SHOPSMITH INC
Form 10-Q
February 13, 2004

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant To Section 13 or 15 (d)
of the Securities Exchange Act of 1934

For the quarterly period ended January 3, 2004 Commission File Number 0-9318

SHOPSMITH, INC

(Exact Name of Registrant as
specified in its charter)

Ohio	31-0811466
(State of Incorporation)	(IRS Employer Identification No.)
6530 Poe Avenue Dayton, Ohio	45414
(Address of Principal Executive Offices)	(Zip Code)

Registrant s Telephone Number 937-898-6070

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 ___

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes ___ No _X_

Indicate the number of shares outstanding of each of the registrant s classes of common stock as of January 23, 2004.

Common shares, without par value: 2,605,233 shares.

TABLE OF CONTENTS

CONSOLIDATED BALANCE SHEETS
CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT
CONSOLIDATED STATEMENTS OF CASH FLOWS
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Item 2. Management_s Discussion and Analysis of Financial Condition and Results of Operations
Item 4. Controls and Procedures.
PART II. OTHER INFORMATION
Item 2. Changes in Securities and Use of Proceeds
Item 6. Exhibits and Reports on Form 8-K
SIGNATURES
EX-31.1
EX-31.2
EX-32.1
EX-32.2

Table of Contents

SHOPSMITH, INC. AND SUBSIDIARIES

INDEX

		Page No.
Part I. Financial Information:		
Item 1.	Financial Statements	
	Consolidated Balance Sheets January 3, 2004 and April 5, 2003	3-4
	Consolidated Statements of Operations and Deficit Three Months and Nine Months Ended January 3, 2004 and December 28, 2002	5
	Consolidated Statements of Cash Flows Nine Months Ended January 3, 2004 and December 28, 2002	6
	Notes to Consolidated Financial Statements	7-8
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	9-10
Item 4.	Controls and Procedures	11
Part II. Other Information		
Item 2.	Changes in Securities and Use of Proceeds	12
Item 6.	Exhibits and Reports on Form 8-K	12

Table of Contents

Part I FINANCIAL INFORMATION

SHOPSMITH, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	January 3, 2004 (Unaudited)	April 5, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 800	$ 250,316
Accounts receivable:		
Trade, less allowance for doubtful accounts:		
$362,212 on January 3, 2004 and $915,489 on April 5, 2003	999,159	1,395,660
Inventories:		
Finished products	853,724	856,629
Raw materials and work in process	1,327,442	1,098,679
Total inventories	2,181,166	1,955,308
Prepaid expenses	240,260	209,072
Total current assets	3,421,385	3,810,356
Properties:		
Land, building and improvements	3,150,298	3,148,348
Machinery, equipment and tooling	6,777,449	6,723,950
Total cost	9,927,747	9,872,298
Less, accumulated depreciation and amortization	7,331,053	7,213,852
Net properties	2,596,694	2,658,446
Long-term portion of accounts receivable trade, less allowance for doubtful accounts:		
$250,111 on January 3, 2004 and $205,709 on April 5, 2003	681,823	577,080
Other assets	3,128	3,128
Total assets	$6,703,030	$7,049,010

Continued

Table of Contents

SHOPSMITH, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	January 3, 2004 (Unaudited)	April 5, 2003
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$1,232,894	$ 949,801
Note payable		400,000
Current portion of long-term debt and capital lease obligation	106,395	105,458
Customer advances	78,197	65,489
Accrued liabilities:		
Compensation, employee benefits and payroll taxes	251,425	396,573
Sales taxes payable	60,866	64,177
Accrued recourse liability	311,768	351,055
Accrued expenses	300,856	273,605
Other	52,500	72,921
Total current liabilities	2,394,901	2,679,079
Long-term debt and capital lease obligation	2,294,037	2,374,220
Total liabilities	4,688,938	5,053,299
Shareholders equity:		
Preferred shares- without par value; authorized 500,000; none issued Common shares- without par value; authorized 5,000,000; issued and outstanding 2,605,233	2,806,482	2,806,482
Deficit	(792,390)	(810,771)
Total shareholders equity	2,014,092	1,995,711
Total liabilities and shareholders equity	$6,703,030	$7,049,010

See notes to consolidated financial statements.

Table of Contents

SHOPSMITH, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

	Three Months Ended		Nine Months Ended	
	January 3, 2004 (Unaudited)	December 28, 2002 (Unaudited)	January 3, 2004 (Unaudited)	December 28, 2002 (Unaudited)
Net sales	$3,645,732	$3,986,866	$9,932,570	$10,608,638
Cost of products sold	1,795,158	2,039,175	4,890,152	5,192,364
Gross margin	1,850,574	1,947,691	5,042,418	5,416,274
Selling expenses	1,410,002	1,446,248	3,695,276	3,919,028
Administrative expenses	418,114	456,423	1,282,344	1,232,283
Total operating expenses	1,828,116	1,902,671	4,977,620	5,151,311
Income before other income and expense	22,458	45,020	64,798	264,963
Interest income	53,081	35,658	140,242	85,902
Interest expense	53,145	82,664	186,164	255,481
Other income, net	1,557	1,986	4,386	4,616
Income before income taxes	23,951		23,262	100,000
Income tax expense			4,881	
Net income	23,951		18,381	100,000
Deficit:				
Beginning	(816,341)	(810,771)	(810,771)	(910,771)
Ending	$ (792,390)	$ (810,771)	$ (792,390)	$ (810,771)
Net income per common share (Note 3)				
Basic	$ 0.01	$	$ 0.01	$ 0.04
Diluted	$ 0.01	$	$ 0.01	$ 0.04

See notes to consolidated financial statements.

Table of Contents

SHOPSMITH, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended	
	January 3, 2004 (Unaudited)	December 28, 2002 (Unaudited)
Cash flows from operating activities:		
Net Income	$ 18,381	$ 100,000
Adjustments to reconcile net Income to cash from operating activities:		
Depreciation and amortization	117,201	145,286
Provision for doubtful accounts	212,815	189,813
Changes in operating assets and liabilities:		
Restricted cash		126,645
Accounts receivable	78,943	(542,542)
Inventories	(225,858)	(36,529)
Prepaid expenses	(31,188)	41,485
Accounts payable and customer advances	295,801	(95,024)
Other current liabilities	(180,916)	84,755
Cash from operating activities	285,179	13,889
Cash flows from investing activities:		
Property additions	(55,449)	(11,875)
Cash (used in) investing activities	(55,449)	(11,875)
Cash flows from financing activities:		
Payments on note payable	(400,000)	
Payments on long-term debt and capital lease obligation	(79,246)	(77,513)
Cash (used in) financing activities	(479,246)	(77,513)
Net decrease in cash	(249,516)	(75,499)
Cash and cash equivalents:		
At beginning of period	250,316	76,324
At end of period	$ 800	$ 825

See notes to consolidated financial statements.

Table of Contents

SHOPSMITH, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. In the opinion of management, all adjustments (consisting of only normal and recurring adjustments) have been made as of January 3, 2004 and December 28, 2002 to present the financial statements fairly. However, the results of operations for the nine months then ended are not necessarily indicative of results for the full fiscal year. The financial statements and notes are presented as permitted by Form 10-Q, and do not contain certain information included in the annual financial statements. The financial statements accompanying this report should be read in conjunction with the financial statements and notes thereto included in the Annual Report to Shareholders for the year ended April 5, 2003.

2. Taxable income for the three and nine months ended January 3, 2004 and for the nine months ended December 28, 2002 was offset by a net operating loss carryforward. The tax expense shown for the nine months ended January 3, 2004 relates to a provision for alternative minimum tax.

3. Basic income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted income per share reflects per share amounts that would have resulted if dilutive stock options had been converted into common stock. The following reconciles amounts reported in the financial statements:

	Three Months Ended		Nine Months Ended	
	January 3, 2004	December 28, 2002	January 3, 2004	December 28, 2002
Net income	$ 23,951	$	$ 18,381	$ 100,000
Weighted average shares	2,605,233	2,605,233	2,605,233	2,605,233
Additional dilutive shares	22,500		3,762	
Total dilutive shares	2,627,733	2,605,233	2,608,995	2,605,233
Basic income per share	$ 0.01	$	$ 0.01	$ 0.04
Diluted income per share	$ 0.01	$	$ 0.01	$ 0.04

There were no additional dilutive shares included in the computation for the periods ended December 28, 2002 because the stock options were anti-dilutive.

Table of Contents

4. During fiscal 2002, Shopsmith entered into an arrangement with John R. Folkerth, the Company s CEO, which allowed the Company to borrow up to $500,000 with interest at twelve percent. The maximum authorized borrowing was increased to $600,000 in July 2002. Substantially all personal property except for certain receivables was pledged as collateral. Interest was due monthly and the note was payable on demand. At April 5, 2003, there was $400,000 outstanding under this arrangement. Borrowings from Mr. Folkerth were subject to Mr. Folkerth s approval and were payable upon demand by Mr. Folkerth. The note payable was paid in full on July 31, 2003.

5. On December 31, 2002, Shopsmith entered into a loan agreement with Provident Bank which allows the Company to borrow up to the lesser of $750,000 or 80% of eligible receivables due from Lowes Companies, Inc., with interest charged at one and one-half percent over the bank s prime rate. On July 17, 2003, this agreement was amended to allow borrowings up to $1,400,000. The agreement requires compliance with certain net income, net worth, and miscellaneous covenants. Substantially all personal property is pledged as collateral. At January 3, 2004, there were no amounts outstanding under this agreement.

6. A major retailer represented 40% and 37% of net sales for the quarters ended January 3, 2004 and December 28, 2002, respectively. This retailer also represented 38% and 42% of trade accounts receivable at January 3, 2004 and April 5, 2003, respectively.

7. In May 2002, Shopsmith had implemented an employee salary reduction plan. Reductions under this plan continued through December 2002. As part of this plan, fiscal 2003 pre-tax income above $100,000 was used to return the amount of the reduction to the employees and if income had permitted, to pay an additional incentive equal to the amount of the reduction. Fiscal 2003 income levels permitted approximately $70,000 or 76% of the reduction to be returned. This amount was paid during the quarter ended July 5, 2003, and no further liabilities exist under the plan.

8. The Company has adopted the disclosure only provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, and, accordingly, accounts for its stock option plans using the intrinsic value method of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees.

The following table illustrates the effect on net income and earnings per share if compensation expense was measured using the fair value recognition provisions of SFAS No. 123.

	Three Months Ended		Nine Months Ended	
	January 3, 2004	December 28, 2002	January 3, 2004	December 28, 2002
Net income as reported	$ 23,951	$	$18,381	$100,000
Net income pro forma	$ 23,951	$	$18,381	$ 80,000
Diluted earnings per share as reported	$ 0.01	$	$ 0.01	$ 0.04
Diluted earnings per share pro forma	$ 0.01	$	$ 0.01	$ 0.03

9. New Accounting Pronouncements In May 2003, the Financial Accounting Standards Board (FASB) issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity . SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial

instruments with characteristics of both liabilities and equity. SFAS No. 150 was effective for financial instruments entered into or modified after May 31, 2003, and otherwise was effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this statement did not have an impact on the Company s consolidated financial statements.

In January 2003, the FASB issued FIN 46, Consolidation of Variable Interest Entities . This standard clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements , and addresses consolidation by business enterprises of variable interest entities. FIN 46 requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risk among the parties involved. FIN 46 also enhances the disclosure requirements related to variable interest entities. This statement was effective for the Company on October 4, 2003 for variable interest entities created or in which an enterprise obtains an interest after January 31, 2003. FIN 46 is effective for the Company beginning January 4, 2004 for all interest in variable interest entities acquired before February 1, 2003. The adoption of this statement did not have an impact on the Company s consolidated financial statements.

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

General

Shopsmith manufactures and sells woodworking products. Our core product, the Mark V, is sold directly to consumers through demonstration sales events and indirectly to consumers through distributors (primarily Lowe s where Shopsmith also conducts sales demonstrations), along with smaller amounts through other efforts. Mark V sales demonstrations are performed in shopping malls, at home shows, and at state fairs. Other woodworking products and accessories are sold through mail and Internet channels. Shopsmith recognizes revenue for these orders at the time of product shipment.

Critical Accounting Policies And Estimates

The financial condition and results of operations for Shopsmith presented in the Consolidated Financial Statements, accompanying notes , selected financial data appearing elsewhere within this report, and management s discussion and analysis are dependent upon the Company s accounting policies. The selection and application of these accounting policies involve judgements, estimates, and uncertainties that are susceptible to change. In management s opinion, the Company s critical accounting policies include the allowance for doubtful accounts and accrued recourse liability.

Allowance For Doubtful Accounts

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Customer accounts are stratified by type of account, original credit rating, and recent payment history. Estimated loss rates are then applied to these groups. Deterioration of our customers ability to make payments could require additions to the allowance.

Accounts repurchased under the recourse provision, discussed below, are carried in trade accounts receivable net of an allowance for doubtful accounts while the Company attempts to collect them. An allowance also exists for estimated future losses on accounts not yet repurchased as discussed below in Accrued Recourse Liability. Since these accounts are not classified as trade accounts receivable until the repurchase occurs, the allowance percentage of doubtful accounts to total receivables is unusually high compared to other receivable arrangements.

Accrued Recourse Liability

Certain retail installment contracts sold to financial institutions through the fiscal year ended March 31, 2001 included a recourse provision. Under this recourse provision, Shopsmith is obligated to purchase the installment contract if the customer defaults on his obligation to the financial institution. The Company s liability for future recourse obligations has been estimated using factors based on the value and rate of change of the value of the outstanding accounts, the rate and changes in the rate of repurchases required under the recourse provision, as well as estimates of amounts collectable after the accounts are repurchased. If these factors would deteriorate, additional accruals would be necessary and would affect future operating results.

Results of Operations

Fiscal 2004 third quarter sales decreased to $3,646,000, or 8.6% from $3,987,000 generated during the same period a year ago. Fiscal 2004 year-to-date sales decreased to $9,933,000, or 6.4% from $10,609,000 last year. The decreases in the third quarter occurred primarily in our demonstration event Mark V sales.

Gross margin rates for the fiscal 2004 third quarter increased by 1.9 percentage points compared to the same period last year due to the decreased proportion of sales through distributors. On a year-to-date basis, gross margin rates decreased by 0.3 percentage points. Operating expenses were reduced by $75,000 to $1,828,000 in the fiscal 2004 third quarter from $1,903,000 in last year s third quarter. This reduction was due to continued improvement in expense controls on Mark V sales events. On a year to date basis, administrative costs were higher than the same period for last year because of a $60,000 favorable agreement on finance participation rebates that occurred in last year s second quarter. For fiscal 2004 year-to-date, operating costs decreased by $173,000 to $4,978,000 from $5,151,000 in the prior year.

Provisions for recoverable federal income taxes are based on estimated annual effective rates, less a valuation reserve. Taxable income for the periods ended January 3, 2004 and December 28, 2002 was offset by the utilization of net operating loss carryforwards. The expense recorded for the nine months ended January 3, 2004 reflected alternative minimum tax payments.

With the reduction in operating expenses, the Company recorded net income of $24,000 or $.01 per diluted share in the quarter ended January 3, 2004 compared to net income of $0 or $.00 per diluted share for the same period of last year. For fiscal 2004

Table of Contents

year-to-date, net income of $18,000 or $.01 per diluted share was earned, compared to net income of $100,000 or $.04 per diluted share for the same period last year.

Liquidity and Financial Position

Cash provided from operations totaled $285,000 for the nine months ended January 3, 2004, compared with $14,000 for the same period of the preceding year. Payment of $400,000 on a note payable, decreases in accounts receivable and an increase in inventories were the primary factors affecting cash for the period.

The current ratio was 1.42 to 1 at both January 3, 2004 and April 5, 2003 respectively. The debt to equity ratio decreased to 2.33 to 1 from 2.53 to 1 at April 5, 2003.

During fiscal 2002, Shopsmith entered into an arrangement with John R. Folkerth, the Company s CEO, which allowed the Company to borrow up to $500,000 with interest at twelve percent. The maximum authorized borrowing was increased to $600,000 in July 2002. Substantially all personal property except for certain receivables was pledged as collateral. Interest was due monthly and the note was payable on demand. At July 5, 2003, there was $300,000 outstanding under this arrangement all of which was paid in full on July 31, 2003. Borrowings from Mr. Folkerth were subject to Mr. Folkerth s approval and were payable upon demand by Mr. Folkerth.

On December 31, 2002, Shopsmith entered into a loan agreement with Provident Bank which allows the Company to borrow up to the lesser of $750,000 or 80% of eligible receivables due from Lowes Companies, Inc., with interest charged at one and one-half percent over the Bank s prime rate. On July 17, 2003, this agreement was amended to allow borrowings up to $1,400,000. The agreement requires compliance with certain net income, net worth, and miscellaneous covenants. Substantially all personal property is pledged as collateral. At January 3, 2004, there were no amounts outstanding under this agreement.

With the increased borrowing allowed under the amended agreement with Provident Bank, the Company believes that adequate liquidity is available for the remainder of the current fiscal year. The Company believes that continued profitability is critical to ensuring adequate liquidity in future fiscal years.

Forward Looking Statements

The foregoing discussion and the Company s consolidated financial statements contain certain forward-looking statements that involve risks and uncertainties, including but not limited to the following: (i) the operating cash flows together with currently available working capital may be inadequate to finance the operating needs of the Company; (ii) cancellation by Lowe s of the in-store sales program; (iii) the Company may fail to comply with the financial covenants contained in its Loan Agreement dated December 31, 2002 with Provident Bank, in which event the Bank may declare all amounts owed by the Company to the Bank to be immediately due and payable; and (iv) actual losses related to doubtful accounts and recourse liabilities (discussed under Critical Accounting Policies and Estimates) may exceed current estimates.

Table of Contents

Item 4. Controls and Procedures.

(a) Evaluation of Disclosure Controls and Procedures

The Company s Chairman and Chief Executive Officer, John R. Folkerth, and the Company s Chief Financial Officer, Mark A. May, have evaluated the Company s disclosure controls and procedures within 90 days of the filing of this report. Messrs. Folkerth and May have concluded that the Company s disclosure controls and procedures are functioning effectively to provide reasonable assurance that the Company can meet its disclosure obligations. The reporting process is designed to ensure that information required to be disclosed by the Company in the reports that it files or submits with the Commission is recorded, processed, summarized and reported within the time periods specified in the Commission s rules and forms. Since Messrs. Folkerth s and May s most recent review of the Company s internal controls systems, there have been no significant changes in internal controls or in other factors that could significantly affect these controls.

Table of Contents

PART II. OTHER INFORMATION

Item 2. Changes in Securities and Use of Proceeds

The Loan Agreement between the Company and Provident Bank prohibits the payment of dividends.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

31.1	Certification of the Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K:

During the quarter ended January 3, 2004 the Company filed the following report on Form 8-K:

A Form 8-K filed on November 19, 2003 included the text of the Company s press release reporting the results of its operations for the quarter ended October 4, 2003.

SIGNATURES

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

SHOPSMITH, INC

By /s/ Mark A May

Mark A. May

Vice President of Finance (Principal Financial and Accounting Officer)

Date: January 27, 2004