

SCOTTS LIQUID GOLD INC
Form 10-Q
May 16, 2016

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 March 31, 2016

Or

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

For the transition period from _____ to _____

Commission File Number: 001-13458

SCOTT'S LIQUID GOLD-INC.

(Exact name of registrant as specified in its charter)

Colorado
(State or other jurisdiction of
incorporation or organization)

84-0920811
(I.R.S.
Employer
Identification
No.)

4880 Havana Street, Suite 400, Denver, CO

80239

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(Address of principal executive offices)

(Zip Code)

303-373-4860

(Registrant's telephone number, including area code)

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 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

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

As of May 13, 2016, the Registrant had 11,737,478 of its common stock, \$0.10 par value per share, outstanding.

CAUTIONARY NOTE ON FORWARD-LOOKING INFORMATION

This Quarterly Report on Form 10-Q (this “Report”) contains “forward-looking statements” within the meaning of U.S. federal securities laws. All statements, other than statements of historical fact, included in this Report that address activities, events, or developments with respect to our financial condition, results of operations, or economic performance that we expect, believe, or anticipate will or may occur in the future, or that address plans and objectives of management for future operations, are forward-looking statements. You can typically identify forward-looking statements by the use of words, such as “may,” “could,” “should,” “assume,” “project,” “believe,” “anticipate,” “expect,” “estimate,” “potential,” “plan,” and other similar words. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements and our performance inherently involve risk and uncertainty that could cause actual results to differ materially from the forward-looking statements. Factors that would cause or contribute to such differences include, but are not limited to:

- changing consumer preferences and the continued acceptance of each of our significant products in the marketplace;
- the degree of success of any new product or product line introduction by us;
- competitive factors, including any decrease in distribution of (i.e., retail stores carrying) our significant products;
- continuation of our distributorship agreements for Montagne Jeunesse skin care products and Batiste Dry Shampoos;
- the need for effective advertising of our products and limited resources available for such advertising;
- new competitive products and/or technological changes;
- dependence upon third party vendors and upon sales to major customers;
- the availability of necessary raw materials and potential increases in the prices of these raw materials;
- changes in the regulation of our products, including applicable environmental and U.S. Food and Drug Administration (“FDA”) regulations;
- the continuing availability of financing on terms and conditions that are acceptable to us;
- the degree of success of the integration of product lines or businesses we may acquire;
- future losses which could affect our liquidity;
- the loss of any executive officer; and
- other matters discussed in this Report, including the risks described in the Risk Factors section of this Report.

We caution you that forward-looking statements are not guarantees of future performance and that actual results or performance may be materially different from those expressed or implied in the forward-looking statements. The forward-looking statements in this Report speak as of the filing date of this Report. Although we may from time to time voluntarily update our prior forward-looking statements, we undertake no obligation to revise any forward-looking statements in order to reflect events or circumstances that may arise after the date of this Report.

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PART I

ITEM 1. FINANCIAL STATEMENTS.

Consolidated Statements of Operations (Unaudited)

Scott's Liquid Gold-Inc. & Subsidiaries

	Three Months Ended	
	March 31,	
	2016	2015
Net sales	\$7,855,900	\$6,948,200
Operating costs and expenses:		
Cost of sales	3,857,100	3,739,400
Advertising	486,100	247,200
Selling	1,249,800	1,353,200
General and administrative	953,100	909,200
Total operating costs and expenses	6,546,100	6,249,000
Income from operations	1,309,800	699,200
Other income	6,200	4,100
Interest expense	(7,400)	(7,300)
Income before income taxes	1,308,600	696,000
Income tax expense	(552,100)	(12,400)
Net income	\$756,500	\$683,600
Net income per common share		
Basic	\$0.06	\$0.06
Diluted	\$0.06	\$0.06
Weighted average shares outstanding:		
Basic	11,710,745	11,557,281
Diluted	11,927,124	11,874,589

See accompanying notes to these Consolidated Financial Statements (Unaudited).

Consolidated Balance Sheets

Scott's Liquid Gold-Inc. & Subsidiaries

	March 31, 2016 (unaudited)	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$5,947,200	\$7,165,100
Trade receivables, net	2,812,800	1,014,700
Inventories, net	5,190,600	4,698,600
Prepaid expenses	359,100	227,200
Total current assets	14,309,700	13,105,600
Property and equipment, net	552,800	430,000
Deferred tax asset	2,038,300	2,556,200
Other assets	51,000	51,000
Total assets	\$16,951,800	\$16,142,800
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	1,712,600	1,238,000
Accrued payroll and benefits	260,700	780,300
Income taxes payable	30,300	5,300
Accrued property taxes	31,400	23,400
Total current liabilities	2,035,000	2,047,000
Total liabilities	2,035,000	2,047,000
Shareholders' equity:		
Common stock; \$0.10 par value, authorized 50,000,000 shares; issued and outstanding 11,710,745 shares (2016) and 11,710,745 shares (2015)	1,171,100	1,171,100
Capital in excess of par	5,965,600	5,901,100
Retained earnings	7,780,100	7,023,600
Total shareholders' equity	14,916,800	14,095,800
Total liabilities and shareholders' equity	\$16,951,800	\$16,142,800

See accompanying notes to these Consolidated Financial Statements (Unaudited).

Consolidated Statements of Cash Flows (Unaudited)

Scott's Liquid Gold-Inc. & Subsidiaries

	Three Months Ended	
	March 31, 2016	2015
Cash flows from operating activities:		
Net income	\$756,500	\$683,600
Adjustment to reconcile net income to net cash (used) provided by operating activities:		
Depreciation and amortization	45,300	39,500
Stock-based compensation	64,500	17,200
Deferred income taxes	517,900	0
Change in operating assets and liabilities:		
Trade receivables	(1,798,100)	(987,800)
Inventories	(492,000)	(256,400)
Prepaid expenses and other assets	(131,900)	3,100
Income taxes payable (receivable)	25,000	6,600
Accounts payable and accrued expenses	(37,000)	643,700
Total adjustments to net income	(1,806,300)	(534,100)
Net Cash (Used) Provided by Operating Activities	(1,049,800)	149,500
Cash flow from investing activities:		
Purchase of property and equipment	(168,100)	(7,400)
Net Cash Used by Investing Activities	(168,100)	(7,400)
Cash flow from financing activities:		
Proceeds from exercise of stock options	0	6,900
Net Cash Provided by Financing Activities	0	6,900
Net (Decrease) Increase in Cash and Cash Equivalents	(1,217,900)	149,000
Cash and Cash Equivalents, beginning of period	7,165,100	5,896,600
Cash and Cash Equivalents, end of period	\$5,947,200	\$6,045,600
Supplemental disclosures:		
Cash paid during the period for interest	\$7,400	\$7,300

See accompanying notes to these Consolidated Financial Statements (Unaudited).

Notes to Consolidated Financial Statements (Unaudited)

Scott's Liquid Gold-Inc. & Subsidiaries

Note 1. Organization and 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, the "Company," "we," "our," or "us") develop, manufacture, market and sell quality household and skin and hair care products. We are also a distributor in the United States of Montagne Jeunesse skin sachets and Batiste Dry Shampoo manufactured by two other companies. Our business is comprised of two segments, household products and skin and hair 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 Presentation

The Consolidated Statements of Operations, Consolidated Balance Sheets, and the Consolidated Statements of Cash Flows included in this Report have been prepared by the Company. In our opinion, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position at March 31, 2016 and results of operations and cash flows for all periods have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. These consolidated financial statements should be read in conjunction with our financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015. The results of operations for the period ended March 31, 2016 are not necessarily indicative of the operating results for the full year.

(d) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts in our financial statements 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. Significant estimates include, but are not limited to, the realization of deferred tax assets, reserves for slow moving and obsolete inventory, customer returns and allowances, and stock-based compensation. Actual results could differ from our estimates.

(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, effective as of October 31, 2008, we entered into a financing agreement with Summit Financial Resources, L.P. ("Summit") for the purpose of providing working capital. The financing agreement with Summit was amended on March 12, 2009, March 16, 2011 (effective March 1, 2011) and June 29, 2012 (effective July 1, 2012). The agreement has a term that expires on January 1, 2017, but it may be renewed for additional 12 month periods unless either party elects to cancel in writing at least 60 days prior to January 1, 2017 and thereafter on

the anniversary date of each 12 month period.

The agreement provides for a factoring line up to \$1.5 million and is secured primarily by accounts receivables, inventory, any lease in which we are a lessor and all investment property and guarantees by our active subsidiaries. Under the agreement, Summit will make loans at our request and in its discretion based on: (i) its purchases of our receivables, with recourse against us, at an advance rate of 85% (or such other percentage determined by Summit in its discretion) and (ii) our inventory not to exceed certain amounts, including an aggregate maximum of \$500,000. Advances under the agreement have an interest rate of 1.0% over the prime

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rate (as published in The Wall Street Journal) for the accounts receivables portion of the advances and 2.5% over the prime rate for the inventory portion of the borrowings. At March 31, 2016, the prime rate was 3.50%.

There is also an administrative fee of 0.85% per month on the average monthly outstanding loan on the receivable portion of any advance if the average quarterly loan in the prior quarter was less than or equal to \$1,000,000, and 0.75% per month if the average quarterly loan in the prior quarter was greater than \$1,000,000 and of 1.0% per month on the average monthly outstanding loan on the inventory portion of any advance.

The agreement provides that neither we nor our active subsidiaries may engage in a change in control transaction without the prior written consent of Summit. Events of default include, but are not limited to, our failure to make a payment when due or a default occurring on any of our other indebtedness.

In 2016 and 2015, we did not sell any of our accounts receivables to Summit. At March 31, 2016 and December 31, 2015 the entire credit line of \$1.5 million was available for future factoring of accounts receivable invoices and borrowings secured by our inventory.

We report these transactions as a secured borrowing rather than as a sale. As a result, affected accounts receivable, if any, are reported under the "Current Assets" section within our Consolidated Balance Sheets as "Trade receivables, net." Similarly, the net liability owing to Summit, if any, appears as "Obligations collateralized by receivables and inventory" within the "Current Liabilities" section of our Consolidated Balance Sheets. Net proceeds received on obligations collateralized by receivables and inventory appear as "net cash provided (used) by operating activities" within the "Adjustment to reconcile net income to net cash used by operating activities" section of our Consolidated Statements of Cash Flows.

On March 16, 2011, with the consent of Summit, we entered into a financing agreement with Wells Fargo Bank, National Association ("Wells Fargo") for the purpose of further lowering the cost of borrowing associated with the financing of our accounts receivable and on January 29, 2016 we terminated our agreement with Wells Fargo due to Wal-Mart Stores, Inc. ("Wal-Mart"), changing its accounts payable policy. Pursuant to this agreement, we were able to sell accounts receivables from Wal-Mart at a discount to Wells Fargo; provided, however, that Wells Fargo could reject offers to purchase such receivables in its discretion. These receivables could be purchased by Wells Fargo at a cost to us equal to LIBOR plus 1.15% per annum. The LIBOR rate used depends on the days to maturity of the receivable sold, typically ranging from 102 to 105 days. At January 29, 2016, Wells Fargo used the 105-day LIBOR rate of 0.70%.

During the three months ended March 31, 2016 and 2015, we sold approximately \$306,800 and \$1,055,000, respectively, of our relevant accounts receivable to Wells Fargo for approximately \$305,200 and \$1,050,600, respectively. The difference between the invoiced amount of the receivable and the cash that we received from Wells Fargo is a cost to us. This cost is in lieu of any cash discount our customer would have been allowed and, thus, is treated in a manner consistent with standard trade discounts granted to our customers.

The reporting of the sale of accounts receivables to Wells Fargo is treated as a sale rather than as a secured borrowing. As a result, affected accounts receivables are relieved from the Company's financial statements upon receipt of the cash proceeds.

(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 this reserve based upon historical and anticipated sales.

Inventories were comprised of the following at:

	March 31, 2016	December 31, 2015
Finished goods	\$2,248,300	\$ 2,101,300
Raw materials	3,062,300	2,717,300
Inventory reserve for obsolescence	(120,000)	(120,000)
	\$5,190,600	\$ 4,698,600

(h) Property and Equipment

Property and equipment are recorded at historical cost. Depreciation is provided using the straight-line method over the estimated useful lives of the assets ranging from three to 20 years. 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 years and three to five years, respectively. Maintenance and repairs are expensed as incurred. Improvements that extend the useful lives of the asset 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 we believe are creditworthy. During the three months end March 31, 2016, we maintained balances in various operating accounts in excess of federally insured limits. 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, accounts payable and accrued expenses approximate fair value due to the short-term nature of these financial instruments. As of March 31, 2016 and December 31, 2015 we had no long-term debt.

(j) Income Taxes

Deferred income tax assets and liabilities are recognized for the future income 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.

Taxes are reported based on tax positions that meet a more-likely-than-not standard and that are measured at the amount that is more-likely-than-not to be realized. Differences between financial and tax reporting which do not meet this threshold are required to be recorded as unrecognized tax benefits or expense. We classify penalty and interest expense related to income tax liabilities as an income tax expense. There are no significant interest and penalties recognized in the statement of operations or accrued on the balance sheet.

The effective tax rate for the three months ended March 31, 2016, was 42.2%, which differs from the statutory income tax rate due to permanent book to tax differences.

As of December 31, 2014, the Company had a deferred tax asset of \$0, net of a valuation allowance of \$3,379,100. As of that date and until the second quarter of 2015, a full valuation allowance had been provided against deferred tax assets, as it was more-likely-than-not that the Company's net deferred tax asset would not be realized in the foreseeable future due to the Company's cumulative book loss. Consequently, the Company was unable to recognize any income tax benefit in such prior periods. However, the Company had, as of June 30, 2015, reported positive income for nine consecutive quarters and the 36 month cumulative income before income taxes was approximately \$3.4 million. Accordingly, the Company as of June 30, 2015 released a portion of the valuation allowance related to the deferred tax asset of approximately \$3.1 million as well as an additional \$70,200 in the third quarter ended September 30, 2015. The analysis of the partial valuation allowance release was in accordance with accounting standards for interim period reporting. The remaining \$169,200 in valuation allowance was released during the fourth quarter of 2015.

(k) Revenue Recognition

Our revenue recognition policy is significant because the amount and timing of revenue is a key component of our results of operations. Certain criteria are required to be met in order to recognize revenue. If these criteria are not met, then the associated revenue is deferred until it is met. In our case, the criteria generally are met when we have an arrangement to sell a product, we have delivered the product in accordance with that arrangement, the sales price of the product is determinable and we believe that we will be paid for the sale.

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We establish reserves for customer returns of our products and customer allowances. We estimate these reserves based upon, among other things, an assessment of historical trends, information from customers and anticipated returns related to current sales activity. These reserves are established in the period of sale and reduce our revenue in that period.

Our reserve for customer allowances includes primarily reserves for trade promotions to support price features, displays, slotting fees and other merchandising of our products to our customers. The actual level of returns and customer allowances are influenced by several factors, including the promotional efforts of our customers, changes in mix of our customers, changes in the mix of the products we sell and the maturity of the product. We may change our estimates based on actual results and consideration of other factors that cause returns and allowances. In the event that actual results differ from our estimates, the results of future periods may be impacted.

We also establish reserves for coupons, rebates and certain other promotional programs for consumers. We estimate these reserves based upon, among other things, an assessment of historical trends and current sales activity. These reserves are recorded as a reduction of revenue at the later of the date at which the revenue is recognized or the date at which the sale incentive is offered.

We have also established an allowance for doubtful accounts. We estimate this allowance based upon, among other things, an assessment of the credit risk of specific customers and historical trends. We believe our allowance for doubtful accounts is adequate to absorb any losses which may arise. In the event that actual losses differ from our estimates, the results of future periods may be impacted.

At March 31, 2016 and December 31, 2015 approximately \$745,800 and \$1,179,700, respectively, had been reserved as a reduction of accounts receivable. Trade promotions to our customers and incentives such as coupons to our consumers are deducted from gross sales and totaled \$451,600 and \$510,100 for the three months ended March 31, 2016 and 2015, respectively.

(l) Advertising Costs

Advertising costs are expensed as incurred.

(m) Stock-based Compensation

During the three months ended March 31, 2016, we granted options to acquire 3,000 shares of our common stock to one of our production personnel at a price of \$1.20 per share, which vest ratably over 48 months, or upon a change in control under certain circumstances, and which expire after 10 years. During the three months ended March 31, 2015, we did not grant any stock options.

The weighted average fair market value of the options granted in the first three months of 2016 was estimated on the date of grant, using a Black-Scholes option pricing model with the following assumptions:

	March 31, 2016
Expected life of options (using the “simplified” method)	10 years
Average risk-free interest rate	1.5%
Average expected volatility of stock	134%
Expected dividend rate	None
Fair value of options granted	\$3,488

Compensation cost related to stock options recognized in operating results (included in general and administrative expenses) was \$64,500 and \$17,200 in the three months ended March 31, 2016 and 2015, respectively. Approximately \$774,400 of total unrecognized compensation costs related to non-vested stock options is expected to be recognized over the next 12 – 60 months, depending on the vesting provisions of the options. 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 associated with options granted to the non-employee directors, no tax benefit is recognized for the excess of the tax deduction over the book expense previously 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 exercise of non-qualified stock options, a corresponding tax benefit may be recognized.