STARRETT L S CO
Form 10-Q
November 02, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 23, 2006____

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	04-1866480
(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	Identification No.)

121 CRESCENT STREET, ATHOL, MASSACHUSETTS	01331-1915
(Address of principal executive offices)	(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 filings requirements for the past 90 days.

YES X NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act, (Check One):

Large Accelerated Filer___ Accelerated Filer_X_ Non-Accelerated Filer____

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES NO X

Common Shares outstanding as of October 20, 2006:

Class A Common Shares	5,683,521
Class B Common Shares	996,514

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	
	9/23/06	9/24/05
Net sales	$ 51,092	$ 47,531
Cost of goods sold	(37,524)	(37,515)

Selling and general expense	(13,328)	(12,590)
Other (expense) income	55	(94)
(Loss) earnings before income taxes	295	(2,668)
Income tax (benefit) expense	74	(824)
Net (loss) earnings	$ 221	$ (1,844)
Basic and diluted (loss) earnings per share	$ .03	$ (.28)
Average outstanding shares used in		
per share calculations (in thousands)		
Basic	6,671	6,663
Diluted	6,678	6,663
Dividends per share	$ .10	$ .10

See notes to consolidated financial statements

THE L. S. STARRETT COMPANY

Consolidated Statements of Cash Flows

(in thousands of dollars)(unaudited)

	13 Weeks Ended	
	9/23/06	9/24/05
Cash flows from operating activities:		
Net (loss) earnings	$ 221	$ (1,844)
Noncash operating activities:		
Gain from sale of real estate	(299)	0
Depreciation	2,508	2,536
Amortization	308	0
Deferred taxes	(174)	(883)
Unrealized transaction (gains) losses	(155)	(56)
Retirement benefits	(292)	(77)
Working capital changes:		
Receivables	(243)	818
Inventories	1,595	(1,875)
Other current assets	1,192	390
Other current liabilities	(1,264)	(1,227)
Prepaid pension cost and other	55	153
Net cash (used in) from operating activities	3,452	(2,065)
Cash flows from investing activities:		
Additions to plant and equipment	(1,455)	(2,033)
Proceeds from sale of real estate	394	0
Decrease in investments	808	4,987
Net cash provided from (used in) investing		

activities	(253)	2,954
Cash flows from financing activities:		
Proceeds from short-term borrowings	240	370
Short-term debt repayments	(1,868)	(850)
Proceeds from long-term borrowings	171	-
Long-term debt repayments	-	(133)
Common stock issued	108	15
Treasury shares purchased	(35)	(170)
Dividends	(669)	(666)
Net cash used in financing activities	(2,053)	(1,434)
Effect of exchange rate changes on cash	85	32
Net (decrease) increase in cash	1,231	(513)
Cash, beginning of period	3,976	4,479
Cash, end of period	5,207	3,966

See notes to consolidated financial statements

THE L. S. STARRETT COMPANY

Consolidated Balance Sheets

(in thousands of dollars)

	Sept. 23 2006	June 24 2006
ASSETS	(unaudited)	
Current assets:		
Cash	$ 5,207	$ 3,976
Investments	18,764	19,424
Accounts receivable (less allowance for doubtful accounts of $1,474 and $1,417)	32,864	31,768
Inventories:		
Raw materials and supplies	15,074	13,902
Goods in process and finished parts	18,525	18,336
Finished goods	22,080	23,740
	55,679	55,978
Prepaid expenses, taxes and other current assets	7,336	8,238
Total current assets	119,850	119,384
Property, plant and equipment, at cost (less accumulated depreciation of $117,124 and $114,843)	62,938	60,924
Intangible assets (less accumulated amortization		

of $442 and $134)	4,858	3,882
Goodwill	5,260	8,580
Prepaid pension cost	34,670	34,551
Other assets	716	761
	$228,292	$228,082

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Notes payable and current maturities	$ 4,943	$ 5,119
Accounts payable and accrued expenses	16,093	15,744
Accrued current income tax	5,440	5,436
Accrued salaries and wages	5,061	4,849
Total current liabilities	31,537	31,148
Deferred income taxes	2,504	2,627
Long-term debt	11,002	13,054
Accumulated postretirement benefit obligation	15,837	16,011
Total liabilities	$ 60,880	$ 62,840
Stockholders' equity:		
Class A Common $1 par (20,000,000 shares authorized; 5,674,451 outstanding at 9/23/06; 5,628,642 outstanding at 6/24/06)	5,674	5,629
Class B Common $1 par (10,000,000 shares authorized; 999,978 outstanding at 9/23/06; 1,040,215		

outstanding at 6/24/06)	1,000	1,040
Additional paid-in capital	50,653	50,569
Retained earnings reinvested and employed in		
the business	123,465	123,913
Accumulated other comprehensive loss	(13,380)	(15,909)
Total stockholders' equity	167,412	165,242
	$228,292	$228,082

See notes to consolidated financial statements

THE L. S. STARRETT COMPANY

Consolidated Statements of Stockholders' Equity

For the Thirteen Weeks Ended September 23, 2006 and September 24, 2005

(in thousands of dollars)(except per share data)

(unaudited)

	Common Stock Out-standing ($1 Par)	Addi-tional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance June 25, 2005	$ 6,664	$ 50,466	$130,361	$(19,065)	$168,426
Comprehensive income:					

Net (loss)			(1,844)		(1,844)
Unrealized net (loss)					
on investments				(2)	(2)
Translation gain, net				398	398
Total comprehensive (loss)					(1,448)
Dividends ($.10 per share)			(666)		(666)
Treasury shares:					
Purchased	(10)	(83)	(77)		(170)
Issued	1	14			15
Stock Purchase Plan	0	14			14
Balance September 24, 2005	$ 6,655	$ 50,411	$127,774	$(18,669)	$166,171

Balance June 24, 2006	$ 6,669	$ 50,569	$123,913	$(15,909)	$165,242
Comprehensive income:					
Net income			221		221
Unrealized net (loss)					
on investments				(76)	(76)
Translation gain, net				2,605	2,605
Total comprehensive income					2,750
Dividends ($.10 per share)			(669)		(669)
Treasury shares:					
Purchased	(3)	(32)			(35)

Issued	8	100			108
Stock Purchase Plan	0	16			16
Balance September 23, 2006	$ 6,674	$ 50,653	$123,465	$(13,380)	$167,412

Cumulative Balance:

Translation loss	$(10,800)
Unrealized loss on investments	(120)
Minimum pension liability	(2,460)
	$(13,380)

See notes to consolidated financial statements

THE L. S. STARRETT COMPANY

Condensed 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 September 23, 2006 and June 24, 2006; the results of operations and cash flows for the thirteen weeks ended September 23, 2006 and September 24, 2005; and changes in stockholders' equity for the thirteen weeks ended September 23, 2006 and September 24, 2005.

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 24, 2006, and these financial statements should be read in conjunction with said annual report.

Shares used to compute basic and diluted loss per share are the same in the September 2005 quarter since the inclusion of common stock equivalents (6,852 shares) is antidilutive in periods with a loss.

Included in investments at September 23, 2006 is $2.2 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.

Accounts payable and accrued expenses at September 23, 2006 consist primarily of accounts payable ($4.6 million), accrued benefits
($1.3 million) and accrued taxes other than income ($1.6 million).

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

	Thirteen Weeks Ended September	
	2006	2005
Interest income	$ 308	$ 292
Interest expense and commitment fees	(450)	(336)
Realized and unrealized exchange		
gains (losses), net	(37)	41

Gain on sale of real estate	299	
Other	(65)	(91)
Other (expense) income	$ 55	$ (94)

Net periodic costs (benefits) for the Company's defined benefit pension plans consists of the following (in thousands):

	Thirteen Weeks Ended September	
	2006	2005
Service cost	$ 765	$ 957
Interest cost	1,701	1,624
Expected return on plan assets	(2,584)	(2,613)
Amort. of transition obligation	-	(1)
Amort. of prior service cost	109	107
Amort. of unrecognized (gain)loss	38	79
	$ 29	$ 153

Net Periodic costs for the Company's postretirement medical plan consist of the following (in thousands):

	Thirteen Weeks Ended September	
	2006	2005
Service cost	$ 102	$ 138
Interest cost	177	206
Amort. of prior service cost	(214)	(119)

Amort. of unrecognized loss	12	32
	$ 77	$ 257

Approximately 55% of all inventories are valued on the LIFO method. At

September 23, 2006 and June 24, 2006, total inventories are approximately

$24 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):

	September 2006	June 2006
Reducing Revolver	$ 12,000	$ 12,000
Capitalized lease obligations payable in		
Brazilian currency due 2007-2011, 15%-23%	3,491	4,282
Less current portion	4,489	3,228
	$ 11,002	$ 13,054

TRU-STONE ACQUISITION

On April 28, 2006, the Company acquired 100% of the assets of Tru-Stone Technologies, Inc. (Tru-Stone). The acquisition of Tru-Stone has been accounted for under the purchase method. As such, the total purchase price has been allocated to assets acquired and liabilities assumed based on management s best estimates of fair value, with the excess cost over the net tangible and identifiable intangible assets acquired being allocated to goodwill.

The initial allocation of the total purchase price of Tru-Stone s net tangible and identifiable intangible assets was based on preliminary fair values as of April 28, 2006. A revised analysis has been completed during the current quarter. The total purchase price of $19,986 has been reallocated based upon the revised analysis as follows (in thousands):

Purchase price allocated:		
Accounts receivable	$	1,638
Inventory		2,246
Other current assets		118
Property, plant and equipment		5,968
Accounts payable and accrued liabilities		(544)
Intangible asset - non-compete agreements		1,330
Intangible asset customer relationships		3,970
Goodwill		5,260
Total purchase price	$	19,986

Adjustments to reflect the revised allocation have been recorded in the quarter ended September 23, 2006. Such adjustments had an insignificant impact on net income.

RECENT ACCOUNTING PRONOUNCEMENTS

The FASB issued Statement 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans: an amendment of FASB Statement No.87, 88, 106, and 132(R), which applies to all single-employer defined benefit pension and postretirement benefit plans.

The Statement requires recognition of the funded status of postretirement benefit plans in the statement of financial position. An employer must recognize an asset or liability in its statement of financial position for the differences between the fair value of the plan assets and the projected benefit obligation (PBO)(pension plans), or the accumulated postretirement benefit obligation (other postretirement plans). Changes in the plans funded status must be recognized, in the year of change, in accumulated other comprehensive income (AOCI). The Statement also will require entities to measure the funded status of the plans as of the date of the year-end statement of financial position, with a few exceptions. Adoption of this pronouncement is effective for the Company in fiscal 2007. The recognition provision will be adopted in the last quarter of fiscal 2007.

Based on June 30, 2006 information, FAS 158 would require an adjustment to increase the Company s accumulated other comprehensive loss in the amount of $12.0 million (before tax effect), which represents the excess of the Company s net prepaid ($34.5 million) over the Company s PBO funded status ($22.5 million).

In addition, the amount will be offset by an increase in AOCI due to the retiree medical plan. This plan would have an increase to AOCI in the amount of $4.0 million(before tax effect), which represents the excess of the Company s accrued benefit liability ($16.7 million) over the Company s APBO funded status ($12.7 million).

The net result will be a decrease in AOCI of $11.6 million(before tax effect).

The FASB recently issued FASB Interpretation 48, Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statements No. 109, which clarifies Statement 109, Accounting for Income Taxes, indicates criterion that an individual tax position must satisfy for some or all of the benefits of that position to be recognized in the financial statements. Under Interpretation 48, an entity should evaluate a tax position using a two step process:

1.

Evaluate the position for recognition: an enterprise should recognize the financial statement benefit of a tax position only after determining that the relevant tax authority would more-likely-than-not sustain the position following an audit.

2.

Measure the benefit amount for tax position that meets the more-likely-than-not threshold: The amount recognized in the financial statements should be the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority.

Interpretation 48 contains significant disclosure requirements, including a tabular reconciliation of the beginning and ending balances of unrecognized tax benefits, as well as information concerning tax positions for which a material change in the liability for unrecognized tax benefits is reasonably possible within the next 12 months.

The scope of the Interpretation includes all tax positions accounted for in accordance with Statement 109. The term tax position includes, but is not limited to, the following:

1.

A decision not to file a tax return in a jurisdiction

2.

The allocation of income between jurisdictions

3.

The characterization of income in the tax return

4.

A decision to exclude taxable income in the tax return

5.

A decision to classify a transaction, entity, or other position as tax-exempt in the tax return

Interpretation 48 applies only to taxes that are subject to Statement 109. Uncertainties related to taxes that are not based on a measurement of income, such as franchise taxes, sales tax, and ad valorem taxes, should be accounted for by applying Statement 5, Accounting for Contingencies, and other applicable accounting literature.

The Company is currently evaluating the effect of this Interpretation and has not yet determined its effect. Therefore, the Company will begin applying Interpretation 48 on July 1, 2007.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

Overview

As more fully discussed below, the Company had net income of $.2 million, or $.03 per share, in the first quarter of fiscal 2007 (fiscal 2007 quarter) compared to a net loss of $1.8 million, or $.28 per share, in the first quarter of fiscal 2006 (fiscal 2006 quarter). The primary reasons for improved earnings are the acquisition of Tru-Stone, better utilization and absorption of overhead in our international operations and the gain on the sale of the Alum Bank plant in this quarter.

Sales

Sales for the fiscal 2007 quarter are up 7.5% compared to the fiscal 2006 quarter. Domestic sales are up $2.5 million or 9.0%, while foreign sales are up $1.0 million or 5.3% (.7% in local currency). The increase in domestic sales is attributed to a stronger U.S. economy as a whole, the acquisition of Tru-Stone, offset by a decline in Evans sales due to reduced unit volumes. Excluding the effects of Tru-Stone and Evans, domestic sales increased 11.3%.

The increase in foreign sales is attributed to higher export sales overall and the general expansion worldwide into newer markets.

(Loss) earnings before taxes

The current quarter s pre-tax earnings of $.3 million represents an increase of pre-tax earnings of $3.0 million from last year s pre-tax loss of $2.7 million. Approximately $3.6 million is at the gross margin line. The gross margin percentage increased from 21.1% in the prior year to 26.6% in the current quarter. The increase in gross margin is primarily a result of higher sales dollar volume (excluding the Evans division) and the acquisition of Tru-Stone. Unfortunately, lower unit volumes at Evans offset the positive impact of cost reductions at that division, when comparing the current quarter to the prior year quarter.

Selling and general expense is up $.7 million primarily as a result of higher sales volume. As a percentage of sales, selling and general expense decreased from 26.5% in the prior quarter to 26.1% in the current quarter.

The current quarter includes a one-time gain of $.3 million from the sale of the Alum Bank plant on September 21, 2006.

Income tax benefit

The effective income tax rate is a 25% provision in the fiscal 2007 quarter versus a 31% benefit for the fiscal 2006 quarter. The current quarter s rate reflects a combined federal, state and foreign rate adjusted for permanent book/tax differences, the most significant of which is the anticipated effect of the Brazilian dividend to be paid in the second quarter of fiscal 2007. The prior year quarter s rate reflects the impact of permanent book/tax differences and the phasing out of the Puerto Rico tax incentives as those operations were moved to the Dominican Republic.

The Company continues to believe that 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 (loss) earnings per share

As a result of the above factors, the Company had basic and diluted net income per share of $.03 in the fiscal 2007 quarter compared to basic and diluted net loss per share of $.28 in the fiscal 2006 quarter.

LIQUIDITY AND CAPITAL RESOURCES

Cash flows	13 Weeks Ended	
	9/23/06	9/24/05
Cash (used in) provided by operations	3,452	(2,065)
Cash provided from (used in) investing activities	(253)	2,954
Cash used in financing activities	(2,053)	(1,434)

Cash provided by operations increased significantly in the current quarter compared to the same quarter a year ago. This increase is primarily a result of the improvement in net earnings and a reduction in inventories.

The Company s investing activities consist of expenditures for plant and equipment, the investment of cash not immediately needed for operations and the proceeds from the sale of the Alum Bank plant.

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 return to consistent profitability, additional steps will have to be taken in order to maintain liquidity, including plant consolidations, further workforce and dividend reductions (see Reorganization Plans below). In addition to its cash and investments, the Company maintains a $10 million line of credit, of which, as of September 23, 2006, $890,000 is being utilized in the form of standby letters of credit for insurance purposes. 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 3.8 to one as of September 23, 2006 and 3.8 to one as of June 24, 2006.

REORGANIZATION PLANS

The continued migration of manufacturing to low wage countries has adversely affected the Company's customer base and competitive position, particularly in North America. As a result, the Company has been rethinking almost all aspects of its business and is formulating plans to lower wage costs, consolidate operations, move its strategic focus from manufacturing location to product group and distribution channel, as well as to achieving the goals of enhanced marketing focus and global procurement. The Company sold its Alum Bank, Pennsylvania level manufacturing plant and has relocated the manufacturing to the Dominican Republic, where production began in fiscal 2005. The tape measure production of the Evans Division facilities in Charleston, South Carolina has been transferred to the Dominican Republic at an adjacent site. The Company expects to sell its Glendale, Arizona facility during fiscal 2007.

OFF-BALANCE SHEET ARRANGEMENTS

The Company does not have any material off-balance sheet arrangements as defined under the Securities and Exchange Commission 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 footnote to the Company s Consolidated Financial Statements included in the Form 10-K for the year ended June 24, 2006, 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.

The allowance for doubtful accounts and sales returns of $1.5 million and $1.4 million as of September 23, 2006 and June 24, 2006, respectively, is based on our assessment of the collectibility of specific customer accounts, the aging of our 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 our previous experience, or actual future returns do not reflect historical trends, the estimates of the recoverability of the amounts due the Company and sales 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, the Company may be required to increase the inventory reserve and, as a result, 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.

Accounting for income taxes requires estimates of future tax liabilities. Due to temporary differences in the timing of 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, the Company assesses the likelihood that the asset will be realized. If realization is in doubt because of uncertainty regarding future profitability or enacted tax rates, the Company provides a valuation allowance related to the asset. Should any significant changes in the tax law or the estimate of the necessary valuation allowance occur, the Company 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 actuaries in calculating such amounts. These assumptions include discount rates, healthcare cost trends, inflation, salary growth, long-term return on plan assets, employee turnover rates, retirement rates, mortality 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 assumptions are accumulated and amortized over future periods. Significant differences in actual experience or significant changes in assumptions would affect pension and other postretirement benefit costs and obligations.

SAFE HARBOR STATEMENT

UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Report on Form 10-Q contains forward-looking statements about the Company s business, competition, sales, gross margins, 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 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 40% of the Company s sales and 20% 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 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 will also adversely impact the Company s performance. 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: Sales to the Company s top two customers accounted for approximately 14% of revenues in fiscal 2006. Sears sales and unit volume has decreased significantly during fiscal 2006 and the first quarter of fiscal 2007. This situation is problematic and if the Sears brands (i.e., Craftsman) we support are 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, 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. Depending on the risk, deductibles can be as high as 5% of the loss or $500,000.

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 2006, the cost of steel rose approximately 5%. Because of competitive pressures, the Company generally has not been able to pass on these increases to the customer resulting in reduction to the gross margins. The cost of producing the Company s products is also sensitive to the price of energy. 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. 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 significantly overfunded, a significant (over 30%) 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. There would also be a similar risk for the Company s underfunded UK plan.

Risks Related to Acquisitions: Acquisitions, such as our acquisition of Tru-Stone in fiscal 2006, 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, these activities could have an adverse effect on the Company s business, financial condition and operating results.

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 September 23, 2006, the Company was party to an interest rate swap agreement, which is more fully described in the fiscal 2006 Form 10-K. The Company does not enter into long-term supply contracts with either fixed prices or quantities. The Company does not engage in regular hedging activities to minimize the impact of foreign currency fluctuations. Net foreign monetary assets are approximately $4 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 $21.8 million and debt of $3.4 million at September 23, 2006) or the cash flows or future earnings associated with those financial instruments. A 10% change in interest rates would impact the fair value of the Company's fixed rate investments of approximately $2.2 million by $27,000.

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, have evaluated the Company's disclosure controls and procedures as of September 23, 2006, and they have concluded that our disclosure controls and procedures were not effective as of such date because we identified a material weakness in our internal control in ensuring that 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. This material weakness relates to the accounting for income taxes. The Company continues to take the remediation actions described in our fiscal 2006 Form 10-K, and while these actions have strengthened our internal control over financial reporting, management believes that the Company continues to have a material weakness in its accounting for income taxes. The Company believes that certain initiatives taking place in fiscal 2007 will fully remediate this weakness. The Audit Committee will continue to monitor the progress of the Company s remediation efforts. 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 2. Unregistered Sales of Equity Securities and Use of Proceeds

Summary of Stock Repurchases:

A summary of the Company's repurchases of shares of its common stock for the three months ended September 23, 2006 is as follows:

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Shares Purchased	Average Price	Shares Purchased Under Announced Programs	Shares yet to be Purchased Under Announced Programs
6/24/06-7/29/06	none			
7/30/06-8/26/06	2,500	$13.85	none	none
8/27/06-9/23/06	none			

Item 6. Exhibits

(a)

Exhibits

31a Certification of Chief Executive Officer Pursuant to Rule 13a-14(a), filed herewith.

31b Certification of Chief Financial Officer Pursuant to Rule 13a-14(a), filed herewith.

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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), filed herewith.

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 November 2, 2006 S/R. J. HYLEK

R. J. HYLEK (Treasurer and

(Chief Financial Officer)

Date November 2, 2006 S/S.G.THOMSON

S.G. THOMSON (Chief Accounting Officer)