

SCOTTS LIQUID GOLD INC
Form 10-Q
August 14, 2012
Table of Contents

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 June 30, 2012

For the quarterly period ended June 30, 2012

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, Denver, CO (Address of principal executive offices) | 80239 (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 August 10, 2012, the Registrant had 10,937,000 of its common stock, \$0.10 par value per share, outstanding.

Table of Contents

CAUTIONARY NOTE ON FORWARD-LOOKING INFORMATION

This Report may contain forward-looking statements within the meaning of U.S. federal securities laws. 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 risks and uncertainties 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, 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; 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; limited resources available for such advertising; new competitive products and/or technological changes; dependence upon third party vendors and upon sales to major customers; changes in the regulation of our products, including applicable environmental regulations; continuing losses which could affect our liquidity; the loss of any executive officer; and other matters discussed in our Annual Report on Form 10-K for the year ended December 31, 2011 and this Report. 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.

Table of Contents

TABLE OF CONTENTS

| | Page |
|--|-------------|
| <u>PART I</u> | |
| Item 1. <u>Financial Statements</u> | 1 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 12 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 18 |
| Item 4. <u>Controls and Procedures</u> | 18 |
| <u>PART II</u> | |
| Item 1A. <u>Risk Factors</u> | 18 |
| Item 5. <u>Other Information</u> | 19 |
| Item 6. <u>Exhibits</u> | 19 |

Table of Contents**PART I****ITEM 1. FINANCIAL STATEMENTS.****Consolidated Statements of Operations (Unaudited)**

Scott's Liquid Gold-Inc. & Subsidiaries

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|--------------|------------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net sales | \$ 3,717,500 | \$ 3,996,800 | \$ 7,755,900 | \$ 7,865,200 |
| Operating costs and expenses: | | | | |
| Cost of sales | 2,097,800 | 2,035,800 | 4,287,100 | 4,026,800 |
| Advertising | 107,800 | 168,200 | 195,400 | 248,400 |
| Selling | 1,164,200 | 1,125,000 | 2,254,800 | 2,158,300 |
| General and administrative | 668,600 | 604,900 | 1,355,900 | 1,212,700 |
| | 4,038,400 | 3,933,900 | 8,093,200 | 7,646,200 |
| (Loss) income from operations | (320,900) | 62,900 | (337,300) | 219,000 |
| Rental and other income | 32,300 | 42,400 | 64,600 | 82,000 |
| Interest expense | (66,000) | (54,300) | (127,900) | (124,200) |
| (Loss) income before income taxes | (354,600) | 51,000 | (400,600) | 176,800 |
| Income tax expense | 0 | 0 | 0 | 0 |
| Net (loss) income | \$ (354,600) | \$ 51,000 | \$ (400,600) | \$ 176,800 |
| Net (loss) income per common share (Note 2): | | | | |
| Basic | \$ (0.03) | \$ 0.01 | \$ (0.04) | \$ 0.02 |
| Diluted | \$ (0.03) | \$ 0.00 | \$ (0.04) | \$ 0.01 |
| Weighted average shares outstanding: | | | | |
| Basic | 10,937,000 | 10,898,500 | 10,932,856 | 10,898,500 |
| Diluted | 10,937,000 | 12,207,750 | 10,932,856 | 12,207,750 |

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

Table of Contents**Consolidated Balance Sheets**

Scott's Liquid Gold-Inc. & Subsidiaries

| | June 30, 2012 | December 31, 2011 |
|--|--------------------------|------------------------------|
| | (unaudited) | |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 163,600 | \$ 575,900 |
| Trade receivables, net | 993,300 | 447,900 |
| Inventories, net | 2,154,500 | 2,019,200 |
| Prepaid expenses | 129,900 | 133,400 |
| Total current assets | 3,494,700 | 3,176,400 |
| Property, plant and equipment, net | 10,393,500 | 10,632,100 |
| Other assets | 58,000 | 68,400 |
| Total assets | \$ 13,946,200 | \$ 13,876,900 |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Obligations collateralized by receivables | \$ 924,200 | \$ 277,100 |
| Accounts payable | 1,605,600 | 1,442,700 |
| Accrued payroll and benefits | 601,600 | 579,200 |
| Accrued property taxes | 93,700 | 230,600 |
| Other accrued expenses | 84,900 | 227,300 |
| Current maturities of long-term debt | 346,800 | 340,800 |
| Total current liabilities | 3,710,200 | 3,097,700 |
| Long-term debt, net of current maturities | 3,188,400 | 3,363,400 |
| Total liabilities | 6,898,600 | 6,461,100 |
| Shareholders' equity: | | |
| Common stock; \$0.10 par value, authorized 50,000,000 shares; issued and outstanding 10,937,000 shares (2012) and 10,907,000 shares (2011) | 1,093,700 | 1,090,700 |
| Capital in excess of par | 5,476,300 | 5,446,900 |
| Retained earnings | 477,600 | 878,200 |
| Total shareholders' equity | 7,047,600 | 7,415,800 |
| Total liabilities and shareholders' equity | \$ 13,946,200 | \$ 13,876,900 |

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

Table of Contents**Consolidated Statements of Cash Flows (Unaudited)**

Scott's Liquid Gold-Inc. & Subsidiaries

| | Six Months Ended June 30, | |
|--|--------------------------------------|------------------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net (loss) income | \$ (400,600) | \$ 176,800 |
| Adjustment to reconcile net (loss) income to net cash (used by) provided by operating activities: | | |
| Depreciation and amortization | 238,600 | 249,600 |
| Stock-based compensation | 27,300 | 41,700 |
| Change in assets and liabilities: | | |
| Trade receivables | (545,400) | (1,057,300) |
| Inventories | (135,300) | (825,300) |
| Prepaid expenses and other assets | 13,900 | 57,000 |
| Net proceeds on obligations collateralized by receivables | 647,100 | 1,302,600 |
| Accounts payable and accrued expenses | (94,000) | 235,200 |
| Total adjustments to net (loss) income | 152,200 | 3,500 |
| Net Cash (Used by) Provided by Operating Activities | (248,400) | 180,300 |
| Cash flow from investing activities: | | |
| Purchase of property, plant and equipment | 0 | (4,000) |
| Net Cash Used by Investing Activities | 0 | (4,000) |
| Cash flow from financing activities: | | |
| Principal payments on long-term debt | (169,000) | (163,900) |
| Proceeds from exercise of stock options | 5,100 | 0 |
| Net Cash Used by Financing Activities | (163,900) | (163,900) |
| Net (Decrease) Increase in Cash and Cash Equivalents | (412,300) | 12,400 |
| Cash and Cash Equivalents, beginning of period | 575,900 | 480,700 |
| Cash and Cash Equivalents, end of period | \$ 163,600 | \$ 493,100 |
| Supplemental disclosures: | | |
| Cash paid during the period for interest | \$ 125,900 | \$ 124,600 |

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

Table of Contents

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 an exclusive 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 June 30, 2012 and results of operations and cash flow 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, 2011. The results of operations for the period ended June 30, 2012 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, coupon redemptions, 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.

Table of Contents

(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 improving working capital. The financing agreement with Summit was amended on March 12, 2009, March 16, 2011 (effective March 1, 2011) and then again on June 29, 2012 (effective July 1, 2012). The agreement has a term that expires on January 1, 2014, 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, 2014 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 receivable, 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. Prior to the recent amendment on June 29, 2012, advances under the agreement had an interest 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 of the borrowings. The recent amendment reduced these interest rates to 1.0% over the prime rate for the accounts receivable portion and 2.5% over the prime rate for the inventory portion. Consequently, our interest cost adjusts with changes in the prime rate. At June 30, 2012, the prime rate was 3.25%.

In addition, prior to the recent amendment on June 29, 2012, there was an administrative fee of 1.0% per month on the average monthly outstanding loan on the receivable portion of any advance and 1.35% per month on the average monthly outstanding loan on the inventory portion of any advance. The recent amendment reduced these administrative fees to 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 to 0.75% if the average quarterly loan in the prior quarter was greater than \$1,000,000 and to 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.

During the six months ended June 30, 2012, we sold approximately \$5,615,200 of our accounts receivables to Summit for approximately \$4,772,900. As the advance rate on these accounts receivables was 85%, we retained an interest equal to 15% of those accounts receivables. At June 30, 2012, approximately \$575,800 of this credit line was available for future factoring of accounts receivable invoices and borrowings secured by our inventory.

We report these transactions, using the Financial Accounting Standards Board's (FASB) authoritative guidance, as a secured borrowing rather than as a sale. As a result, affected accounts receivable are reported under Current Assets within our balance sheet as Trade receivables, net. Similarly, the net liability owing to Summit appears as Obligations collateralized by receivables within the Current Liabilities section of our balance sheet. Net proceeds received on obligations collateralized by receivables appear as cash provided by operating activities within our Consolidated Statements of Cash Flow.

Table of Contents

On March 16, 2011, under a consent agreement from 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. Pursuant to this agreement, we may sell accounts receivables from our largest customer at a discount to Wells Fargo; provided, however, that Wells Fargo may reject offers to purchase such receivables in its discretion. These receivables may 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 June 28, 2012, Wells Fargo used the 104-day LIBOR rate of 0.56%.

The agreement has no fixed termination date, but continues unless terminated by either party giving 30 days prior written notice to the other party. During the six months ended June 30, we sold approximately \$1,760,900 of our relevant accounts receivable to Wells Fargo for approximately \$1,720,100. 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:

| | June 30, 2012 | December 31, 2011 |
|------------------------------------|----------------------|--------------------------|
| Finished goods | \$ 1,075,200 | \$ 1,191,000 |
| Raw materials | 1,239,300 | 1,067,200 |
| Inventory reserve for obsolescence | (160,000) | (239,000) |
| | \$ 2,154,500 | \$ 2,019,200 |

Table of Contents

(h) Property, Plant and Equipment

Property, plant 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 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. Carpets, 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 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. Periodically throughout the year, we have 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. Our long-term debt bears interest at a fixed rate that adjusts annually on the anniversary date to the then prime rate. The carrying value of our long-term debt approximates fair value as of June 30, 2012 and December 31, 2011.

(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, 2011, due to changes in the real estate market in Denver, Colorado, we conducted an evaluation into the fair value impairment of our property, plant and equipment with particular attention to our land and office, warehouse and manufacturing buildings (the Facilities). The Facilities have an original cost of \$17,485,800 and a depreciated book value at December 31, 2011 of approximately \$10,068,900. We evaluated the value of the Facilities using both an income capitalization approach and a market value approach. This evaluation returned a range of fair value estimates between approximately \$10.1 million to \$10.6 million. Based upon this evaluation, we found there to be no impairment in the carrying values of our long-lived assets at December 31, 2011. Moreover, there have been no events or changes in circumstances that would indicate that the fair value has declined as of June 30, 2012. The valuation of our Facilities, however, can be affected by future events, including changes in the economy and the commercial real estate market in which our Facilities are located.

Table of Contents

(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.

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. 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.

(l) *Revenue Recognition*

Our revenue recognition policy is significant because the amount and timing of revenue is a key component of our results of operations. We follow guidance issued by FASB, which requires that certain criteria be met in order to recognize revenue. If this criteria is not met, then the associated revenue is deferred until it is met. In our case, the criteria generally is 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.

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 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.

At June 30, 2012 and December 31, 2011 approximately \$278,400 and \$497,000, respectively, had been reserved for as a reduction of accounts receivable, and approximately \$10,000 and \$85,000, respectively, had been reserved as current liabilities. Trade promotions to our customers and incentives such as coupons to the consumer are deducted from gross sales and totaled \$892,900 and \$556,200 for the six months ended June 30, 2012 and 2011, respectively.

Table of Contents

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.

(m) Advertising Costs

Advertising costs are expensed as incurred.

(n) Stock-based Compensation

During the six months ended June 30, 2012, we granted 100,000 options for shares of our common stock to an executive officer at a price of \$0.24 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 120% of the market value as of the date of grant. No stock options were granted during the first six months of 2011. Please see Note 2 to our Consolidated Financial Statements (Unaudited) for information regarding the 500,200 fewer stock options outstanding at June 30, 2012 than at June 30, 2011.

The weighted average fair market value of the options granted in the first six months of 2012 was estimated on the date of grant, using a Black-Scholes option pricing model with the following assumptions:

| | June 30, 2012 |
|---|---------------|
| Expected life of options (using the simplified method) | 4.5 years |
| Average risk-free interest rate | 0.9% |
| Average expected volatility of stock | 144% |
| 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 \$27,300 and \$41,700 in the six months ended June 30, 2012 and 2011, respectively. Approximately \$101,700 of total unrecognized compensation costs related to non-vested stock options is expected to be recognized over the next 48 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 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 selling expenses. Other selling expenses consist primarily of wages and benefits for sales and sales support personnel, travel, brokerage commissions and promotional costs, as well as certain other indirect costs. Shipping and handling costs totaled \$684,000 and \$721,000 for the six months ended June 30, 2012 and 2011, respectively.

Table of Contents

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.

Note 2. Earnings per Share

We present basic and diluted earnings or loss per share in accordance with authoritative guidance which establishes standards for computing and presenting basic and diluted earnings per share. Per share data is determined by using the weighted average number of common shares outstanding. Common equivalent shares are considered only for diluted earnings per share, unless considered anti-dilutive. Common equivalent shares, determined using the treasury stock method, result from stock options with exercise prices that are below the average market price of the common stock.

The potentially dilutive securities are comprised of outstanding stock options of 1,433,350 and 1,933,550 at June 30, 2012 and 2011, respectively, a decrease of 500,200 or 25.9%. This decrease is due primarily to stock options expiring as well as a more limited number of stock options being exercised. At June 30, 2012, potentially dilutive securities were excluded from the computation of weighted average shares outstanding due to their anti-dilutive effect.

The following is a reconciliation of the weighted average number of common shares outstanding for the three and six months ended June 30, 2012 and 2011:

| | 2012 | |
|---|---------------------|-------------------|
| | Three Months | Six Months |
| Common shares outstanding, beginning of the period | 10,937,000 | 10,907,000 |
| Weighted average common shares issued | 0 | 25,856 |
| Weighted average number of common shares outstanding | 10,937,000 | 10,932,856 |
| Dilutive effect of common share equivalents | 0 | 0 |
| Diluted weighted average number of common shares outstanding | 10,937,000 | 10,932,856 |

| | 2011 | |
|---|---------------------|-------------------|
| | Three Months | Six Months |
| Common shares outstanding, beginning of the period | 10,898,500 | 10,898,500 |
| Weighted average common shares issued | 0 | 0 |
| Weighted average number of common shares outstanding | 10,898,500 | 10,898,500 |
| Dilutive effect of common share equivalents | 1,309,250 | 1,309,250 |
| Diluted weighted average number of common shares outstanding | 12,207,750 | 12,207,750 |

We have authorized 20,000,000 shares of preferred stock issuable in one or more series, none of which are issued or outstanding as of June 30, 2012.

Table of Contents**Note 3. Segment Information.**

We operate in two different segments: household products and skin and hair care products. Our products are sold nationally and internationally (primarily Canada), directly through our sales force and indirectly through independent brokers, to mass merchandisers, drugstores, supermarkets, hardware stores and other retail outlets and to wholesale distributors. We have chosen to organize our business around these segments based on differences in the products sold.

Accounting policies for our segments are the same as those described in Note 1. We evaluate segment performance based on segment income or loss before income taxes.

The following provides information on our segments for the three and six months ended June 30:

| | Three Months Ended June 30, | | 2011 | |
|-----------------------------------|-----------------------------|-----------------------------|--------------------|-----------------------------|
| | 2012 | | | |
| | Household Products | Skin and Hair Care Products | Household Products | Skin and Hair Care Products |
| Net sales to external customers | \$ 1,212,200 | \$ 2,205,300 | \$ 1,537,900 | \$ 2,458,900 |
| (Loss) income before income taxes | \$ (399,500) | \$ 44,900 | \$ (168,000) | \$ 219,000 |
| Identifiable assets | \$ 2,307,200 | \$ 4,260,200 | \$ 2,568,000 | \$ 4,340,100 |

| | Six Months Ended June 30, | | 2011 | |
|-----------------------------------|---------------------------|-----------------------------|--------------------|-----------------------------|
| | 2012 | | | |
| | Household Products | Skin and Hair Care Products | Household Products | Skin and Hair Care Products |
| Net sales to external customers | \$ 2,549,700 | \$ 5,206,200 | \$ 3,098,000 | \$ 4,767,200 |
| (Loss) income before income taxes | \$ (747,200) | \$ 346,600 | \$ (210,700) | \$ 387,500 |
| Identifiable assets | \$ 2,307,200 | \$ 4,260,200 | \$ 2,568,000 | \$ 4,340,100 |

The following is a reconciliation of segment information to consolidated information for the three and six months ended June 30:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|---------------|---------------------------|---------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net sales to external customers | \$ 3,717,500 | \$ 3,996,800 | \$ 7,755,900 | \$ 7,865,200 |
| (Loss) income before income taxes | \$ (354,600) | \$ 51,000 | \$ (400,600) | \$ 176,800 |
| Consolidated (loss) income before income taxes | \$ (354,600) | \$ 51,000 | \$ (400,600) | \$ 176,800 |
| Identifiable assets | \$ 6,567,400 | \$ 6,908,100 | \$ 6,567,400 | \$ 6,908,100 |
| Corporate assets | 7,378,800 | 7,983,500 | 7,378,800 | 7,983,500 |
| Consolidated total assets | \$ 13,946,200 | \$ 14,891,600 | \$ 13,946,200 | \$ 14,891,600 |

Edgar Filing: SCOTTS LIQUID GOLD INC - Form 10-Q

Corporate assets noted above are comprised primarily of our cash and investments, and property and equipment not directly associated with the manufacturing, warehousing, shipping and receiving activities.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.****Results of Operations**

Our consolidated net sales for the first six months of 2012 were \$7,755,900 versus \$7,865,200 for the first six months of 2011, a decrease of \$109,300 or 1.4%. We saw a 15.0% increase in net sales of our own line of skin care products and a 5.4% increase in net sales of the skin and hair care products that we distribute for other companies. These increases were offset in part by a 17.7% decrease in sales of our household products.

Our consolidated net sales for the second quarter of 2012 were \$3,717,500 versus \$3,996,800 for the second quarter of 2011, a decrease of \$279,300 or 7.0%. We saw a 5.1% increase in net sales of the skin and hair care products that we distribute for other companies and a 3.3% decrease in net sales of our own line of skin care products. There was also a 21.2% decrease in sales of our household products.

Our net loss for the first six months of 2012 was \$400,600 versus net income of \$176,800 in the first six months of 2011. Our net loss for the second quarter of 2012 was \$354,600 versus net income of \$51,000 in the second quarter of 2011. The loss for the first six months and second quarter of 2012 compared to the net income for the same periods in 2011 resulted primarily from: (1) increases in trade promotions to our customers; (2) increases in costs of sales as detailed below; and (3) increases in operating expenses as detailed below.

We made a strategic decision in the first six months of 2012 to invest in our products earlier in the year by increasing our trade promotions to our customers. We believe that this investment will help increase the distribution of our products to both new and existing customers. We do not expect that our investment in promotions will be as high in the second half of 2012.

Summary of Results as a Percentage of Net Sales

| | Year Ended December 31, 2011 | Six Months Ended June 30, 2012 | Six Months Ended June 30, 2011 |
|-----------------------------|---------------------------------|-----------------------------------|-----------------------------------|
| Net sales | | | |
| Household products | 38.0% | 32.9% | 39.4% |
| Skin and hair care products | 62.0% | 67.1% | 60.6% |
| Total net sales | 100.0% | 100.0% | 100.0% |
| Cost of sales | 54.8% | 55.3% | 51.2% |
| Gross profit | 45.2% | 44.7% | 48.8% |
| Other revenue | 1.0% | 0.8% | 1.0% |
| | 46.2% | 45.5% | 49.8% |
| Operating expenses | 48.8% | 49.1% | 46.0% |
| Interest expense | 1.5% | 1.6% | 1.6% |
| | 50.3% | 50.7% | 47.6% |
| (Loss) income before taxes | (4.1%) | (5.2%) | 2.2% |

Our gross margins may not be comparable to those of other companies because some companies include all of the costs related to their distribution network in cost of sales. In contrast, other companies, like us, exclude a portion of these costs (i.e., freight out to customers and nominal outside warehouse costs) from gross margin. Instead, we include them as part of selling expenses. See Note 1(o), Operating Costs and Expenses Classification, to our Consolidated Financial Statements (Unaudited) in Item 1.

Table of Contents**Six Months Ended June 30, 2012 Compared to Six Months Ended June 30, 2011****Comparative Net Sales**

| | | | Percentage |
|--|-----------------------------------|-----------------------------------|------------------------|
| | Six Months Ended June 30, 2012 | Six Months Ended June 30, 2011 | Increase (Decrease) |
| Scott's Liquid Gold® and other household products | \$ 2,413,800 | \$ 2,871,600 | (15.9%) |
| Touch of Scent® | 135,900 | 226,400 | (40.0%) |
| Total household products | 2,549,700 | 3,098,000 | (17.7%) |
| Alpha Hydrox®, Diabetic cream and shampoo and other skin care products | 2,174,800 | 1,890,600 | 15.0% |
| Montagne Jeunesse and Batiste dry shampoo | 3,031,400 | 2,876,600 | 5.4% |
| Total skin and hair care products | 5,206,200 | 4,767,200 | 9.2% |
| Total net sales | \$ 7,755,900 | \$ 7,865,200 | (1.4%) |

During the first six months of 2012, net sales of skin and hair care products accounted for 67.1% of consolidated net sales compared to 60.6% for the same period in 2011. The net sales of these products for that period were \$5,206,200 in 2012 compared to \$4,767,200 for the same period in 2011, an increase of \$439,000 or 9.2%.

The net sales of our Alpha Hydrox® and other manufactured skin care products were \$2,174,800 in the first six months of 2012 versus \$1,890,600 for the same period in 2011, an increase of \$284,200 or 15.0%. This increase is primarily attributable to increased distribution at new and existing customers and the improved placement of our products at existing customers.

The net sales of Montagne Jeunesse and Batiste dry shampoo were \$3,031,400 in the first six months of 2012 versus \$2,876,000 for the same period in 2011, an increase of \$154,800 or 5.4%. This increase is primarily attributable to increased distribution at new and existing customers and the improved placement of our products at existing customers.

Sales of household products for the first six months of 2012 accounted for 32.9% of consolidated net sales compared to 39.4% for the same period in 2011. During the first six months of 2012, the sales of our household products were \$2,549,700 as compared to \$3,098,000 for the same period in 2011, a decrease of \$548,300 or 17.1%. This decrease reflects primarily decreased distribution in our Clean Screen and Little Clean Screen products. We believe the decline in sales of Clean Screen is the result of new competitors in the segment including competitors with significant name brand recognition. Sales of our Touch of Scent® air fresheners were down by \$90,500 or about 40%.

Due to the decline in sales and distribution of Mold Control 500, this product will be discontinued after 2012. We attribute this decline to the following three primary factors: (1) generally lower actual consumer demand than anticipated; (2) the product is effective, but expensive; and (3) the product involves a delivery system considered by many not to be consumer friendly.

We paid our customers a total of \$892,900 in the first six months of 2012 versus \$556,200 for the same period in 2011, an increase of \$336,700 or 60.5% for trade promotions to support price features, displays and other merchandising of our products. We made a strategic decision this year to invest in our products earlier in the year to build on the momentum from our spending at the end of last year. Moreover, we believed it was important to invest in our products with certain customers earlier in the year ahead of meetings this summer regarding planograms for next year. Our goal was to obtain additional distribution with our existing customers and better product placement in the stores with these customers.

From time to time, our customers return products to us. For our household products, we permit returns only for a limited time. With regard to our skin and hair care products, returns are more frequent

Table of Contents

under an unwritten industry standard that permits returns for a variety of reasons. In the event a skin and hair care customer requests a return of a product, we will consider the request, and may grant such request in order to maintain or enhance our relationship with the customer, even in the absence of an enforceable right of the customer to do so. Typically, customers that return products to us take a credit on our invoice equal to the original sale price plus a handling charge ranging from 8-10% of the original sales price.

From January 1, 2009 through June 30, 2012, our product returns (as a percentage of gross sales) have averaged 1.0% or less. The level of returns as a percentage of gross sales for our household products and the skin and hair care products that we distribute for other companies have remained fairly constant since January 1, 2009 while our own line of skin care products have fluctuated. More recently, as the sales of our skin care products and the number of retailers carrying our products have increased, we have seen a decrease in returns as a percentage of gross sales. Our product returns (indicated as a percentage of gross sales) for the six months ended June 30, 2012 were immaterial.

On a consolidated basis, cost of sales was \$4,287,100 during the first six months of 2012 compared to \$4,026,800 for the same period in 2011, an increase of \$260,300 or about 6.5%, on a net sales decrease of 1.4%. As a percentage of consolidated net sales, cost of sales was 55.3% in the first six months of 2012 versus 51.2% for the same period in 2011.

The cost of sales for our skin and hair care products increased to 50.6% in the first six months of 2012 as compared to 49.0% for the same period in 2011. The costs of sales for our household products increased to 64.7% in the first six months of 2012 as compared to 54.6% for the same period in 2011. These increases reflect primarily more spending on trade promotions in the first six months of 2012 as compared to the same period in 2011 and increases in our costs for certain raw materials.

Operating Expenses, Interest Expense and Other Income

| | Six Months Ended June 30, | | Percentage |
|---------------------------------|----------------------------------|---------------------|--------------------------------|
| | 2012 | 2011 | Increase (Decrease) |
| Operating Expenses | | | |
| Advertising | \$ 195,400 | \$ 248,400 | (21.5%) |
| Selling | 2,254,800 | 2,158,300 | 4.5% |
| General and administrative | 1,355,900 | 1,212,700 | 11.8% |
| Total operating expenses | \$ 3,806,100 | \$ 3,619,400 | 5.2% |
| Rental and Other Income | \$ 64,600 | \$ 82,000 | (21.2%) |
| Interest Expense | \$ 127,900 | \$ 124,200 | 3.0% |

Our operating expenses increased by \$186,700 or 5.2% in the first six months of 2012 when compared to the same period in 2011. These expenses consist primarily of advertising, selling and general and administrative expenses and are discussed below.

Advertising expenses for the first six months of 2012 were \$195,400 compared to \$248,800 for the same period in 2011, a decrease of \$53,000 or 21.3%, primarily related to a reduction in spending on printed collateral materials for our customers and consumers.

Table of Contents

Selling expenses for the first six months of 2012 were \$2,254,800 compared to \$2,158,300 for the same period in 2011, an increase of \$96,500 or 4.5%. The increase was comprised primarily of an increase of \$86,900 in rebates for our household and skin and hair care products.

General and administrative expenses for the first six months of 2012 were \$1,355,900 compared to \$1,212,700 for the same period of 2011, an increase of \$143,200 or 11.8%. This increase is attributable to the following two primary factors: (1) recent changes in personnel within our finance and accounting group; and (2) an increase in expenses for audit fees and legal fees.

Rental and other income for the first six months of 2012 of \$64,600 included \$63,300 of net rental receipts and \$800 in interest earned on our cash reserves. This compares to total rental and other income in 2011 of \$82,000 which included \$76,600 of net rental receipts and \$2,600 in interest earned on our cash reserves. The decrease in rental income is a result of a tenant, that was leasing one-half floor of our office building, stopping payments at the end of December 2011 when the tenant vacated the space due to financial difficulties.

Interest expense for the first six months of 2012 was \$127,900 and included \$45,500 in administrative fees incurred relative to the sale of accounts receivable invoices to Summit. Interest expense for the first six months of 2011 was \$124,200 and included \$34,600 in collateral management and/or administrative fees paid to Summit. The increase is due to higher borrowings under our line of credit with Summit to fund increased gross sales activity in the first six months of 2012 compared to the same period in 2011.

Three Months Ended June 30, 2012 Compared to Three Months Ended June 30, 2011**Comparative Net Sales**

| | | | Percentage |
|--|-------------------------------------|--------------|------------------------|
| | Three Months Ended June 30, 2012 | 2011 | Increase (Decrease) |
| Scott's Liquid Gold® and other household products | \$ 1,170,200 | \$ 1,421,200 | (17.7%) |
| Touch of Scent® | 42,000 | 116,700 | (64.0%) |
| Total household products | 1,212,200 | 1,537,900 | (21.2%) |
| Alpha Hydrox®, Diabetic cream and shampoo and other skin care products | 903,600 | 934,600 | (3.3)% |
| Montagne Jeunesse and Batiste dry shampoo | 1,601,700 | 1,524,300 | 5.1% |
| Total skin and hair care products | 2,505,300 | 2,458,900 | 1.9% |
| Total net sales | \$ 3,717,500 | \$ 3,996,800 | (7.0%) |

The net sales of our skin and hair care products were 2,505,300 in the second quarter of 2012 compared to \$2,548,900 for the same period in 2011, an increase of \$43,600 or 1.7%. The net sales of our Alpha Hydrox® and other manufactured skin care products were \$903,600 in the second quarter of 2012 versus \$934,600 for the same period in 2011, a decrease of \$31,000 or 3.3%. This decrease is primarily attributable to higher trade promotions paid to our customers to support price features, displays and other merchandising of our products.

The net sales of Montagne Jeunesse and Batiste dry shampoo were \$1,601,700 in the second quarter of 2012 versus \$1,524,300 for the same period in 2011, an increase of \$77,400 or 5.1%. This increase is primarily attributable to increased distribution at new and existing customers and the improved placement of our products at existing customers.

Table of Contents

During the second quarter of 2012, the sales of our household products were \$1,212,200 as compared to \$1,537,900 for the same period in 2011, a decrease of \$325,700 or 21.2%. This decrease reflects primarily decreased distribution in our Clean Screen and Little Clean Screen products. We believe the decline in sales of Clean Screen is the result of new competitors in the segment including competitors with significant name brand recognition. Sales of our Touch of Scent® air fresheners were down by \$74,700 or about 64.0%.

Due to the decline in sales and distribution of Mold Control 500, this product will be discontinued after 2012. We attribute this decline to the following three primary factors: (1) generally lower actual consumer demand than anticipated; (2) the product is effective, but expensive; and (3) the product involves a delivery system considered by many not to be consumer friendly.

We paid our customers a total of \$536,500 in the second quarter of 2012 versus \$288,600 for the same period in 2011, an increase of \$247,900 or 85.9% for trade promotions to support price features, displays and other merchandising of our products. We made a strategic decision this year to invest in our products earlier in the year to build on the momentum from our spending at the end of last year. Moreover, we believed it was important to invest in our products with certain customers earlier in the year ahead of meetings this summer regarding planograms for next year. Our goal was to obtain additional distribution with our existing customers and better product placement in the stores with these customers.

On a consolidated basis, cost of sales was \$2,097,800 during the second quarter of 2012 compared to \$2,035,800 for the same period in 2011, an increase of \$62,000 or 3.0%, on a net sales decrease of 7.0%. As a percentage of consolidated net sales, cost of sales was 56.4% in the second quarter of 2012 versus 50.9% for the same period in 2011.

The cost of sales for our skin and hair care products increased to 50.8% in the second quarter of 2012 as compared to 47.7% for the same period in 2011. The costs of sales for our household products increased to 68.0% in the second quarter of 2012 as compared to 56.1% for the same period in 2011. These increases reflect primarily more spending on trade promotions in the second quarter of 2012 as compared to the same period in 2011 and increases in our costs for certain raw materials.

Operating Expenses, Interest Expense and Other Income

| | Three Months Ended June 30, | | Percentage |
|----------------------------|-----------------------------|--------------|------------------------|
| | 2012 | 2011 | Increase (Decrease) |
| Operating Expenses | | | |
| Advertising | \$ 107,800 | \$ 168,200 | (35.9%) |
| Selling | 1,164,200 | 1,125,000 | 3.5% |
| General and administrative | 668,600 | 604,900 | 10.5% |
| Total operating expenses | \$ 1,940,600 | \$ 1,898,100 | 2.2% |
| Rental and Other Income | \$ 32,300 | \$ 42,400 | (23.8%) |
| Interest Expense | \$ 66,000 | \$ 54,300 | 21.5% |

Our operating expenses increased by \$42,500 or 2.2% in the second quarter of 2012 when compared to the same period in 2011. These expenses consist primarily of advertising, selling and general and administrative expenses and are discussed below.

Advertising expenses for the second quarter of 2012 were \$107,800 compared to \$168,200 for the same period in 2011, a decrease of \$60,400 or 35.9%, primarily related to a reduction in spending on printed collateral materials for our customers and consumers.

Table of Contents

Selling expenses for the second quarter of 2012 were \$1,164,200 compared to \$1,125,000 for the same period in 2011, an increase of \$39,200 or 3.5%. The increase was comprised primarily of an increase in display and other promotional expenses.

General and administrative expenses for the second quarter of 2012 were \$668,600 compared to \$604,900 for the same period of 2011, an increase of \$63,700 or 10.5%. This increase is attributable to the following two primary factors: (1) recent changes in personnel within our finance and accounting group; and (2) an increase in expenses for audit fees and legal fees.

Rental and other income for the second quarter of 2012 of \$32,300 included \$31,500 of net rental receipts and \$800 in interest earned on our cash reserves. This compares to total rental and other income for the second quarter in 2011 of \$42,400 which included \$38,300 of net rental receipts and \$1,300 in interest earned on our cash reserves. The decrease in rental income is the result of a tenant, that was leasing one-half floor of our office building, stopping payments at the end of December 2011 when the tenant vacated the space due to financial difficulties.

Interest expense for the second quarter of 2012 was \$66,000 and included \$24,000 in administrative fees incurred relative to the sale of accounts receivable invoices to Summit. Interest expense for the second quarter of 2011 was \$54,300 and included \$12,400 in collateral management and/or administrative fees paid to Summit. The increase is due to higher borrowings under our line of credit with Summit to fund increased gross sales activity in the second quarter of 2012 compared to the same period in 2011.

Liquidity and Capital Resources

Citywide Loan

On June 28, 2006, we entered into a loan with a fifteen year amortization with Citywide Banks (the Bank) for \$5,156,600 secured by the land, building and fixtures at our Denver, Colorado facilities. Interest on the bank loan is at the prime rate as published in The Wall Street Journal, adjusted annually each June. At June 30, 2012, this rate was 3.25%. The loan requires 180 monthly payments of approximately \$38,200 each. We believe, based upon both an income capitalization approach and a market value approach, that the real property assets securing the loan significantly exceed the principal amount outstanding under the loan agreement. Nevertheless, the loan agreement contains a number of covenants, including the requirement for us to maintain a current ratio through November 30, 2012 of at least 0.9:1.0 and thereafter of at least 1.0:1.0, and a ratio of consolidated long-term debt to consolidated net worth of not more than 1.0:1.0. These ratios are to be calculated in accordance with generally accepted accounting principles in the United States. We may not declare any dividends that would result in a violation of either of these covenants. With regard to our current ratio, our loan agreement with the Bank was temporarily modified on August 10, 2012, to change our current ratio during the period from April 1, 2012 through November 30, 2012 to 0.9:1.0 from 1.0:1.0. We agreed to pay to the Bank a one-time modification fee of \$17,500. The modification was necessary because our current ratio decreased to below 1.0:1.0 during the second quarter of 2012, and the ratio is expected to remain below the 1.0:1.0 level until November of 2012, at which time we expect to regain and maintain compliance with the required ratio under the original stated terms in the loan agreement. The modification enables us to remain in compliance with the terms of the loan agreement with respect to the ratio through such later date and avoid being deemed in default under the loan agreement through such date for failing to comply with the original current ratio requirement. As a result of the modification, we are in full compliance with all of the provisions of the loan agreement as of the date hereof, and, by virtue of the modification and our continued compliance expectations, we continue to classify our indebtedness as long-term in our consolidated financial statements.

Notwithstanding the foregoing, if we are unable to regain and maintain compliance with the required ratio by the expiration date of the modification, we would need to seek another modification or waiver from the Bank in order to maintain compliance with the loan agreement. If a modification or waiver were not then available on terms acceptable to us or at all, the Bank could declare a default under the loan agreement and take advantage of its available remedies thereunder, including increasing the applicable interest rate and accelerating the repayment of the loan. A default under this loan agreement would also result in a default under our financing arrangement with Summit, enabling it to accelerate our obligation to repay it under that arrangement. If our interest rates were to increase or our repayment obligations were to be accelerated under either the loan agreement with the Bank or the Summit arrangement, and if we were unable to refinance our indebtedness or replace it with other third party lenders at that time, our liquidity would be material adversely affected.

Affirmative covenants in the loan agreement include, among other things, compliance in all material respects with applicable laws and regulations and compliance with our agreements with other parties which materially affect our financial condition. Negative covenants in the loan agreement include, among other things, that without the consent of the Bank, we do not: (1) sell, lease or grant a security interest in our assets; (2) engage in any business activity substantially different than those in which we are presently engaged; (3) sell assets out of the ordinary course of business; or (4) purchase another entity or an interest in another entity.

Financing Agreements

Edgar Filing: SCOTTS LIQUID GOLD INC - Form 10-Q

Please see Note 1(f) to our Consolidated Financial Statements (Unaudited) for information on our financing agreements with Summit and Wells Fargo.

Table of Contents

Liquidity

At June 30, 2012, we had \$163,600 in cash and approximately \$575,800 of our credit line with Summit was available for future borrowing. Our net cash used by operating activities in the first six months of 2012 increased by \$428,700 to \$248,400 as compared to the first six months of 2011. For the six months ended June 30, 2012, the primary components of working capital that significantly affected operating cash flows are the following: (1) trade receivables net of proceeds on obligations collateralized by those receivables were \$101,700 less at June 30, 2012 than at December 31, 2011 due primarily to higher borrowings under our line of credit with Summit to fund increased sales activity during June 2012 than December 2011; (2) inventory at June 30, 2012 was \$135,300 more than at December 31, 2011 due primarily to the increased sales activity; and (3) an operating loss for the first six months of 2012 of \$400,600 due primarily to (a) increases in trade promotions to our customers as detailed above; (b) increases in costs of sales as detailed above; and (c) increases in operating expenses as detailed above.

We anticipate that our existing cash and our cash flow from operations, together with our current borrowing arrangements with Summit and Wells Fargo, will be sufficient to meet our cash requirements for the next 12 months. We do not have any significant capital expenditures planned for 2012.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not Applicable.

ITEM 4. CONTROLS AND PROCEDURES.

Disclosure Controls and Procedures

As of June 30, 2012, we conducted an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of June 30, 2012.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting during the six months ended June 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

ITEM 1A. RISK FACTORS.

In addition to the other information set forth in this Report, you should carefully consider the factors discussed in Item 1A, Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, which could materially affect our business, financial condition or future results.

The following are new or modified risk factors that should be read in conjunction with the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011:

If we are unable to maintain compliance with various financial and other covenants required by our loan agreement with the Bank, our liquidity and operations may be materially adversely affected.

Under our loan agreement with the Bank, we are required to comply with various financial and non-financial covenants. Among the financial covenants is a requirement to maintain a minimum current ratio through November 30, 2012 of 0.9:1.0 and thereafter of 1.0:1.0, which is calculated by dividing our total current assets by our total current liabilities. Our current ratio requirement was decreased on August 10, 2012 to 0.9:1.0 for the period from April 1, 2012 through November 30, 2012 because our current ratio fell below 1.0:1.0 during the period covered by this report. Although the Bank agreed to the modification in this instance, there can be no assurance that we will be able to obtain a similar

Edgar Filing: SCOTTS LIQUID GOLD INC - Form 10-Q

modification or other waiver if needed in the future on terms acceptable to us or at all. Failure to comply with any of the covenants, representations or warranties, or failure to modify them to allow future compliance, could result in our being deemed in default under our loan agreement and could cause our interest rates to increase to the default rate and all outstanding borrowings under our loan agreement with the Bank to become immediately due and payable. Additionally, any default under our loan agreement with the Bank could result in a cross default under our lending arrangement with Summit, which could cause interest rates thereunder to increase and all outstanding borrowings under that arrangement to become immediately due and payable. If our interest rates were to increase or our repayment obligations were to be accelerated under either the loan agreement or the Summit arrangement, and if we were unable to refinance our indebtedness or replace it with other third party lenders at that time, our liquidity, business and operations would be material adversely affected.

Table of Contents**ITEM 5. OTHER INFORMATION**

On August 10, 2012, our loan agreement with the Bank was modified temporarily to change our current ratio requirement during the period from April 1, 2012 through November 30, 2012 to 0.9:1.0 from 1.0:1.0. We agreed to pay to the Bank a one-time modification fee of \$17,500 in connection therewith. The current ratio requirement under the loan agreement will automatically revert to 1.0:1.0 effective December 1, 2012. As a result of the modification, we are in full compliance with all provisions of the loan agreement as of the date hereof.

ITEM 6. EXHIBITS.

| Exhibit Number | Document |
|----------------|--|
| 10.1 | First Amendment to Second Amended and Restated Financing Agreement between the Company and Summit, dated June 29, 2012, incorporated by reference to Exhibit 99.1 of the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on July 2, 2012. |
| 31.1 | Rule 13a-14(a) Certification of the Chief Executive Officer |
| 31.2 | Rule 13a-14(a) Certification of the Chief Financial Officer |
| 32.1* | Section 1350 Certification |
| 101.INS** | XBRL Instance Document |
| 101.SCH** | XBRL Taxonomy Extension Schema Document |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase Document |

* Furnished, not filed.

** XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and is otherwise not subject to liability under these sections.

Table of Contents

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.

SCOTT S LIQUID GOLD-INC.

By: /s/ Mark E. Goldstein
Mark E. Goldstein
President and Chief Executive Officer

By: /s/ Barry J. Levine
Barry J. Levine
Treasurer, Chief Financial Officer and Chief
Operating Officer

Date: August 14, 2012

Table of Contents**EXHIBIT INDEX**

| Exhibit Number | Document |
|---------------------------|--|
| 10.1 | First Amendment to Second Amended and Restated Financing Agreement between the Company and Summit, dated June 29, 2012, incorporated by reference to Exhibit 99.1 of the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on July 2, 2012. |
| 31.1 | Rule 13a-14(a) Certification of the Chief Executive Officer |
| 31.2 | Rule 13a-14(a) Certification of the Chief Financial Officer |
| 32.1* | Section 1350 Certification |
| 101.INS** | XBRL Instance Document |
| 101.SCH** | XBRL Taxonomy Extension Schema Document |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase Document |

* Furnished, not filed.

** XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and is otherwise not subject to liability under these sections.