$6.7 million and improved margins accounting for \$4.7 million. North American margins improved 5.2% from 23.6% to 28.8% largely due to a favorable product mix led by a strong recovery by the Tru Stone division. International margins improved 3.0% from 33.0% to 36.0% led by a 2.6% improvement in Brazil.

#### Selling and General Expenses

Selling and general expenses increased \$5.0 million or 18% with North America and International posting increases of \$2.6 million and \$2.4 million, respectively. 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 driver resulting in the International expense increase.

#### Earnings Before Taxes

Earning before taxes increased \$7.6 million from a loss of \$3.4 million in fiscal 2010 to a profit of \$4.1 million in fiscal 2011. The improvement was the result of a \$6.4 million gain in operating income and a \$1.2 million favorable swing in other income. The improved other income was due to lower interest expense coupled with lower foreign exchange losses offsetting \$0.4 million equity loss in a private software development company.



## LIQUIDITY AND CAPITAL RESOURCES

| Cash flows (in thousands)                         | 26 Weeks Ended |          |
|---|----------------|----------|
|   | 12/25/10       | 12/26/09 |
| Cash provided by operations                       | \$259          | \$11,667 |
| Cash (used in) from investing activities          | (1,783)        | (3,624)  |
| Cash provided (used in) from financing activities | 1,670          | (5,249)  |
| Effect of exchange rates changes on cash          | 1,001          | 295      |
| Net increase in cash                              | \$1,147        | \$3,089  |

Cash increased \$1.1 million as increased borrowings and favorable foreign exchange more than offset higher working capital requirements. The \$11.4 million swing in cash provided by operations from \$11.6 million in fiscal 2010 to \$0.3 million in fiscal 2011 was due to the economic recovery resulting in an increase in accounts receivables of \$4.4 million related to higher sales and increased inventories of \$14.4 million to support revenue growth partially offset by higher net income of \$5.6 million.

## 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, \$5.0 million was outstanding as of December 25, 2010. This Loan and Security agreement matures as of April 30, 2012. The Loan and Security agreement was modified in the second quarter of fiscal 2011 and amends certain financial covenants. As of December 25, 2010, the Company is in compliance with all debt covenants related to its Loan and Security Agreement. The effective interest rate on the Loan and Security agreement through December 26, 2010 was 2.4%.

## 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 December 25, 2010 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 have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting, except as discussed below.

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 December 25, 2010. 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 1. Legal Proceedings

On December 15, 2010, the Company successfully settled an outstanding lawsuit with the Brazilian government. Under the terms of the agreement, the Brazilian government agreed to the Company's tax position regarding tax on sales revenues.

### 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.

### Item 6. Exhibits

31a Certification of Chief Executive Officer Pursuant to Rules 13a-15(e)/15(d)-15(e) and 13a-15(f)/15(d)-15(f), filed herewith.

31b Certification of Principal Accounting Officer Pursuant to Rules 13a-15(e)/15(d)-15(e) and 13a-15(f)/15(d)-15(f), filed herewith.

32 Certification of Chief Executive Officer and Principal Accounting Officer Pursuant to Rule 13a-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code), filed herewith.

## 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

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(Registrant)

Date February 3, 2011

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

Date February 3, 2011

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