KATY INDUSTRIES INC
Form 10-Q
May 13, 2008

United States
Securities and Exchange Commission
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: March 31, 2008

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 001-05558

Katy Industries, Inc.
(Exact name of registrant as specified in its charter)

Delaware	75-1277589
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2461 South Clark Street, Suite 630, Arlington, Virginia 22202
(Address of principal executive offices) (Zip Code)
Registrant's telephone number, including area code: (703) 236-4300

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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

Class	Outstanding at April 30, 2008
Common Stock, $1 Par Value	7,951,176 Shares

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

KATY INDUSTRIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
AS OF MARCH 31, 2008 (UNAUDITED) AND DECEMBER 31, 2007
(Amounts in Thousands)

ASSETS

	March 31, 2008	December 31, 2007
CURRENT ASSETS:		
Cash and cash equivalents	$ 618	$ 2,015
Accounts receivable, net	19,868	18,077
Inventories, net	25,150	26,160
Receivable from disposition	3,553	6,799
Other current assets	2,064	2,520
Total current assets	51,253	55,571
OTHER ASSETS:		
Goodwill	665	665
Intangibles, net	4,733	4,853
Other	2,959	3,470
Total other assets	8,357	8,988
PROPERTY AND EQUIPMENT:		
Land and improvements	336	336
Buildings and improvements	9,697	9,666
Machinery and equipment	95,801	96,650
	105,834	106,652
Less - Accumulated depreciation	(73,090)	(72,647)
Property and equipment, net	32,744	34,005
Total assets	$ 92,354	$ 98,564

See Notes to Condensed Consolidated Financial Statements.

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KATY INDUSTRIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
AS OF MARCH 31, 2008 (UNAUDITED) AND DECEMBER 31, 2007
(Amounts in Thousands, Except Share Data)

LIABILITIES AND STOCKHOLDERS' EQUITY

	March 31, 2008	December 31, 2007
CURRENT LIABILITIES:		
Accounts payable	$ 11,340	$ 14,995
Accrued compensation	2,725	2,629
Accrued expenses	21,159	22,325
Current maturities of long-term debt	1,500	1,500
Revolving credit agreement	5,794	2,853
Total current liabilities	42,518	44,302
LONG-TERM DEBT, less current maturities	8,701	9,100
OTHER LIABILITIES	8,241	8,706
Total liabilities	59,460	62,108
COMMITMENTS AND CONTINGENCIES (Note 9)	0	0
STOCKHOLDERS' EQUITY:		
15% Convertible preferred stock, $100 par value, authorized 1,200,000 shares, issued and outstanding 1,131,551 shares, liquidation value $113,155	108,256	108,256
Common stock, $1 par value; authorized 35,000,000 shares; issued 9,822,304 shares	9,822	9,822
Additional paid-in capital	27,375	27,338
Accumulated other comprehensive loss	(1,277)	(1,112)
Accumulated deficit	(89,349)	(85,915)
Treasury stock, at cost, 1,871,128 shares	(21,933)	(21,933)
Total stockholders' equity	32,894	36,456
Total liabilities and stockholders' equity	$ 92,354	$ 98,564

See Notes to Condensed Consolidated Financial Statements.

KATY INDUSTRIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED MARCH 31, 2008 AND 2007
(Amounts in Thousands, Except Share and Per Share Data)
(Unaudited)

	2008	2007
Net sales	$ 41,691	$ 45,552
Cost of goods sold	37,863	39,956
Gross profit	3,828	5,596
Selling, general and administrative expenses	6,737	7,574
Severance, restructuring and related charges	138	208
Loss (gain) on sale of assets	533	(120)
Operating loss	(3,580)	(2,066)
Interest expense	(483)	(1,195)
Other, net	(14)	32
Loss from continuing operations before benefit from (provision for) income taxes	(4,077)	(3,229)
Benefit from (provision for) income taxes from continuing operations	352	(89)
Loss from continuing operations	(3,725)	(3,318)
Loss from operations of discontinued businesses (net of tax)	(252)	(2,127)
Gain on sale of discontinued businesses (net of tax)	543	1,666
Net loss	$ (3,434)	$ (3,779)
Loss per share of common stock - Basic and diluted		
Loss from continuing operations	$ (0.47)	$ (0.42)
Discontinued operations	0.04	(0.06)
Net loss	$ (0.43)	$ (0.48)
Weighted average common shares outstanding (thousands):		
Basic and diluted	7,951	7,951

See Notes to Condensed Consolidated Financial Statements.

KATY INDUSTRIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED MARCH 31, 2008 AND 2007
(Amounts in Thousands)
(Unaudited)

	2008	2007
Cash flows from operating activities:		
Net loss	$ (3,434)	$ (3,779)
(Income) loss from discontinued operations	(291)	461
Loss from continuing operations	(3,725)	(3,318)
Depreciation and amortization	1,823	1,865
Write-off and amortization of debt issuance costs	96	619
Stock option expense	37	94
Loss (gain) on sale of assets	533	(120)
Deferred income taxes	-	(94)
	(1,236)	(954)
Changes in operating assets and liabilities:		
Accounts receivable	(1,833)	(2,075)
Inventories	928	(807)
Other assets	134	77
Accounts payable	(1,489)	261
Accrued expenses	(1,017)	(1,995)
Other, net	(363)	843
	(3,640)	(3,696)
Net cash used in continuing operations	(4,876)	(4,650)
Net cash used in discontinued operations	(320)	(195)
Net cash used in operating activities	(5,196)	(4,845)
Cash flows from investing activities:		
Capital expenditures of continuing operations	(1,037)	(979)
Proceeds from sale of assets, net	35	120
Net cash used in continuing operations	(1,002)	(859)
Net cash provided by discontinued operations	4,424	5,995
Net cash provided by investing activities	3,422	5,136
Cash flows from financing activities:		
Net borrowings (repayments) on revolving loans	2,940	(2,388)
Decrease in book overdraft	(2,110)	(2,123)
Repayments of term loans	(399)	(24)
Direct costs associated with debt facilities	-	(125)
Repurchases of common stock	-	(3)
Net cash provided by (used in) continuing operations	431	(4,663)
Net cash used in discontinued operations	-	(97)
Net cash provided by (used in) financing activities	431	(4,760)
Effect of exchange rate changes on cash and cash equivalents	(54)	(4)

Net decrease in cash and cash equivalents	(1,397)	(4,473)
Cash and cash equivalents, beginning of period	2,015	7,392
Cash and cash equivalents, end of period	$ 618	$ 2,919

See Notes to Condensed Consolidated Financial Statements.

KATY INDUSTRIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2008
(Unaudited)

(1) Restatement of Prior Financial Information

As a result of accounting errors in the Company's raw material inventory records, management and the Company's Audit Committee determined on August 6, 2007 that the Company's previously issued consolidated financial statements for the three months ended March 31, 2007 should no longer be relied upon. The Company's decision to restate its consolidated financial statements was based on facts obtained by management and the results of an independent investigation of the physical raw material inventory counting process at Continental Commercial Products, LLP ("CCP"). These procedures resulted in the identification of the overstatement of raw material inventory when completing the physical inventory. At the time of the physical inventories, the Company did not have sufficient controls in place to ensure that the accurate physical raw material inventory on hand was properly accounted for and reported in the proper period. The Company filed on August 17, 2007 an amended Quarterly Report on Form 10-Q/A as of March 31, 2007 in order to restate the consolidated financial statements. All amounts included in this Quarterly Report for the above period have been properly reflected for the restatement.

(2) Significant Accounting Policies

Consolidation Policy and Basis of Presentation
The condensed consolidated financial statements include the accounts of Katy Industries, Inc. and subsidiaries in which it has a greater than 50% interest, collectively "Katy" or the Company. All significant intercompany accounts, profits and transactions have been eliminated in consolidation. Investments in affiliates which do not meet the criteria of a variable interest entity, and which are not majority owned but with respect to which the Company exercises significant influence, are reported using the equity method. The condensed consolidated financial statements at March 31, 2008 and December 31, 2007 and for the three month periods ended March 31, 2008 and 2007 are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial condition and results of operations of the Company. Interim results may not be indicative of results to be realized for the entire year. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto, together with management's discussion and analysis of financial condition and results of operations, contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. The condensed balance sheet as of December 31, 2007 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States ("GAAP").

Use of Estimates and Reclassifications
The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Certain reclassifications associated with the presentation of discontinued operations were made to the 2007 amounts in order to conform to the 2008 presentation.

Inventories
The components of inventories are as follows (amounts in thousands):

	March 31, 2008	December 31, 2007
Raw materials	$ 14,997	$ 17,022
Work in process	762	763
Finished goods	15,088	13,762
Inventory reserves	(1,340)	(1,376)
LIFO reserve	(4,357)	(4,011)
	$ 25,150	$ 26,160

At March 31, 2008 and December 31, 2007, approximately 56% and 62%, respectively, of Katy's inventories were accounted for using the last-in, first-out ("LIFO") method of costing, while the remaining inventories were accounted for using the first-in, first-out ("FIFO") method. Current cost, as determined using the FIFO method, exceeded LIFO cost by $4.4 million and $4.0 million at March 31, 2008 and December 31, 2007, respectively.

Property, Plant and Equipment
Property and equipment are stated at cost and depreciated over their estimated useful lives: buildings (10-40 years) using the straight-line method; machinery and equipment (3-20 years) using the straight-line method; tooling (5 years) using the straight-line method; and leasehold improvements using the straight-line method over the remaining lease period or useful life, if shorter. Costs for repair and maintenance of machinery and equipment are expensed as incurred, unless the result significantly increases the useful life or functionality of the asset, in which case capitalization is considered. Depreciation expense from continuing operations was $1.7 million and $1.7 million for the three month periods ended March 31, 2008 and 2007, respectively.

With leases expiring on December 31, 2008 for our largest facility in Bridgeton, Missouri, the Company anticipates exploring alternative options which will utilize significantly less square footage in order to improve the overhead cost structure. As a result, the Company anticipates incurring approximately $1.2 million in the non-cash write off of fixed assets for assets expected to be sold or abandoned in 2008. For the three month period ended March 31, 2008, the Company recognized a $0.5 million loss on the sale of fixed assets and $0.1 million in accelerated depreciation associated with this activity.

Stock Options and Other Stock Awards
On January 1, 2006, the Company adopted Statement of Financial Accounting Standard ("SFAS") No. 123R, Share-Based Payment ("SFAS No. 123R") using the modified prospective method. Under this method, compensation cost recognized during the three month periods ended March 31, 2008 and 2007 includes: a) compensation cost for all stock options granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with SFAS No. 123R amortized over the options' vesting period and b) compensation cost for outstanding stock appreciation rights based on the March 31 fair value estimated in accordance with SFAS No. 123R.

Compensation (income) expense is included in selling, general and administrative expense in the Condensed Consolidated Statements of Operations. The components of compensation (income) expense are as follows:

	Three Months Ended March 31, 2008		Three Months Ended March 31, 2007	
Stock option expense	$	37	$	94
Stock appreciation right income		(164)		(179)
	$	(127)	$	(85)

The fair value for stock options was estimated at the date of grant using a Black-Scholes option pricing model. The Company used the simplified method, as allowed by Staff Accounting Bulletin ("SAB") No. 107, Share-Based Payment, for estimating the expected term by averaging the minimum and maximum lives expected for each award. In addition, the Company estimated volatility by considering its historical stock volatility over a term comparable to the remaining expected life of each award. The risk-free interest rate was the current yield available on U.S. treasury rates with issues with a remaining term equal in term to each award. The Company estimates forfeitures using historical results. The Company's estimates of forfeitures will be adjusted over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from their estimate. The assumptions for expected term, volatility and risk-free rate are presented in the table below:

Expected term (years)	5.3 - 6.5
Volatility	53.8% - 57.6%
Risk-free rate	3.98% - 4.48%

The fair value for stock appreciation rights, a liability award, was estimated at the effective date of SFAS No. 123R, and March 31, 2008 and 2007, using a Black-Scholes option pricing model. The Company estimated the expected term by averaging the minimum and maximum lives expected for each award. In addition, the Company estimated volatility by considering its historical stock volatility over a term comparable to the remaining expected life of each award. The risk-free interest rate was the current yield available on U.S. treasury rates with issues with a remaining term equal in term to each award. The Company estimates forfeitures using historical results. The Company's estimates of forfeitures will be adjusted over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from their estimate. The assumptions for expected term, volatility and risk-free rate are presented in the table below:

	March 31, 2008	March 31, 2007
Expected term (years)	3.0 - 4.5	3.0 - 5.3
Volatility	92.3% - 105.1%	53.7% - 58.6%
Risk-free rate	1.79% - 2.13%	4.54%

Comprehensive Loss
The components of comprehensive loss are as follows (amounts in thousands):

	Three Months Ended March 31,			
	2008		2007	
Net loss	$	(3,434)	$	(3,779)
Foreign currency translation losses		(165)		(334)
Unrealized losses on interest rate swap		-		(29)
Pension and other postretirement benefits		-		(17)
		(165)		(380)
Comprehensive loss	$	(3,599)	$	(4,159)

(3) New Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141 (revised 2007), Business Combinations ("SFAS No. 141R"). SFAS No. 141R establishes principles and requirements for how an acquirer in a business combination (a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (b) recognizes and measures the goodwill acquired in a business combination or a gain from a bargain purchase, and (c) determines what information to disclose to enable users of financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141R will be applied prospectively to business combinations that have an acquisition date on or after January 1, 2009. The provisions of SFAS 141R will not impact the Company's consolidated financial statements for prior periods.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements-an amendment of ARB No. 51 ("SFAS No. 160"). SFAS No. 160 requires the recognition of a noncontrolling interest, or minority interest, as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. SFAS No. 160 also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. For the Company, SFAS No. 160 is effective January 1, 2009. The Company is currently evaluating the impact this statement may have in its future financial statements.

(4) Intangible Assets

Following is detailed information regarding Katy’s intangible assets (amounts in thousands):

	March 31, 2008			December 31, 2007		
	Gross Amount	Accumulated Amortization	Net Carrying Amount	Gross Amount	Accumulated Amortization	Net Carrying Amount
Patents	$ 1,044					