SCOTTS LIQUID GOLD INC
Form 10-Q
May 10, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OF THE

SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED March 31, 2011

Commission File No. 001-13458

SCOTT S LIQUID GOLD-INC.

4880 Havana Street

Denver, CO 80239

Phone: 303-373-4860

Colorado	**84-0920811**
State of Incorporation	**I.R.S. Employer**
	Identification No.

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act. Yes ¨ No x

As of May 9, 2011, the Registrant had 10,898,500 of its $0.10 par value common stock outstanding.

Table of Contents

TABLE OF CONTENTS

		Page
PART I FINANCIAL INFORMATION		**3**
Item 1.	Financial Statements	3
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3.	Quantitative and Qualitative Disclosures About Market Risks	21
Item 4.	Controls and Procedures	21
PART II OTHER INFORMATION		**22**
Item 6.	Exhibits	22

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

SCOTT S LIQUID GOLD-INC. & SUBSIDIARIES

Consolidated Statements of Operations (Unaudited)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
Net sales	$ 3,868,400	$ 3,599,400
Operating costs and expenses:		
Cost of sales	1,991,000	1,881,100
Advertising	80,200	71,400
Selling	1,033,300	963,500
General and administrative	607,800	609,500
	3,712,300	3,525,500
Income from operations	156,100	73,900
Rental and other income	39,600	34,500
Interest expense	(69,900)	(69,200)
Income before income taxes	125,800	39,200
Income tax expense		
Net income	$ 125,800	$ 39,200
Net income per common share (Note 2):		
Basic & Diluted	$ .01	$
Weighted average shares outstanding:		
Basic	10,898,500	10,795,000
Diluted	12,136,750	11,196,750

See accompanying notes to consolidated financial statements.

Table of Contents

SCOTT S LIQUID GOLD-INC. & SUBSIDIARIES

Consolidated Balance Sheets

	March 31, 2011 (Unaudited)	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 572,600	$ 480,700
Trade receivables, net of allowance of $61,600 and $61,300, respectively, for doubtful accounts	1,103,600	836,400
Inventories, net	2,267,200	1,681,500
Prepaid expenses	236,000	205,000
Total current assets, net	4,179,400	3,203,600
Property, plant and equipment, net	10,947,400	11,062,400
Other assets	85,200	91,000
TOTAL ASSETS	$ 15,212,000	$ 14,357,000
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Obligations collateralized by receivables	$ 480,300	$ 340,900
Accounts payable	1,575,100	983,300
Accrued payroll and benefits	642,600	583,100
Accrued property taxes	265,100	208,500
Other accrued expenses	170,900	231,900
Current maturities of long-term debt	332,600	330,200
Total current liabilities	3,466,600	2,677,900
Long-term debt, net of current maturities	3,619,800	3,704,100
TOTAL LIABILITIES	7,086,400	6,382,000
Shareholders equity:		
Common stock; $.10 par value, authorized 50,000,000 shares; issued and outstanding 10,898,500 shares, and 10,898,500 shares, respectively	1,089,900	1,089,900
Capital in excess of par	5,397,900	5,373,100
Retained earnings	1,637,800	1,512,000
Shareholders equity	8,125,600	7,975,000
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 15,212,000	$ 14,357,000

See accompanying notes to consolidated financial statements.

SCOTT S LIQUID GOLD-INC. & SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

	Three Months Ended March 31,	
	2011	**2010**
Cash flows from operating activities:		
Net income	$ 125,800	$ 39,200
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	124,800	128,400
Stock-based compensation	24,800	19,500
Gain on sale of securities		(300)
Changes in assets and liabilities:		
Trade receivables, net	(267,200)	(338,600)
Inventories, net	(585,700)	(190,100)
Prepaid expenses and other assets	(31,000)	(64,200)
Accounts payable and accrued expenses	646,900	586,100
Total adjustments to net income	(87,400)	140,800
Net Cash Provided by Operating Activities	38,400	180,000
Cash flows from investing activities:		
Proceeds from sale of securities		4,300
Real estate brokerage fees		(41,200)
Purchase of property, plant & equipment	(4,000)	(1,800)
Net Cash Used by Investing Activities	(4,000)	(38,700)
Cash flows from financing activities:		
Proceeds (payments) on obligations collateralized by receivables	139,400	(69,900)
Principal payments on long-term borrowings	(81,900)	(79,400)
Net Cash Provided (Used) by Financing Activities	57,500	(149,300)
Net Increase (Decrease) in Cash and Cash Equivalents	91,900	(8,000)
Cash and Cash Equivalents, beginning of period	480,700	654,100
Cash and Cash Equivalents, end of period	$ 572,600	$ 646,100
Supplemental disclosures:		
Cash paid during period for: Interest	$ 70,300	$ 69,200

See accompanying notes to consolidated financial statements.

Table of Contents

SCOTT S LIQUID GOLD-INC. & SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

Note 1. Summary of Significant Accounting Policies

(a) Company Background

Scott s Liquid Gold-Inc. (a Colorado corporation) was incorporated on February 15, 1954. Scott s Liquid Gold-Inc. and its wholly-owned subsidiaries (collectively, we or our) manufacture and market quality household and skin care products, and we fill, package and market our Mold Control 500 product. Since the first quarter of 2001, we have acted as the distributor in the United States for beauty care products contained in individual sachets and manufactured by Montagne Jeunesse. In 2009, we began the distribution of Batiste dry shampoo manufactured by Vivalis. Our business is comprised of two segments household products and skin care products.

(b) Principles of Consolidation

Our consolidated financial statements include our accounts and those of our wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated.

(c) Basis of Preparation of Financial Statements

We have prepared these unaudited interim consolidated financial statements in accordance with the rules and regulations of the Securities and Exchange Commission. Such rules and regulations allow the omission of certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles as long as the statements are not misleading. In the opinion of management, all adjustments necessary for a fair presentation of these interim statements have been included and are of a normal recurring nature. These interim financial statements should be read in conjunction with our financial statements included in our 2010 Annual Report on Form 10-K. The results of operations for the interim period may not be indicative of the results to be expected for the full fiscal year.

(d) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include, but are not limited to, realization of deferred tax assets, reserves for slow moving and obsolete inventory, customer returns and allowances, coupon redemptions, bad debts, and stock-based compensation.

(e) Cash Equivalents

We consider all highly liquid investments with an original maturity of three months or less at the date of acquisition to be cash equivalents.

(f) Sale of Accounts Receivable

On November 3, 2008, we established a $1.2 million factoring line with an asset-based lender, Summit Financial Resources (Summit or Lender), and secured by accounts receivable, inventory, any lease in which we are a lessor, all investment property and guarantees by our active subsidiaries. On March 12, 2009 we entered into the First Amended and Restated Financing Agreement with the Lender and, subsequently, on March 16, 2011 (effective as of March 1, 2011) we entered into the Second Amended and Restated Financing Agreement with the Lender (the Summit Financial Agreement). This most recent amendment, among other things, increased our factoring line from $1.2 million to $1.5 million and increased the advance rate from 70% to 85% of eligible receivables. Advances under the agreement bear interest at a rate of 1.5% over the prime rate (as published in the Wall Street Journal) for the accounts receivable portion of the advances and 4.0% over the prime rate for the inventory portion, if any, of the borrowings. Consequently, our interest cost adjusts with changes in the prime rate (3.25% as of March 31, 2011). In addition, there are administrative fees of 1.0% of the average monthly balance of outstanding advances on accounts receivable and 1.35% on the average monthly balance of outstanding advances on inventory. The administrative fee with respect to advances against accounts receivable is less costly than the collateral management fee under the previous agreement in which a 0.28% fee was charged on the face value of the receivable (rather than on the advance amount) for each 10-day period that an advance remained outstanding. The administrative fee with respect to advances on inventory is unchanged from the former collateral management fee relative to advances on inventory. The term of the Summit Financial Agreement is eighteen months (expiring September 1, 2012), renewable automatically for additional one-year terms unless either party provides written notice of non-renewal at least 60 days prior to the end of the current financing period. At March 31, 2011, approximately $1.02 million of this credit line was available to the Company assuming sufficient levels of eligible receivables.

We follow Financial Accounting Standards Board (FASB) authoritative guidance as it relates to distinguishing between transfers of financial assets that are sales from transfers that are secured borrowings. Under this the reporting of the sale of accounts receivable is treated as a secured borrowing rather than as a sale. As a result, effected accounts receivable are reported under Current Assets within the Company s balance sheet as Trade receivables subject to reserves for doubtful accounts, returns and other allowances. Similarly, the net liability owing to Summit Financial Resources appears as Obligations collateralized by receivables within the Current Liabilities section of the Company s balance sheet. Net Proceeds received from the sale of accounts receivable appear as cash provided or used by financing activities within the Company s Consolidated Statements of Cash Flows.

On March 16, 2011, under a consent agreement from Summit, the Company entered into a financing agreement with Wells Fargo Bank (the Wells Fargo Agreement) for the purpose of further lowering the cost of borrowing associated with the financing of our accounts receivable. Pursuant to this agreement, the Company may sell receivables relating to our largest account at a discount to Wells Fargo; provided, however, that Wells Fargo may reject offers to purchase such receivables in its discretion. Under the Wells Fargo Agreement, the accounts receivable with our largest customer may be purchased by Wells Fargo at a cost to us equal to LIBOR plus 1.15% per annum, the LIBOR rate being either the 30-day, 60-day or 90-day rate dependent upon the days to maturity of the receivable sold to Wells Fargo (90-day LIBOR rate is 0.30% as of March 31, 2011). The Wells Fargo Agreement will continue unless terminated by either party upon 30 days written notice.

Table of Contents

With respect to the Wells Fargo Agreement, we follow FASB authoritative guidance as it relates to distinguishing between transfers of financial assets that are sales from transfers that are secured borrowings. These transactions qualify for a sale of assets since (1) we have transferred all of our rights, title and interest in the selected accounts receivable invoices to the Lender, (2) the Lender may pledge, sell or transfer the selected accounts receivable invoices, and (3) we have no effective control over the selected accounts receivable invoices since we are not entitled to nor obligated to repurchase or redeem the invoices before their maturity and we do not have the ability to unilaterally cause the Lender to return the invoices. Under the authoritative guidance, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. Through March 31, 2011, we have not sold any of our accounts receivable invoices to Wells Fargo under this agreement.

(g) Inventories

Inventories consist of raw materials and finished goods and are stated at the lower of cost (first-in, first-out method) or market. We record a reserve for slow moving and obsolete products and raw materials. We estimate reserves for slow moving and obsolete products and raw materials based upon historical and anticipated sales.

Inventories were comprised of the following at:

	March 31, 2011	December 31, 2010
Finished goods	$ 1,086,900	$ 877,100
Raw materials	1,471,500	1,095,600
Inventory reserve for obsolescence	(291,200)	(291,200)
	$ 2,267,200	$ 1,681,500

(h) Property, Plant and Equipment

Property, plant and equipment are recorded at historical cost. Depreciation is provided using the straight-line method over estimated useful lives of the assets ranging from three to 45 years. Building structures and building improvements are estimated to have useful lives of 35 to 45 years and three to 20 years, respectively. Production equipment and production support equipment are estimated to have useful lives of 15 to 20 years and three to 10 years, respectively. Office furniture and office machines are estimated to have useful lives of 10 to 20 and three to five years, respectively. Carpet, drapes and company vehicles are estimated to have useful lives of five to 10 years. Maintenance and repairs are expensed as incurred. Improvements that extend the useful lives of the assets or provide improved efficiency are capitalized.

(i) Financial Instruments

Financial instruments which potentially subject us to concentrations of credit risk include cash and cash equivalents and trade receivables. We maintain our cash balances in the form of bank demand deposits with financial institutions that management believes are creditworthy. We establish an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends and other information. We have no significant financial instruments with off-balance sheet risk of accounting loss, such as foreign exchange contracts, option contracts or other foreign currency hedging arrangements.

The recorded amounts for cash and cash equivalents, receivables, other current assets, and obligations collateralized by receivables, accounts payable and accrued expenses approximate fair value due to the short-term nature of these financial instruments. Our long-term debt bears interest at a fixed rate that adjusts annually on the anniversary date to a then prime rate. The carrying value of long-term debt approximates fair value as of March 31, 2011 and December 31, 2010.

(j) Long-Lived Assets

We follow FASB authoritative guidance as it relates to the proper accounting treatment for the impairment or disposal of long-lived assets. This guidance requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

As of December 31, 2010, due to changes in the real estate market in Denver, Colorado and the continuing economic downturn, we conducted an evaluation into fair value impairment with regard to our property, plant and equipment with particular attention to our land and buildings (facilities), which have an original cost of $17,485,800 and a depreciated book value at December 31, 2010 of approximately $10,423,800. For the facilities, we performed an evaluation utilizing an income capitalization model employing rental, vacancy and capitalization rates obtained from independent market data relative to our area of the Denver market as well as the actual rental rate in effect in the current lease of a portion of our office space. This evaluation returned a range of fair value estimates in excess of (a) the carrying value of the facilities and (b) the current listing price for the facilities. We currently have the facilities listed for sale at the price of $11,500,000 for the improved property plus an unstated amount for an unimproved, adjacent 5.5 acre parcel of land with a value estimated by us at $1,200,000. Based upon our evaluation, we find there to be no impairment in the carrying values of our long-lived assets at December 31, 2010 and there have been no events or changes in circumstances that indicate the fair value of the facilities has declined in the three months ended March 31, 2011; however, the valuation of our facilities can be affected by future events including the commercial real estate market in which our facilities are located.

(k) Income Taxes

We follow FASB authoritative guidance for the accounting for income taxes which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences attributable to differences between the financial statement carrying amounts of assets and liabilities and their respective income tax bases. A valuation allowance is provided when it is more likely than not that some portion or all of a deferred tax asset will not be realized. The ultimate realization of deferred tax assets is

dependent upon the generation of future taxable income during the period in which related temporary differences become deductible. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

(l) Revenue Recognition

Revenue is recognized when an arrangement exists to sell our product, we have delivered such product in accordance with that arrangement, the sales price is determinable, and collectability is probable. Reserves for estimated market development support, pricing allowances and returns are provided in the period of sale as a reduction of revenue. Reserves for returns and allowances are recorded as a reduction of revenue, and are maintained at a level that management believes is appropriate to account for amounts applicable to existing sales. Reserves for coupons and certain other promotional activities are recorded as a reduction of revenue at the later of the date at which the related revenue is recognized or the date at which the sales incentive is offered. At March 31, 2011 and December 31, 2010 approximately $282,000 and $303,000, respectively, had been reserved as a reduction of accounts receivable, and approximately $13,000 and $73,000, respectively, had been accrued as current liabilities. Co-op advertising, marketing funds, slotting fees and coupons are deducted from gross sales and totaled $267,600 and $202,800 in the quarters ended March 31, 2011 and 2010, respectively.

(m) Advertising Costs

Advertising costs are expensed as incurred.

(n) Stock-based Compensation

No stock options have been granted during the first quarter of 2011, however, during the first quarter of 2010, we granted 21,000 options for shares of our common stock to certain employees at $0.30 per share. The options, which vest ratably over 48 months, or upon a change in control, and which expire after five years, were granted at or above the market value as of the date of grant.

The weighted-average fair market value of the options granted in the first quarter of 2010 were estimated on the date of grant, using a Black-Scholes option pricing model with the following assumptions:

	March 31, 2010
Expected life of options (using the simplified method)	4.5 years
Risk-free interest rate	2.6%
Expected volatility of stock	120%
Expected dividend rate	None

Compensation cost related to stock options recognized in operating results (included in general and administrative expenses) under authoritative guidance issued by the FASB was $24,800 in the three months ended March 31, 2011. Approximately $153,400 of total unrecognized compensation costs related to non-vested stock options is expected to be recognized over the next 45 months. In accordance with this same authoritative guidance, there was no tax benefit from recording the non-cash expense as it relates to the options granted to employees, as these were qualified stock options, which are not normally tax deductible. With respect to the non-cash expense

Table of Contents

associated with the options granted to the non-employee directors, no tax benefit was recognized due to the existence of as yet unutilized net operating losses. At such time as these operating losses have been utilized and a tax benefit is realized from the issuance of non-qualified stock options, a corresponding tax benefit may be recognized.

(o) Operating Costs and Expenses Classification

Cost of sales includes costs associated with manufacturing and distribution including labor, materials, freight-in, purchasing and receiving, quality control, internal transfer costs, repairs, maintenance and other indirect costs, as well as warehousing and distribution costs. We classify shipping and handling costs comprised primarily of freight-out and nominal outside warehousing costs as a component of selling expense on the accompanying Consolidated Statement of Operations. Shipping and handling costs totaled $358,400 and $294,800, for the quarters ended March 31, 2011 and 2010, respectively.

Selling expenses consist primarily of shipping and handling costs, wages and benefits for sales and sales support personnel, travel, brokerage commissions, promotional costs, as well as other indirect costs.

General and administrative expenses consist primarily of wages and benefits associated with management and administrative support departments, business insurance costs, professional fees, office facility related expenses, and other general support costs.

Table of Contents

Note 2. Earnings per Share

Per share data was determined by using the weighted average number of common shares outstanding. Potentially dilutive securities, including stock options, are considered only for diluted earnings per share, unless considered anti-dilutive. The potentially dilutive securities are comprised of outstanding stock options of 1,933,550 and 1,932,650 at March 31, 2011 and 2010, respectively. At March 31, 2011, those securities for which the average market price for the three months ended March 31, 2011 exceeded the exercise price total approximately 1,238,250 shares. At March 31, 2010, those securities for which the average market price for the three months ended March 31, 2010 exceeded the exercise price total approximately 401,750 shares.

A reconciliation of the weighted average number of common shares outstanding for the three months ended March 31 follows:

	2011	2010