

STARRETT L S CO  
Form 10-Q  
February 05, 2009

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 27, 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 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

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company” in Rule 12b-2 of the Exchange Act, (Check One):

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 January 31, 2009  
outstanding as of

Class A 5,744,988  
Common Shares

Class B Common 879,135  
Shares

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THE L. S. STARRETT COMPANY

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## Part I. Financial Information

## Item 1. 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 |            |
|--|----------------|-----------|----------------|------------|
|  | 12/27/08       | 12/29/07  | 12/27/08       | 12/29/07   |
| Net sales  | \$ 54,081      | \$ 62,436 | \$ 122,066     | \$ 121,986 |
| Cost of goods sold   | (37,766)       | (42,892)  | (84,558)       | (83,888)   |
| Selling and general expense  | (15,493)       | (15,766)  | (32,991)       | (30,469)   |
| Other income (expense)   | 820            | 2,162     | 1,355          | 1,896      |
| Earnings before income taxes   | 1,642          | 5,940     | 5,872          | 9,525      |
| Income tax expense   | 507            | 2,517     | 2,114          | 3,772      |
| Net earnings   | \$ 1,135       | \$ 3,423  | \$ 3,758       | \$ 5,753   |
| Basic and diluted earnings per share   | \$ .17         | \$ .52    | \$ .57         | \$ .87     |
| Average outstanding shares used in per share calculations<br>(in thousands): |                |           |                |            |
| Basic  | 6,617          | 6,587     | 6,617          | 6,591      |
| Diluted  | 6,620          | 6,596     | 6,624          | 6,601      |
| Dividends per share  | \$ .12         | \$ .20    | \$ .24         | \$ .30     |

See Notes to Consolidated Financial Statements

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

|   | 13 Weeks Ended  |                 | 26 Weeks Ended  |                 |
|---|-----------------|-----------------|-----------------|-----------------|
|   | 12/27/08        | 12/29/07        | 12/27/08        | 12/29/07        |
| <b>Cash flows from operating activities:</b>                  |                 |                 |                 |                 |
| Net earnings  | \$ 1,135        | \$ 3,423        | \$ 3,758        | \$ 5,753        |
| <b>Non-cash items included:</b>                               |                 |                 |                 |                 |
| Gain from sale of real estate                                 | -               | (1,703)         | -               | (1,703)         |
| Depreciation  | 2,150           | 2,465           | 4,506           | 4,839           |
| Impaired assets   | -               | 95              | -               | 95              |
| Amortization  | 312             | 321             | 624             | 616             |
| Net long-term tax payable                                     | 123             | -               | 224             | -               |
| Deferred taxes  | (639)           | 660             | (562)           | 1,107           |
| Unrealized transaction (gains) losses                         | 1,319           | (758)           | 1,295           | (556)           |
| Retirement benefits   | (479)           | (922)           | (989)           | (1,743)         |
| Cumulative effect of adopting FIN48                           | -               | -               | -               | (313)           |
| <b>Working capital changes:</b>                               |                 |                 |                 |                 |
| Receivables   | 3,231           | 2,384           | 1,000           | (730)           |
| Inventories   | (6,745)         | 2,628           | (11,109)        | 4,812           |
| Other current assets  | (144)           | (239)           | (761)           | 668             |
| Other current liabilities                                     | (2,980)         | 1,117           | (3,175)         | 1,044           |
| Prepaid pension cost and other                                | 854             | 303             | 1,832           | 648             |
| <b>Net cash (used in) provided by operating activities</b>    | <b>(1,863)</b>  | <b>9,774</b>    | <b>(3,357)</b>  | <b>14,537</b>   |
| <b>Cash flows (used in) provided by investing activities:</b> |                 |                 |                 |                 |
| Additions to plant and equipment                              | (2,457)         | (1,701)         | (5,425)         | (4,098)         |
| Proceeds from sale of real estate                             | -               | 2,416           | -               | 2,416           |
| Decrease (increase) in investments                            | 3,384           | (9,090)         | 6,683           | (9,850)         |
| Purchase of Kinemetric Engineering                            | (270)           | -               | (270)           | (2,060)         |
| <b>Net cash provided by (used in) investing activities</b>    | <b>657</b>      | <b>(8,375)</b>  | <b>988</b>      | <b>(13,592)</b> |
| <b>Cash flows (used in) provided by financing activities:</b> |                 |                 |                 |                 |
| Proceeds from short-term borrowings                           | 5,610           | 2,265           | 9,646           | 4,481           |
| Short-term debt repayments                                    | (3,945)         | (1,567)         | (4,365)         | (3,711)         |
| Long-term debt repayments                                     | (56)            | (109)           | (190)           | (224)           |
| Proceeds from common stock issued                             | 176             | 157             | 332             | 268             |
| Treasury shares purchased                                     | (188)           | -               | (188)           | (317)           |
| Dividends   | (795)           | (1,318)         | (1,589)         | (1,978)         |
| <b>Net cash provided by (used in) financing activities</b>    | <b>802</b>      | <b>(572)</b>    | <b>3,646</b>    | <b>(1,481)</b>  |
| <b>Effect of exchange rate changes on cash</b>                | <b>(1,146)</b>  | <b>136</b>      | <b>(1,660)</b>  | <b>166</b>      |
| <b>Net (decrease) increase in cash</b>                        | <b>(1,550)</b>  | <b>963</b>      | <b>(383)</b>    | <b>(370)</b>    |
| Cash, beginning of period                                     | 7,682           | 6,375           | 6,515           | 7,708           |
| <b>Cash, end of period</b>                                    | <b>\$ 6,132</b> | <b>\$ 7,338</b> | <b>\$ 6,132</b> | <b>\$ 7,338</b> |

See Notes to Consolidated Financial Statements

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

|  | Dec. 27<br>2008<br>(unaudited) | June 28<br>2008 |
|--|--------------------------------|-----------------|
| <b>ASSETS</b>  |                                |                 |
| Current assets:  |                                |                 |
| Cash   | \$ 6,132                       | \$ 6,515        |
| Investments  | 10,295                         | 19,806          |
| Accounts receivable (less allowance for doubtful accounts of \$664 and \$701)  | 30,797                         | 39,627          |
| Inventories:   |                                |                 |
| Raw materials and supplies   | 19,728                         | 15,104          |
| Goods in process and finished parts  | 17,404                         | 16,653          |
| Finished goods   | 26,146                         | 29,400          |
|  | 63,278                         | 61,157          |
| Current deferred income tax asset  | 5,631                          | 5,996           |
| Prepaid expenses, taxes and other current assets   | 5,397                          | 5,535           |
| Total current assets   | 121,530                        | 138,636         |
| Property, plant and equipment, at cost (less accumulated depreciation of \$116,522 and \$131,386)                              |                                |                 |
|  | 55,566                         | 60,945          |
| Property held for sale   | 1,912                          | 1,912           |
| Intangible assets (less accumulated amortization of \$3,101 and \$2,477)   | 3,140                          | 3,764           |
| Goodwill   | 6,302                          | 6,032           |
| Pension asset  | 35,335                         | 34,643          |
| Other assets   | 291                            | 1,877           |
| Long-term taxes receivable   | 2,905                          | 2,476           |
| Total assets   | \$ 226,981                     | \$ 250,285      |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                |                 |
| Current liabilities:   |                                |                 |
| Notes payable and current maturities   | \$ 9,080                       | \$ 4,121        |
| Accounts payable and accrued expenses  | 12,961                         | 18,041          |
| Accrued salaries and wages   | 5,380                          | 6,907           |
| Total current liabilities  | 27,421                         | 29,069          |
| Long-term taxes payable  | 8,551                          | 8,522           |
| Deferred income taxes  | 5,815                          | 6,312           |
| Long-term debt   | 5,334                          | 5,834           |
| Postretirement benefit liability   | 12,682                         | 13,775          |
| Total liabilities  | 59,803                         | 63,512          |
| Stockholders' equity:  |                                |                 |
| Class A Common \$1 par (20,000,000 shrs. authorized)<br>5,739,388 outstanding on 12/27/08,<br>5,708,100 outstanding on 6/28/08 | 5,739                          | 5,708           |
| Class B Common \$1 par (10,000,000 shrs. authorized)   | 879                            | 906             |

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879,135 outstanding on 12/27/08,

906,065 outstanding on 6/28/08

|   |            |            |
|---|------------|------------|
| Additional paid-in capital                                | 49,784     | 49,613     |
| Retained earnings reinvested and employed in the business | 136,278    | 134,109    |
| Accumulated other comprehensive loss                      | (25,502)   | (3,563)    |
| Total stockholders' equity                                | 167,178    | 186,773    |
| Total liabilities and stockholders' equity                | \$ 226,981 | \$ 250,285 |

See Notes to Consolidated Financial Statements

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THE L. S. STARRETT COMPANY  
Consolidated Statements of Stockholders' Equity  
For the Twenty-six Weeks Ended December 27, 2008 and December 29, 2007  
(in thousands of dollars except per share data)  
(unaudited)

|   | Common Stock<br>Out-standing<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 30, 2007                                       | \$ 5,632                                  | \$ 963  | \$ 49,282                             | \$ 127,023           | \$ (5,786)                                     | \$ 177,114 |
| Comprehensive income (loss):                                |   |         |                                       |                      |  |            |
| Net earnings  |   |         |                                       | 5,753                |  | 5,753      |
| Unrealized net loss on<br>investments and swap<br>agreement |   |         |                                       |                      | (36)   | (36)       |
| Translation gain, net                                       |   |         |                                       |                      | 4,243  | 4,243      |
| Total comprehensive income                                  |   |         |                                       |                      |  | 9,960      |
| Tax adjustment for FIN 48                                   |   |         |                                       | (313)                |  | (313)      |
| Dividends (\$.30 per share)                                 |   |         |                                       | (1,978)              |  | (1,978)    |
| Treasury shares:  |   |         |                                       |                      |  |            |
| Purchased   | (20)                                      |         | (297)                                 |                      |  | (317)      |
| Issued  | 10  |         | 177                                   |                      |  | 187        |
| Issuance of stock under ESPP                                |   | 5       | 99                                    |                      |  | 104        |
| Conversion  | 44  | (44)    |                                       |                      |  | -          |
| Balance December 29, 2007                                   | \$ 5,666                                  | \$ 924  | \$ 49,261                             | \$ 130,485           | \$ (1,579)                                     | \$ 184,757 |
| Balance June 28, 2008                                       | \$ 5,708                                  | \$ 906  | \$ 49,613                             | \$ 134,109           | \$ (3,563)                                     | \$ 186,773 |
| Comprehensive income (loss):                                |   |         |                                       |                      |  |            |
| Net earnings  |   |         |                                       | 3,758                |  | 3,758      |
| Unrealized net gain on<br>investments and swap<br>agreement |   |         |                                       |                      | 229  | 229        |
| Translation loss, net                                       |   |         |                                       |                      | (22,168)                                       | (22,168)   |
| Total comprehensive loss                                    |   |         |                                       |                      |  | (18,181)   |
| Dividends (\$.24 per share)                                 |   |         |                                       | (1,589)              |  | (1,589)    |
| Treasury shares:  |   |         |                                       |                      |  |            |
| Purchased   | (15)                                      |         | (173)                                 |                      |  | (188)      |
| Issued  | 15  |         | 268                                   |                      |  | 283        |
| Issuance of stock under ESPP                                |   | 4       | 76                                    |                      |  | 80         |
| Conversion  | 31  | (31)    |                                       |                      |  | -          |
| Balance December 27, 2008                                   | \$ 5,739                                  | \$ 879  | \$ 49,784                             | \$ 136,278           | \$ (25,502)                                    | \$ 167,178 |
| Cumulative Balance:   |   |         |                                       |                      |  |            |
| Translation loss  |   |         |                                       |                      | (21,562)                                       | (112)      |

Unrealized loss on  
investments and  
swap agreements

Amounts not recognized as a  
component of net periodic  
benefit cost

(3,828)

\$ (25,502)

See Notes to Consolidated Financial Statements

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

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 27, 2008 and June 28, 2008; the results of operations and cash flows for the thirteen and twenty-six weeks ended December 27, 2008 and December 29, 2007; and changes in stockholders' equity for the twenty-six weeks ended December 27, 2008 and December 29, 2007.

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 28, 2008, and these financial statements should be read in conjunction with said Annual Report on Form 10-K. Note that significant foreign locations are reported on a one month lag.

Included in investments at December 27, 2008 is \$1.8 million of AAA rated Puerto Rico debt obligations that have maturities greater than one year but carry the benefit of possibly reducing repatriation taxes. These investments represent "core cash" and are part of the Company's overall cash management and liquidity program and, under SFAS 115, are considered "available for sale." The investments themselves are highly liquid, carry no early redemption penalties, and are not designated for acquiring non-current assets. Cash and investments held in foreign locations amounted to \$11.4 million and \$18.8 million at December 27, 2008 and June 28, 2008, respectively. The other significant component of investments at December 27, 2008 is \$7.1 million of investments in certificates of deposit which are carried at cost.

On October 1, 2008, the Company adopted SFAS No. 157, Fair Value Measurements ("Statement No. 157"). Statement No. 157 defines and establishes a framework for measuring fair value and expands disclosures about fair value instruments. In accordance with Statement No. 157, 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. The Company does not have any financial liabilities that are required to be measured at fair value on a recurring basis. 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:

- 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).
- Level 2 – Financial assets whose value are based on quoted market prices in markets where trading occurs infrequently or whose values are based on quoted prices of instruments with similar attributes in active markets. The Company does not currently have any Level 2 financial assets.
- 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 assumptions about the assumptions a market participant would use in pricing the asset. The Company does not currently have any Level 3 financial assets.

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As of December 27, 2008, the Company's Level 1 financial assets were as follows:

|                          | Level 1   |
|--------------------------|-----------|
| Money Market Funds       | \$ 1,462  |
| Certificates of Deposits | 7,082     |
| International Bonds      | 1,751     |
|                          | \$ 10,295 |

The Company has determined that a triggering event has occurred during the second quarter of fiscal 2009 relating to the \$5.3 million of goodwill on acquisition of Tru-Stone. This event is represented by a downturn in quarterly sales and the outlook for their markets served. In accordance with FAS 142, Goodwill and Other Intangibles, the Company performed the step one evaluation on the carrying value and tangible book value of Tru-Stone, using a

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discounted cash flow methodology, which resulted in an implied fair value greater than the carrying value. Further, the Company's stock price has been trading below its book value and tangible book value for over four consecutive quarters. The Company attributes this low stock price to both the overall market conditions and company specific factors, including low trading volume of the Company's stock. On this basis, the Company did not consider it necessary to perform a step one analysis on the other remaining reporting unit with goodwill.

Accounts payable and accrued expenses at December 27, 2008 and June 28, 2008 consisted primarily of accounts payable (\$5.8 million and \$9.0 million), accrued benefits (\$1.2 million and \$1.1 million), accrued taxes other than income (\$.8 million and \$2.1 million), and other accrued expenses (\$5.1 million and \$5.8 million).

Other income (expense) is comprised of the following (in thousands):

|  | Thirteen Weeks<br>Ended December |          | Twenty-six Weeks<br>Ended December |          |
|--|----------------------------------|----------|------------------------------------|----------|
|  | 2008                             | 2007     | 2008                               | 2007     |
| Interest income                        | \$ 224                           | \$ 423   | \$ 541                             | \$ 734   |
| Interest expense and commitment fees   | (214)                            | (198)    | (396)                              | (453)    |
| Realized and unrealized exchange gains | 668                              | 278      | 1,098                              | 79       |
| Gains on sale of real estate           | -                                | 1,703    | -                                  | 1,703    |
| Other                                  | 142                              | (44)     | 112                                | (167)    |
|  | \$ 820                           | \$ 2,162 | \$ 1,355                           | \$ 1,896 |

The Company adopted FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes" ("FIN No. 48"), at the beginning of fiscal year 2008. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN No. 48 prescribes a two-step process to determine the amount of tax benefit to be recognized. First, the tax position must be evaluated to determine the likelihood that it will be sustained upon external examination. If the tax position is deemed "more-likely-than-not" to be sustained, the tax position is then assessed to determine the amount of benefit to recognize in the financial statements. The amount of the benefit that may be recognized is the largest amount that has a greater than 50 percent likelihood of being realized upon ultimate settlement. As a result of implementing FIN No. 48, the Company recognized a cumulative effect adjustment of \$.3 million to decrease the July 1, 2007 retained earnings balance and increase long-term tax payable. Also in connection with this implementation the Company has reclassified \$2.9 million of unrecognized tax benefits into a long-term taxes receivable representing the corollary effect of transfer pricing competent authority adjustments.

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 2003. Currently, the Company does not have any income tax audits in progress at the Federal level, or in the numerous states, local and international jurisdictions in which it operates. 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 (except for Brazil, which has 1997-2006 still open for examination).

The Company recognizes interest expense related to income tax matters in income tax expense. The Company has accrued \$.1 million of interest as of June 28, 2008. The amount did not change significantly during the six months ended December 27, 2008.

The Company has identified no uncertain tax position for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease within the next twelve months.



Net periodic benefit costs (benefits) 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 |          |
|------------------------------------|----------------------------------|----------|------------------------------------|----------|
|                                    | 2008                             | 2007     | 2008                               | 2007     |
| Service cost                       | \$ 556                           | \$ 555   | \$ 1,129                           | \$ 1,199 |
| Interest cost                      | 1,710                            | 1,658    | 3,494                              | 3,503    |
| Expected return on plan assets     | (2,561)                          | (2,959)  | (5,197)                            | (5,909)  |
| Amort. of prior service cost       | 105                              | 112      | 215                                | 224      |
| Amort. of unrecognized (gain) loss | (3)                              | (2)      | (6)                                | (4)      |
|                                    | \$ (193)                         | \$ (636) | \$ (365)                           | \$ (987) |

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

|                              | Thirteen Weeks<br>Ended December |       | Twenty-six Weeks<br>Ended December |        |
|------------------------------|----------------------------------|-------|------------------------------------|--------|
|                              | 2008                             | 2007  | 2008                               | 2007   |
| Service cost                 | \$ 88                            | \$ 97 | \$ 176                             | \$ 197 |
| Interest cost                | 177                              | 191   | 354                                | 371    |
| Amort. of prior service cost | (226)                            | (226) | (452)                              | (453)  |
| Amort. of unrecognized loss  | -                                | 35    | -                                  | 57     |
|                              | \$ 39                            | \$ 97 | \$ 78                              | \$ 172 |

Approximately 56% of all inventories are valued on the LIFO method. LIFO inventories were \$21.6 million and \$17.9 million, respectively, at December 27, 2008 and June 28, 2008, such amounts being approximately \$32.3 and \$27.5 million less than if determined on a FIFO basis. The Company has not realized any material LIFO layer liquidation profits in the periods presented.

Long-term debt is comprised of the following (in thousands):

|  | December<br>27, 2008 | June 28,<br>2008 |
|--|----------------------|------------------|
| Reducing revolver  | \$ 7,200             | \$ 7,200         |
| Capitalized lease obligations payable in Brazilian currency due 2009-2011, 13.3%-23.1% | 897                  | 1,569            |
|  | \$ 8,097             | \$ 8,769         |
| Less current portion   | 2,763                | 2,935            |
|  | \$ 5,334             | \$ 5,834         |

Current notes payable, primarily in Brazilian currency, carry interest at up to 23.1%. The average rate for the quarter ended December 27, 2008 was approximately 19.4%.

#### RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("FAS 157"). FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. FAS 157 applies under other accounting pronouncements that require or permit fair value measurements and accordingly, does

not require any new fair value measurements. FAS 157 was initially effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In February 2008, the FASB issued FASB Staff Position (FSP) FAS 157-2. This FSP permits a delay in the effective date of FAS 157 to fiscal years beginning after November 15, 2008, for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). In October 2008, the FASB issued FSP FAS 157-3, "Determining the Fair Value of a Financial Asset when the Market for That Asset is Not Active," which clarifies the application of FAS 157 for financial assets in a market that is not active.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (“SFAS 159”). SFAS 159 permits companies to make a one-time election to carry eligible types of financial assets and liabilities at fair value, even if fair value measurement is not required under generally accepted accounting principles in the United States (“U.S. GAAP”). SFAS 159 has been adopted by the Company beginning in the first quarter of fiscal 2009, and the Company has determined SFAS 159 has no material impact on its consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), Business Combinations (“SFAS 141R”). SFAS 141R establishes principles and requirements for how the acquiror of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. SFAS 141R also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning December 15, 2008, which is October 1, 2009 for the Company. The Company is currently evaluating the impact of the provisions of SFAS 141R on its consolidated financial statements.

In December 2008, the FASB issued FSP FAS 132R-1 “Employers’ Disclosures about Postretirement Benefit Plan Assets”, which amends FASB Statement 132 (revised 2003), Employers’ Disclosures about Pensions and Other Postretirement Benefits. Beginning in fiscal years ending after December 15, 2009, employers will be required to provide more transparency about the assets in their postretirement benefit plans, including defined benefit pension plans. FSP FAS 132R-1 was issued in response to users’ concerns that employers’ financial statements do not provide adequate transparency about the types of assets and associated risks in employers’ postretirement plans. In current disclosures of the major categories of plan assets, many employers provide information about only four asset categories: equity, debt, real estate, and other investments. For many employers, the “other investment” category has increased to include a significant percentage of plan assets. Users indicate that such disclosure is not sufficiently specific to permit evaluation of the nature and risks of assets held as investments.

FSP FAS 132R-1’s amended disclosure requirements about plan assets are principles-based. The objectives of the disclosures are to provide users with an understanding of the following:

- How investment decisions are made, including factors necessary to understanding investment policies and strategies
  - The major categories of plan assets
  - The inputs and valuation techniques used to measure the fair value of plan assets
- The effect of fair value measurements using significant unobservable inputs (Level 3 measurements in Statement 157 on changes in plan assets for the period)
  - Significant concentrations of risk within plan assets

Employers are required to consider these overall disclosure objectives in providing the detailed disclosures required by Statement 132R, as amended by FSP FAS 132R-1.

In December 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51”. This statement improves the relevance, comparability and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards that require; the ownership interests in subsidiaries held by parties other than the parent and the amount of consolidated net income attributable to the parent and to the noncontrolling interest be clearly identified and presented on the face of the consolidated statement of income, changes in a parent’s ownership interest while the parent retains its controlling financial interest in its subsidiary be accounted for consistently, when a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary be initially measured at fair value, entities provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners.

SFAS No. 160 affects those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Early adoption is prohibited. The Company does not believe that SFAS No. 160 will have an impact on its consolidated financial statements.

Item 2.

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

RESULTS OF OPERATIONS

QUARTERS ENDED DECEMBER 27, 2008 AND DECEMBER 29, 2007

Overview

The Company experienced the severity of the global economic recession during the quarter. Net income was \$1.1 million, or \$.17 per basic and diluted share, in the second quarter of fiscal 2009 (fiscal 2009 quarter) compared to net income of \$3.4 million, or \$.52 per basic and diluted share, in the second quarter of fiscal 2008 (fiscal 2008 quarter). The quarter to quarter comparison was negatively impacted by lower sales volume and the strengthening of the U.S. dollar upon consolidation of international results. This represents a decrease in net income of \$2.3 million comprised of decreases in gross margin of \$3.2 million and other income of \$1.3 million. This was offset by a decrease of \$.3 million in selling, general and administrative costs, and a decrease in income tax expense of \$2.0 million. These items are discussed in more detail below.

Net Sales

Net sales for the fiscal 2009 quarter were \$54.1 million, a decrease of 13% compared to the fiscal 2008 quarter. North American sales decreased \$3.9 million or 13%, while international sales excluding North America decreased \$4.4 million or 18% (1% in local currency). The decrease in North American sales is related to the widening of the recession to the manufacturing sector in the U.S., lower Evans Rule sales to the construction sector, and decreased sales in Canada. It is likely that the Company's results will continue to be impacted by the current global financial crises.

The decrease in international sales is driven by the weakening of the Brazilian Real, British Pound, and Australian Dollar against the U.S. Dollar, partially offset by greater penetration into the Chinese markets.

Earnings before income taxes

The fiscal 2009 quarter's earnings before income taxes of \$1.6 million represents a decrease of earnings before income taxes of \$4.3 million from the fiscal 2008 quarter's earnings before income taxes of \$5.9 million. Approximately \$3.2 million of the decrease is at the gross margin line. The gross margin percentage decreased from 31.3% in the fiscal 2008 quarter to 30.2% in the fiscal 2009 quarter. The decrease in gross margin is primarily a result of sales decreases quarter over quarter, lower overhead absorption (\$.2 million) at both domestic and international operations due to this lower sales dollar volume.

Selling and general expense is decreased \$.3 million. However, as a percentage of sales, selling and general expenses increased from 25.2% in the fiscal 2008 quarter to 28.6% in the fiscal 2009 quarter. The decrease in selling and general expense is primarily a result of reduced accruals for incentives for the fiscal 2009 quarter (\$.2 million), and a decrease in professional fees (\$.3 million).

The fiscal 2008 quarter includes in other income a one-time gain of \$1.7 million from the sale of the Company's Glendale, Arizona facility on October 19, 2007 for proceeds of \$2.4 million.

Income Taxes

The effective income tax rate is 30.9% in the fiscal 2009 quarter versus 42.4% for the fiscal 2008 quarter. Both rates reflect a combined federal, state and foreign rate adjusted for permanent book/tax differences, the most significant of

which is the effect of the deduction allowable for the Brazilian dividend paid in the second quarter of fiscal 2008 and the dividend paid in the third quarter of fiscal 2007. The change in the effective rate percentage reflects the increased impact of the Brazilian dividend due to lower forecasted taxable income.

No changes in valuation allowances relating to carryforwards for foreign NOL's, foreign tax credits and certain state NOL's are anticipated for fiscal 2009 at this time other than reversals relating to realization of NOL benefits for certain foreign subsidiaries. The Company continues to believe it is more likely than not that it will be able to utilize its tax operating loss carryforward assets reflected on the balance sheet.

#### Net earnings per share

As a result of the above factors, the Company had basic and diluted net earnings of \$.17 per share in the fiscal 2009 quarter compared to a basic and diluted net earnings per share of \$.52 in the fiscal 2008 quarter, a decrease of \$.35 per share. Included in the \$.52 per share for the fiscal 2008 quarter is \$.15 per share related to the sale of the Glendale facility.

#### SIX MONTH PERIODS ENDED DECEMBER 27, 2008 AND DECEMBER 29, 2007

##### Overview

The Company had net income of \$3.8 million, or \$.57 per basic and diluted share in the first six months of fiscal 2009, compared to net income of \$5.8 million, or \$.87 per basic and diluted share in the first six months of fiscal 2008. This represents a decrease in net income of \$2.0 million comprised of a decrease in gross margin of \$.6 million, an increase in selling, general and administrative expenses of \$2.5 million and a decrease in other income of \$.5 million, offset by a decrease in income tax expense of \$1.7 million.

##### Net Sales

Net sales for the first six months of fiscal 2009 were \$122.1 million, up \$.1 million compared to the first six months of fiscal 2008. Domestic sales were flat, while international sales increased 8% (7% increase in local currency). North American sales reflect flat U.S., Canadian and Mexican demand and lower Evans Rule sales to Sears, partially offset by the acquisition of Kinometrics.

The increase in international sales is driven by strong sales in the Brazilian domestic markets and continued expansion in global markets, including Eastern Europe, the Middle East and China, offset by the weakening of the Brazilian Real and British Pound against the U.S. Dollar.

##### Earnings before income taxes

The earnings before income taxes for the first six months of fiscal 2009 were \$5.9 million compared to \$9.5 million of earnings before income taxes for the first six months of fiscal 2008.

This represents a decrease of earnings before income taxes of \$3.6 million. Approximately \$.6 million of this decrease is at the gross margin line. The gross margin percentage decreased from 31.2% in the first six months of fiscal 2008 to 30.7% in the first six months of fiscal 2009. The decrease in gross margin reflects lower sales from period to period and decreases of fixed overhead absorption at domestic manufacturing locations as a result of less capacity utilization, partially offset by the reduction of cost of sales at the Evans Rule Division.

This decrease in gross margin is accompanied by an increase of \$2.5 million in selling and general expense from the first six months of fiscal 2008 to the first six months of fiscal 2009. The increase in selling and general expense is primarily a result of accruals for incentives for the first six months of fiscal 2009 (\$.2 million), higher commissions due to higher sales (\$.1 million), increases in computer maintenance and support (\$.2 million) and additional salaries related primarily to sales and marketing (\$.7 million). Finally, higher foreign exchange gains (\$1.0 million) during the first six months of fiscal 2009 and a one-time gain of \$1.7 million from the sale of the Company's Glendale, Arizona facility during the first six months of fiscal 2008, primarily contributed to a \$.5 million decrease in other income.

##### Income Taxes

The effective income tax rate is a 36.0% provision for the first six months of fiscal 2009 versus a 39.6% tax rate for the first six months of fiscal 2008. Both rates reflect a combined federal, state and foreign worldwide rate adjusted for permanent book/tax differences, the most significant of which is the deduction allowable for the Brazilian dividend paid in December 2008 and December 2007. The change in the effective rate percentage primarily reflects the larger impact of the Brazilian dividend on lower anticipated earnings for fiscal 2009. No changes in valuation allowances

relating to carryforwards for foreign NOL's, foreign tax credit carryforwards and certain state NOL's are anticipated for fiscal 2009 at this time other than reversals relating to realization of NOL benefits for certain foreign subsidiaries.

The Company continues to believe it is more likely than not that it will be able to utilize its tax operating loss carryforward of approximately \$2.5 million reflected on the balance sheet.



## Net earnings per share

As a result of the above factors, the Company had basic and diluted net earnings per share for the first six months of fiscal 2009 of \$.57 per share compared to an earnings per share of \$.87 in the first six months of fiscal 2008, a decrease of \$.30 per share. Included in the \$.87 per share for the first six months of fiscal 2008 is \$.15 per share related to the sale of the Glendale facility.

## LIQUIDITY AND CAPITAL RESOURCES

|   | 13 Weeks Ended |          | 26 Weeks Ended |          |
|---|----------------|----------|----------------|----------|
|   | 12/27/08       | 12/29/07 | 12/27/08       | 12/29/07 |
| Cash flows (in thousands)                         |                |          |                |          |
| Cash (used in) provided by operations             | (1,863)        | 9,774    | (3,357)        | 14,537   |
| Cash provided from (used in) investing activities | 657            | (8,375)  | 988            | (13,592) |
| Cash provided from (used in) financing activities | 802            | (572)    | 3,646          | (1,481)  |

The fiscal 2009 quarter showed a use of cash in operations of \$1.9 million compared to \$9.8 million of cash generated in operations in the fiscal 2008 quarter. This decrease is driven by lower net earnings, an increase in inventories and a decrease in current liabilities, partially offset by a reduction in receivables.

For the first six months of fiscal 2009, there was a \$3.4 million use of cash in operations compared to \$14.5 million of cash generated in the same six month period a year ago. This decrease is driven by lower net earnings, an increase in inventories and an decrease in current liabilities, partially offset by a reduction in receivables.

It is anticipated that inventory levels will decrease over the next quarter as usage exceeds incoming receipts.

The Company's investing activities for the fiscal 2009 quarter and six month period consist of expenditures for plant and equipment, the use of short-term investments and an earnout related to the purchase of Kinemetrics. Expenditures for plant and equipment were relatively consistent when comparing the fiscal 2009 quarter to the same period a year ago. Such expenditures for the six month period increased compared to the same period a year ago as replacement equipment was required at certain plant locations. The proceeds from the sale of the Glendale distribution facility is included in the fiscal 2008 quarter and the first six months of fiscal 2008. The purchase of Kinemetrics was completed in the first quarter of fiscal 2008 and is included in the prior six month period. The amount included in the fiscal 2009 quarter and six month period represents additional purchase price relating to an earn-out provision for the Kinemetrics acquisition.

Cash flows related to financing activities are primarily the takedown of the line of credit, the payment of dividends and repayments of debt.

The Company maintains a defined benefit pension plan which as of December 27, 2008 was overfunded for accounting and for funding purposes although the amount of this overfunding has decreased dramatically since June 28, 2008 due to a significant decline in the U.S. stock market. Due to the continued overfunded status however, it is not anticipated that the Company will be required to provide any funding for this plan during fiscal 2009.

## 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 have to be taken in order to maintain liquidity, including plant consolidations and work force and dividend reductions (see Strategic and Other Activities

below). In addition to its cash and investments, the Company maintains a \$10 million line of credit, of which, as of December 27, 2008, \$5.0 million was taken down for short-term working capital purposes and \$1.0 million is being utilized in the form of standby letters of credit for insurance purposes. This line of credit will terminate as of April 28, 2009. It is expected to be renewed prior to that date. As certain investments are redeemed at maturity in January and February 2009, it is expected that the takedown related to the line of credit will be repaid. As of December 27, 2008, the Company is in compliance with all debt covenants related to its Reducing Revolver and its Line of Credit Agreement. Although the credit line is not currently collateralized, it is possible, based on the Company's financial performance, that in the future the Company will have to provide collateral in order to maintain the credit agreement. The Company has a working capital ratio of 4.4 to one as of December 27, 2008 and 4.8 to one as of June 28, 2008.

## STRATEGIC AND OTHER ACTIVITIES

Globalization has had a profound impact on product offerings and buying behaviors of industry and consumers in North America and around the world, forcing the Company to adapt to this new, highly competitive business environment. The Company continuously evaluates most all aspects of its business, aiming for new world-class ideas to set itself apart from its competition.

The strategic focus has shifted from manufacturing locations to global brand building through product portfolio and distribution channel management while reducing costs through lean manufacturing, plant consolidations, global sourcing and improved logistics.

The execution of these strategic initiatives has expanded the Company's manufacturing and distribution in developing economies which has increased its international sales revenues to approximately 45% of its consolidated sales.

On September 21, 2006, the Company sold its Alum Bank, PA level manufacturing plant and relocated the manufacturing to the Dominican Republic, where production began in fiscal 2005. The tape measure production of the Evans Rule Division facilities in Puerto Rico and Charleston, SC has been transferred to the Dominican Republic. The Company vacated and plans to sell its Evans Rule facility in North Charleston, SC. The Company's goal is to achieve labor savings and maintain margins while satisfying the demands of its customers for lower prices. The Company has closed three warehouses, the most recent being the Glendale, AZ facility, which was sold in fiscal 2008. Also during fiscal 2006, the Company began a lean manufacturing initiative in its Athol, MA facility, which has reduced costs over time. This initiative has continued through fiscal 2007 and 2008 and has continued in fiscal 2009.

The Tru-Stone acquisition in April 2006 represented a strategic acquisition for the Company in that it provides an enhancement of the Company's granite surface plate capabilities. Profit margins for the Company's standard plate business have improved as the Company's existing granite surface plate facility was consolidated into Tru-Stone, where average gross margins have been higher. Along the same line, the Kinemetric Engineering acquisition in July 2007 represented another strategic acquisition in the field of precision video-based metrology which, when combined with the Company's existing optical projection line, has provided a very comprehensive product offering.

If the Company continues to be impacted by the worldwide recession, there will likely be layoffs, shortened hours per week and possible temporary idling of manufacturing plants to reduce costs in the short-term.

## 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 as defined under the Securities and Exchange Commission's rules.

## CRITICAL ACCOUNTING POLICIES

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 the amounts reported in the consolidated financial statements and accompanying notes. The first note to the Company's Consolidated Financial Statements included in the Form 10-K for the year ended June 28, 2008 describes the significant accounting policies and methods used in the preparation of the consolidated financial statements.

Judgments, assumptions, and estimates are used for, but not limited to, the allowance for doubtful accounts receivable and returned goods; inventory allowances; income tax reserves; employee turnover, discount, and return rates used to calculate pension obligations; and normal expense accruals for such things as workers compensation and employee medical expenses.

Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results may differ from those estimates, and such differences may be material to the Company's Consolidated Financial Statements. The following sections describe the Company's critical accounting policies.

Sales of merchandise and freight billed to customers are recognized when title passes and all substantial risks of ownership change, which occurs either upon shipment or upon delivery based upon contractual terms. Sales are net of provision for cash discounts, returns, customer discounts (such as volume or trade discounts), cooperative advertising and other sales related discounts.

The allowance for doubtful accounts and sales returns of \$1.0 million and \$1.2 million as of December 27, 2008 and June 28, 2008, respectively, is based on the Company's assessment of the collectability of specific customer accounts, the aging of the Company's accounts receivable and trends in product returns. While the Company believes that the allowance for doubtful accounts and sales returns is adequate, if there is a deterioration of a major customer's credit worthiness, actual defaults are higher than the Company's previous experience, or actual future returns do not reflect historical trends, the estimates of the recoverability of the amounts due the Company, the Company could be adversely affected.

Inventory purchases and commitments are based upon future demand forecasts. If there is a sudden and significant decrease in demand for our products or there is a higher risk of inventory obsolescence because of rapidly changing technology and requirements, we may be required to increase our inventory reserve and, as a result, our gross profit margin could be adversely affected.

The Company generally values property, plant and equipment (PP&E) at historical cost less accumulated depreciation. Impairment losses are recorded when indicators of impairment, such as plant closures, are present and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount. The Company continually reviews for such impairment and believes that PP&E is being carried at its appropriate value.

The Company assesses the fair value of its goodwill, generally based upon a discounted cash flow methodology as of fiscal year end or when other circumstances would indicate potential impairment. The discounted cash flows are estimated utilizing various assumptions regarding future revenue and expenses, working capital, terminal value, and market discount rates. If the carrying amount of the goodwill is greater than the fair value, goodwill impairment may be present. An impairment charge is recognized to the extent the recorded goodwill exceeds the implied fair value of goodwill.

The Company has determined that a triggering event has occurred during the second quarter of fiscal 2009 relating to the \$5.3 million of goodwill on acquisition of Tru-Stone. This event is represented by a downturn in quarterly sales and the outlook for their markets served. In accordance with FAS 142, Goodwill and Other Intangibles, the Company performed the step one evaluation on the carrying value and tangible book value of Tru-Stone, using a discounted cash flow methodology, which resulted in an implied fair value greater than the carrying value. Continued unfavorable economic conditions may continue to have an adverse impact on the business and potentially result in goodwill impairment in the future. Further, the Company's stock price has been trading below its book value and tangible book value for over four consecutive quarters. The Company attributes this low stock price to both the overall market conditions and company specific factors, including low trading volume of the Company's stock. On this basis, the Company did not consider it necessary to perform a step one analysis on the other remaining reporting unit with goodwill.

Accounting for income taxes requires estimates of our future tax liabilities. Due to timing differences in the recognition of items included in income for accounting and tax purposes, deferred tax assets or liabilities are recorded

to reflect the impact arising from these differences on future tax payments. With respect to recorded tax assets, we assess the likelihood that the asset will be realized. If realization is in doubt because of uncertainty regarding future profitability or enacted tax rates, we provide a valuation allowance related to the asset. Tax reserves are also established to cover risks associated with activities or transactions that may be at risk for additional taxes. Should any significant changes in the tax law or our estimate of the necessary valuation allowances or reserves occur, we would record the impact of the change, which could have a material effect on our financial position or results of operations.

Pension and postretirement medical costs and obligations are dependent on assumptions used by our actuaries in calculating such amounts. These assumptions include discount rates, healthcare cost trends, inflation, salary growth, long-term return on plan assets, retirement rates, mortality rates, and other factors. These assumptions are made based on a combination of external market factors, actual historical experience, long-term trend analysis, and an analysis of the assumptions being used by other companies with similar plans. Actual results that differ from our assumptions are accumulated and amortized over future periods. Significant differences in actual experience or significant changes in assumptions would affect our pension and other postretirement benefit costs and obligations.

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

Market risk is the potential change in a financial instrument's value caused by fluctuations in interest and currency exchange rates, and equity and commodity prices. The Company's operating activities expose it to risks that are continually monitored, evaluated, and managed. Proper management of these risks helps reduce the likelihood of earnings volatility. At December 27, 2008, the Company was party to an interest rate swap agreement, which is more fully described in the Company's fiscal 2008 Annual Report on Form 10-K. The Company does engage in limited hedging activities to minimize the impact of foreign currency fluctuations. Net foreign monetary assets are approximately \$12.6 million.

A 10% change in interest rates would not have a significant impact on the aggregate net fair value of the Company's interest rate sensitive financial instruments (primarily variable rate investments of \$8.7 million and debt of \$7.2 million at December 27, 2008) or the cash flows or future earnings associated with those financial instruments. A 10% change in interest rates would have an insignificant impact the fair value of the Company's fixed rate investments of approximately \$6.9 million.

### 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 27, 2008, 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.

## 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 security analysts and investors. The Company is subject to risks that could cause actual events to vary materially from such forward-looking statements, including the following risk factors:

Risks Related to the Economy: The Company's results of operations are materially affected by the conditions in the global economy. The current global financial crisis, which began last year, has deteriorated further and has caused extreme volatility and disruptions in the capital and credit markets. U.S. and foreign economies have experienced and continue to experience significant declines in employment, household wealth and lending. Businesses, including the Company and its customers, have faced and may continue to face weakened demand for their products and services, difficulty obtaining access to financing, increased funding costs, and barriers to expanding operations. Economic and market conditions may worsen and could negatively impact the Company's results of operations.



**Risks Related to Reorganization:** The Company continues to evaluate plans to consolidate and reorganize some of its manufacturing and distribution operations. There can be no assurance that the Company will be successful in these efforts or that any consolidation or reorganization will result in revenue increases or cost savings to the Company. The implementation of these reorganization measures may disrupt the Company's manufacturing and distribution activities, could adversely affect operations, and could result in asset impairment charges and other costs that will be recognized if and when reorganization or restructuring plans are implemented or obligations are incurred. This has occurred with the Company's move to the Dominican Republic from South Carolina. Indeed, the relocation, restructuring and closure of our Evans Rule Division's Charleston, South Carolina facility and start up of that Division's Dominican Republic operations was a factor contributing to the Company's fiscal 2006 loss. If the Company is unable to maintain consistent profitability, additional steps will have to be taken, including further plant consolidations and workforce and dividend reductions.

**Risks Related to Technology:** Although the Company's strategy includes investment in research and development of new and innovative products to meet technology advances, there can be no assurance that the Company will be successful in competing against new technologies developed by competitors.

**Risks Related to Foreign Operations:** Approximately 50% of the Company's sales and 40% of net assets relate to foreign operations. Foreign operations are subject to special risks that can materially affect the sales, profits, cash flows, and financial position of the Company, including taxes and other restrictions on distributions and payments, currency exchange rate fluctuations, political and economic instability, inflation, minimum capital requirements, and exchange controls. In particular, the Company's Brazilian operations, which constitute over half of the Company's revenues from foreign operations, can be very volatile, changing from year to year due to the political situation and economy. As a result, the future performance of the Brazilian operations may be difficult to forecast.

**Risks Related to Industrial Manufacturing Sector:** The market for most of the Company's products is subject to economic conditions affecting the industrial manufacturing sector, including the level of capital spending by industrial companies and the general movement of manufacturing to low cost foreign countries where the Company does not have a substantial market presence. Accordingly, economic weakness in the industrial manufacturing sector as well as the shift of manufacturing to low cost countries where the Company does not have a substantial market presence may, and in some cases has, resulted in decreased demand for certain of the Company's products, which adversely affects sales and performance. Economic weakness in the consumer market could adversely impact the Company's performance as well. In the event that demand for any of the Company's products declines significantly, the Company could be required to recognize certain costs as well as asset impairment charges on long-lived assets related to those products.

**Risks Related to Competition:** The Company's business is subject to direct and indirect competition from both domestic and foreign firms. In particular, low cost foreign sources have created severe competitive pricing pressures. Under certain circumstances, including significant changes in U.S. and foreign currency relationships, such pricing pressures tend to reduce unit sales and/or adversely affect the Company's margins.

**Risks Related to Customer Concentration:** Sears sales and unit volume have decreased significantly during fiscal 2007 and 2008 and the first half of fiscal 2009 has been flat with prior periods. This situation is problematic and if the Sears Craftsman brand we support is no longer viable, this would have a negative effect on the Company's financial performance. The further loss or reduction in orders by Sears or any of the Company's remaining large customers, including reductions due to market, economic or competitive conditions could adversely affect business and results of operations. Moreover, the Company's major customers have placed, and may continue to place pressure on the Company to reduce its prices. This pricing pressure may affect the Company's margins and revenues and could adversely affect business and results of operations.

**Risks Related to Insurance Coverage:** The Company carries liability, property damage, workers' compensation, medical, and other insurance coverages that management considers adequate for the protection of its assets

and operations. There can be no assurance, however, that the coverage limits of such policies will be adequate to cover all claims and losses. Such uncovered claims and losses could have a material adverse effect on the Company. The Company self-insures for dental benefits and retains risk in the form of deductibles and sublimits for most coverages noted above. Depending on the risk, deductibles can be as high as 5% of the loss or \$.5 million.

Risks Related to Raw Material and Energy Costs: Steel is the principal raw material used in the manufacture of the Company's products. The price of steel has historically fluctuated on a cyclical basis and has often depended on a variety of factors over which the Company has no control. During fiscal 2008, the cost of steel rose

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approximately 7%. The cost of producing the Company's products is also sensitive to the price of energy for which the Company has recently experienced increases. The selling prices of the Company's products have not always increased in response to raw material, energy or other cost increases, and the Company is unable to determine to what extent, if any, it will be able to pass future cost increases through to its customers. Indeed, the Company has recently experienced difficulty in passing along the increases in steel and energy costs to its major customers. The Company's inability to pass increased costs through to its customers could materially and adversely affect its financial condition or results of operations.

**Risks Related to Stock Market Performance:** Although the Company's domestic defined benefit pension plan is overfunded, another significant drop in the stock market, even if short in duration, could cause the plan to become temporarily underfunded and require the temporary reclassification of prepaid pension cost on the balance sheet from an asset to a contra equity account, thus reducing stockholders' equity and book value per share and additional funding of the plans may also be necessary. There would be a similar risk to the Company's UK plan, which was underfunded during fiscal 2007 and 2008.

**Risks Related to Acquisitions:** Acquisitions, such as our acquisition of Tru-Stone in fiscal 2006 and Kinemetric Engineering in fiscal 2008, involve special risks, including, the potential assumption of unanticipated liabilities and contingencies, difficulty in assimilating the operations and personnel of the acquired businesses, disruption of the Company's existing business, dissipation of the Company's limited management resources, and impairment of relationships with employees and customers of the acquired business as a result of changes in ownership and management. While the Company believes that strategic acquisitions can improve its competitiveness and profitability, the failure to successfully integrate and realize the expected benefits of such acquisitions could have an adverse effect on the Company's business, financial condition and operating results.

**Risks Related to Investor Expectations.** The Company's operating results have fluctuated from quarter to quarter in the past, and the Company expects that they will continue to do so in the future. The Company's earnings may not continue to grow at rates similar to the growth rates achieved in recent years and may fall short of either a prior quarter or investors' expectations. If the Company fails to meet the expectations of securities analysts or investors, the Company's share price may decline.

**Risks Related to Information Systems.** The efficient operation of the Company's business is dependent on its information systems, including its ability to operate them effectively and to successfully implement new technologies, systems, controls and adequate disaster recovery systems. In addition, the Company must protect the confidentiality of data relating to its business, employees, customers and other third parties. The failure of the Company's information systems to perform as designed or the Company's failure to implement and operate such systems effectively could disrupt the Company's business or subject it to liability and thereby harm its profitability.

**Risks Related to Litigation and Changes in Laws, Regulations and Accounting Rules.** Various aspects of the Company's operations are subject to federal, state, local or foreign laws, rules and regulations, any of which may change from time to time. Generally accepted accounting principles may change from time to time, as well. In addition, the Company is regularly involved in various litigation matters that arise in the ordinary course of business. Litigation, regulatory developments and changes in accounting rules and principles could adversely affect the Company's business operations and financial performance.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

A summary of the Company's repurchases of shares of its common stock for the three months ended December 27, 2008 is as follows:

| ISSUER PURCHASES OF EQUITY SECURITIES |                  |               |
|---------------------------------------|------------------|---------------|
| Period                                | Shares Purchased | Average Price |

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|                   |        |         | Shares Purchased<br>Under Announced<br>Programs | Shares yet to be<br>Purchased Under<br>Announced<br>Programs |
|-------------------|--------|---------|---|--|
| 9/27/08-11/1/08   | 15,000 | \$12.55 | 15,000  | none   |
| 11/2/08-11/29/08  | none   |         |   | none   |
| 11/30/08-12/27/08 | none   |         |   | none   |

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

(a) The annual meeting of shareholders was held on October 8, 2008.

(c) The following directors were elected at the annual meeting:

|  | Votes<br>For | Votes<br>Withheld | Abstentions<br>and Broker<br>Non-votes |
|--|--------------|-------------------|--|
| Class A shares voting as separate class: |              |                   |  |
| Ralph G. Lawrence                        | 4,912,558    | 297,084           | N/A                                    |
| Class A and B shares voting together:    |              |                   |  |
| Stephen F. Walsh                         | 12,043,428   | 272,364           | N/A                                    |
| Salvador de Camargo, Jr.                 | 12,123,545   | 352,484           | N/A                                    |

Item 6. Exhibits

See the exhibit index following the signature page to this quarterly report.

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 February 5, 2009                      S/R. J. Hylek  
R. J. Hylek (Treasurer and Chief Financial Officer)

Date February 5, 2009                      S/R. J. Simkevich  
R.J. Simkevich (Corporate Controller)

EXHIBIT INDEX

| Exhibit Number | Description  |
|----------------|--|
| 10.1           | Change in Control Agreement, dated as of January 16, 2009, between the Company and Douglas A. Starrett.  |
| 10.2           | Form of Change in Control Agreements, dated as of January 16, 2009, executed separately by the Company and each of Randall J. Hylek and Stephen F. Walsh.  |
| 10.3           | Form of Non-Compete Agreements, dated as of January 16, 2009, executed separately by the Company and each of Douglas A Starrett, Randall J. Hylek and Stephen F. Walsh.  |
| 31.a           | Certification of Chief Executive Officer pursuant to Rules 13a-15(e)/15(d)-15(e) and 13a-15(f)/15(d)-15(f).  |
| 31.b           | Certification of Chief Financial Officer pursuant to Rules 13a-15(e)/15(d)-15(e) and 13a-15(f)/15(d)-15(f).  |
| 32             | Certification of Chief Executive Officer and Chief Financial 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). |

