

QEP CO INC
Form 10-Q
January 16, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended November 30, 2006

Or

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

Commission File Number 0-21161

Q.E.P. CO., INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

1001 BROKEN SOUND PARKWAY NW, SUITE A, BOCA RATON, FLORIDA 33487

13-2983807
(I.R.S. Employer
Identification No.)

(Address of principal executive offices)(Zip Code)

Registrant's telephone number, including area code: (561) 994-5550

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

Large Accelerated filer Accelerated filer 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

The number of shares outstanding of each of the registrant's classes of common stock as of January 12, 2007 is 3,430,401 shares of Common Stock, par value \$0.001 per share.

Q.E.P. CO., INC. AND SUBSIDIARIES

INDEX

	Page
<u>PART I - FINANCIAL INFORMATION</u>	
Item 1 - <u>Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets November 30, 2006 (Unaudited) and February 28, 2005*</u>	3
<u>Consolidated Statements of Operations (Unaudited) For the Three and Nine Months Ended November 30, 2006 and 2005</u>	4
<u>Condensed Consolidated Statements of Cash Flows (Unaudited) For the Nine Months Ended November 30, 2006 and 2005</u>	5
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	6
Item 2 - <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
Item 3 - <u>Qualitative and Quantitative Disclosures about Market Risk</u>	31
Item 4 - <u>Controls and Procedures</u>	31
<u>PART II - OTHER INFORMATION</u>	
Item 1 - <u>Legal Proceedings</u>	33
Item 6 - <u>Exhibit</u>	37
<u>Signatures</u>	38
<u>Exhibit Index</u>	39

* Information derived from the Company's audited financial statements on Form 10-K.

PART I. FINANCIAL INFORMATION**Item 1. Financial Statements**

Q.E.P. CO., Inc. and Subsidiaries

Consolidated Balance Sheets

(In thousands, except share data)

	November 30, 2006 (Unaudited)	February 28, 2006
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 1,111	\$ 852
Accounts receivable, less allowance for doubtful accounts of approximately \$276 and \$361 as of November 30, 2006 and February 28, 2006, respectively	31,605	33,258
Inventories	30,347	34,128
Prepaid expenses and other current assets	3,399	3,717
Deferred income taxes	660	617
Total current assets	67,122	72,572
Property and equipment, net	7,265	8,296
Goodwill	9,578	16,799
Other intangible assets, net	2,914	3,109
Other assets	208	310
Total Assets	\$ 87,087	\$ 101,086
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES		
Trade accounts payable	\$ 17,996	\$ 24,041
Accrued liabilities	7,795	7,655
Lines of credit	28,463	26,284
Current maturities of long term debt	4,162	4,431
Put warrant liability	978	2,298
Total current liabilities	59,394	64,709
Notes payable	3,030	4,950
Other long-term debt	2,601	4,197
Deferred income taxes	214	213
Total Liabilities	65,239	74,069
Commitments and Contingencies		
SHAREHOLDERS EQUITY		
Preferred stock, 2,500,000 shares authorized, \$ 1.00 par value; 336,660 shares issued and outstanding at November 30, 2006 and February 28, 2006, respectively	337	337
Common stock; 20,000,000 shares authorized, \$.001 par value; 3,513,341 and 3,458,341 shares issued, and 3,430,401 and 3,387,401 shares outstanding at November 30, 2006 and February 28, 2006, respectively	3	3
Additional paid-in capital	9,964	9,539
Retained earnings	15,151	21,205
Treasury stock; 82,940 and 70,940 shares held at cost outstanding at November 30, 2006 and February 28, 2006, respectively	(639)	(543)
Accumulated other comprehensive income	(2,968)	(3,524)

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		21,848	27,017
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$	87,087	\$ 101,086

The accompanying notes are an integral part of these financial statements.

Q.E.P. CO., INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands except per share data)

(Unaudited)

	For the Three Months Ended November 30,		For the Nine Months Ended November 30,	
	2006	2005 As Restated	2006	2005 As Restated
Net sales	\$ 54,455	\$ 52,822	\$ 163,063	\$ 155,641
Cost of goods sold	39,760	38,472	118,238	112,540
Gross profit	14,695	14,350	44,825	43,101
Operating costs and expenses:				
Shipping	5,560	5,095	16,665	15,416
General and administrative	4,430	4,721	14,565	13,944
Selling and marketing	3,551	3,555	10,842	10,665
Impairment loss on goodwill and other intangibles	(78)		7,520	
Other expense (income), net	(38)	(111)	(41)	(1,275)
Total operating costs and expenses	13,425	13,260	49,551	38,750
Operating income (loss)	1,270	1,090	(4,726)	4,351
Change in put warrant liability	3	88	1,319	1,050
Interest expense, net	(711)	(681)	(2,167)	(1,811)
Income (loss) before provision for income taxes	562	497	(5,574)	3,590
Provision for income taxes	192	152	457	1,003
Net income (loss)	\$ 370	\$ 345	\$ (6,031)	\$ 2,587
Net income (loss) per share:				
Basic	\$ 0.10	\$ 0.10	\$ (1.78)	\$ 0.76
Diluted	\$ 0.10	\$ 0.09	\$ (1.78)	\$ 0.69
Weighted-average number of common shares outstanding				
Basic	3,423	3,387	3,402	3,387
Diluted	3,623	3,741	3,402	3,756

The accompanying notes are an integral part of these financial statements.

Q.E.P. CO., INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	For the Nine Months Ended November 30,	
	2006	2005 As Restated
Cash flows from operating activities:		
Net income (loss)	\$ (6,031)	\$ 2,587
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,895	3,101
Impairment loss on goodwill and other intangibles	7,520	
Change in fair value of put warrant liability	(1,319)	(1,050)
Write-off of Holland accumulated foreign translation	447	
Bad debt expense	171	328
Gain on sale of business		(1,120)
Stock-based compensation expense	191	
Deferred income taxes	(42)	(234)
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	1,482	(4,552)
Inventories	3,782	303
Prepaid expenses and other current assets	318	634
Other assets	4	(621)
Trade accounts payable and accrued liabilities	(5,930)	2,307
Net cash provided by operating activities	2,488	1,683
Cash flows from investing activities:		
Capital expenditures	(485)	(1,267)
Acquisitions, net of cash acquired		(2,512)
Net cash used in investing activities	(485)	(3,779)
Cash flows from financing activities:		
Net borrowings under lines of credit	1,552	900
Borrowings of long-term debt		3,224
Repayments of long-term debt	(2,087)	(1,677)
Repayments of acquisition debt	(1,834)	(870)
Payments related to the purchase of treasury stock	(90)	(90)
Proceeds from exercise of stock options	257	10
Dividends	(22)	(8)
Net cash (used in) provided by financing activities	(2,224)	1,489
Effect of exchange rate changes on cash	480	(168)
Net decrease in cash	259	(775)
Cash and cash equivalents at beginning of period	852	1,869
Cash and cash equivalents at end of period	\$ 1,111	\$ 1,094

The accompanying notes are an integral part of these financial statements.

Q.E.P. CO., INC. AND SUBSIDIARIES

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE A Interim Reporting

The accompanying financial statements for the interim periods are unaudited and include the accounts of Q.E.P. Co., Inc. and its subsidiaries, which are collectively referred to as we, us, our, Q.E.P. or the Company. The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q for interim financial reporting pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). While these statements reflect all normal recurring adjustments which are, in the opinion of management, necessary for fair presentation of the results of the interim period, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Therefore, the interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in our annual report filed on Form 10-K/A for the fiscal year ended February 28, 2006.

Effective with the 2007 fiscal year, we modified our accounting treatment for cooperative advertising and in-store service expenses with our home center customers. The modification was necessary because we changed certain terms in our vendor buying agreement with a large home center customer and believe under the new terms we could no longer reasonably estimate the fair value of the benefit received from these arrangements. According to the guidance under Emerging Issues Task Force 01-9, Accounting for Consideration Given By a Vendor To a Customer (Including a Reseller of the Vendor's Products), if the estimated value received cannot be specifically identified, these promotional funds should be accounted for as a reduction of selling price and netted against gross sales. Prior to March 1, 2006, we classified these items as selling and marketing expense in our consolidated statement of operations. For the three and nine months ended November 30, 2005 these expenses totaled \$1.5 million and \$4.3 million, respectively. For comparative purposes, these amounts have been reclassified resulting in a reduction in sales, gross profit and selling and marketing expenses in our Domestic segment, with no impact on our financial condition, operating income or net earnings.

In the financial statements prepared for the three and nine month periods presented for fiscal 2006, the change in the value of the put warrant liability was recorded in operating expenses. In the presentation included in this interim report, the amount has been reclassified below operating income for all periods presented.

All significant intercompany transactions have been eliminated.

We are a leading manufacturer, marketer and distributor of a broad line of specialty tools and flooring related products for the home improvement market. Under brand names including Q.E.P.®, ROBERTS®, Capitol®, QSet, Vitrex® and Elastiment, we market specialty tools and flooring related products used primarily for the surface preparation and installation of ceramic tile, carpet, vinyl and wood flooring. Q.E.P. markets approximately 3,000 products in the U.S., Canada, Europe, Australia and Latin America. We sell our products primarily to large home improvement retail centers, as well as traditional distribution outlets in all of the markets we serve.

NOTE B Restatement of Consolidated Financial Statements

We have restated the value of the put warrant liability as of the November 30, 2005 and as of the end of the 2006 fiscal year. During these periods, we estimated the value of the put warrant liability using methods and valuation techniques required by the put warrant agreement and in accordance with Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. We reconsidered the methodology used after discussions with the SEC and determined to value the put warrant liability by calculating the difference between our closing stock price at the end of a reporting period and the warrant exercise price of \$3.63 per share multiplied by the 325,000 warrants granted. We believe this methodology provides an appropriate estimate of entity value. As a result, the estimated value of the put warrant liability has been restated for all years in which the warrants were outstanding. This change has no impact on our previously reported operating income or cash flows generated from operations. Changes to the fair value of the put warrants are recognized in earnings. The updated methodology has also been applied to all periods presented for fiscal 2007. The restated amounts as compared to the initially reported information are follows (in thousands except per share data):

	Three Months Ended		Nine Months Ended	
	November 30, 2005		November 30, 2005	
	As		As	
	Previously	Previously	Previously	Previously
	Reported	As Restated	Reported	As Restated
Change in put warrant liability	26	88	(132)	1,050
Income (loss) before provision for income taxes	435	497	2,408	3,590
Provision for income taxes	152	152	1,003	1,003
Net income (loss)	\$ 283	\$ 345	\$ 1,405	\$ 2,587
Net income (loss) per share:				
Basic	\$ 0.08	\$ 0.10	\$ 0.41	\$ 0.76
Diluted	\$ 0.08	\$ 0.09	\$ 0.40	\$ 0.69
Weighted-average number of common shares outstanding				
Basic	3,387	3,387	3,387	3,387
Diluted	3,525	3,741	3,534	3,756

We have also reconsidered the economic characteristics of operations in our geographic regions and have included segment disclosure in accordance with Statement of Financial Accounting Standards No. 131 *Disclosures About Segments of an Enterprise and Related Information* in this report.

NOTE C Inventories

Inventories consisted of the following (in thousands):

	November 30,	February 28,
	2006	2006
Raw materials and work-in-process	5,063	5,822
Finished goods	25,284	28,306
	30,347	34,128

NOTE D Goodwill and Intangible Assets

Under Statement of Financial Accounting Standard No. 142 *Goodwill and Other Intangible Assets*, intangible assets with definite lives are amortized while intangibles with indefinite lives, such as goodwill, are tested annually for impairment or when changes events or changes in circumstances indicate the carrying value may not be recoverable. We perform an impairment test on goodwill during the second quarter of each fiscal year. The impairment test in the second quarter of fiscal 2007 resulted in an estimated non-cash impairment charge of \$7.6 million. The second step of the impairment test completed in the third quarter of fiscal 2007 has resulted in a final impairment charge of \$7.5 million. The reduction in impairment charge of \$0.1 million is recorded as income in the current period. Details of the impairment test are described in Footnote E below. We will continue to assess the impairment of goodwill and other assets in accordance with SFAS No. 142 in the future. If our operating performance and resulting cash flows in the future are less than expected, an additional impairment charge could be incurred which may have a material impact on our results of operations.

All other intangible assets are subject to amortization. The total balance of definite-lived intangible assets is classified as follows (in thousands):

	Weighted Avg Useful Life	November 30, 2006			February 28, 2006		
		Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Trademarks	20	3,007	(945)	2,062	2,971	(820)	2,151
Other intangibles	5	1,295	(443)	852	1,327	(369)	958
		\$ 4,302	\$ (1,388)	\$ 2,914	\$ 4,298	\$ (1,189)	\$ 3,109

We incurred \$0.1 million and \$0.2 million of amortization expense in the three and nine months ended November 30, 2006. We expect to incur a total of approximately \$0.3 million in fiscal 2007. Other intangibles include customer lists, non-compete agreements, patents and financing fees.

NOTE E Impairment of Goodwill

In accordance with SFAS No. 142, goodwill and other intangible assets with indefinite lives are tested for impairment annually and when events or changes in circumstances indicate an impairment could exist. The impairment test involves a two step approach. Under the first step, we are required to determine the fair value of each reporting unit to which goodwill is assigned. If the fair value of the reporting unit exceeds its carrying value, including goodwill, no impairment loss is recognized. However, if the carry value exceeds the fair value, the goodwill of the reporting unit is considered potentially impaired and the second step is completed to quantify the impairment.

Under the second step, we are required to calculate the implied fair value of goodwill by deducting the fair value of all tangible and intangible net assets, including unrecognized intangible assets, of the reporting unit from the fair value of the reporting unit, as determined in the first step. If the implied fair value of goodwill is less than the carrying value of goodwill, we recognize an impairment charge equal to the difference.

During the second quarter of fiscal 2007, we performed our annual impairment test on the goodwill and other intangible assets currently recorded. Earnings forecasts for each of our divisions were updated in support of the fair value estimates used in the initial impairment tests. The valuations were based on market approaches, the present value of future cash flows and closing price of our stock as at August 31, 2006. These tests indicated that the carrying amount of the goodwill exceeded fair value in our Mexico, U.K. and U.S. reporting units, and led us to conclude that goodwill was impaired. In the second quarter of fiscal 2007, we recorded an estimated \$7.6 million impairment charge to reduce the carrying value of goodwill and other intangibles to its implied fair value. The second step of the impairment test was completed in the third quarter of fiscal 2007 and resulted in a final impairment charge of \$7.5 million. The non-cash charge was recorded at our Domestic (\$6.2 million), Europe (\$1.0 million) and Other (\$0.3 million) segments. The reduction in impairment charge from the second to third quarter of fiscal 2007 of \$0.1 million was recorded as income in the current period.

We contracted the assistance of an independent third-party specialist to determine the fair value of the reporting units using methodologies that include both a market and an income approach. The market approach includes analysis of publicly traded companies comparable in terms of functions performed, financial strengths, and markets serviced, along with a survey of transactions involving similar public and non-public companies. The income approach was based on the economic benefit stream of discounted future cash flows. After the non-cash charge for impairment, \$7.0 million of goodwill remains recorded on our Domestic segment, \$0.9 million in our Canada segment, \$0.3 million in our Europe segment and \$1.4 million in our Australia/New Zealand segment. No balance remains in our Other segment.

We will continue to assess the potential of impairment of goodwill and other indefinite-lived intangibles in accordance with FASB Statement No. 142 in future periods. Should our business prospects change, and our expectations for acquired business be further reduced, or other circumstances that affect our business dictate, we may be required to recognize additional impairment charges in accordance with SFAS No. 142.

NOTE F Debt

Revolving Credit Facility

Currently, we have a loan agreement in place with two domestic financial institutions to provide a revolving credit facility, mortgage and term note financing. In March 2005, we amended the facility to consolidate our term notes and increase the amount of borrowing capacity to \$27 million through February 2006 and \$29 million thereafter under the revolving facility under the same formula for eligible accounts receivable and inventory that previously existed. The revolving facility was also extended to July 2008. These loans are collateralized by substantially all of our assets. The agreement also prohibits incurring certain additional indebtedness, limits certain investments, advances or loans, restricts substantial asset sales and capital expenditures and prohibits the payment of dividends, except for dividends due on our Series A and C preferred stock.

As of February 28, 2006, we were in violation of financial covenants under the credit facility that required we maintain a certain senior debt to trailing EBITDA ratio and a certain fixed charge coverage ratio. On March 20, 2006 we were granted a waiver of the non-compliance of these covenants from the lenders. Further, it was determined that we were in violation of an additional financial covenant under the credit facility that required we maintain a certain liabilities to tangible net worth ratio. On June 1, 2006, we received a waiver of this covenant. Also in June 2006, the loan agreement was amended with respect to certain financial covenants. The June 2006 amendment also resulted in a fee of less than \$0.1 million and an increase in the interest rate to a range from Libor plus 1.5% to Libor plus 2.25%.

The credit agreement was further amended on October 23, 2006 to exclude from the covenant calculations the effect of the goodwill impairment charges and the losses recorded related to the Holland transaction. Both the disposition of assets and obligations and the realization of the foreign currency translation as discussed in Footnote M related to Holland were excluded. Without this amendment the excluded items recorded in the second quarter of fiscal 2006 would have caused us to be in violation as of August 31, 2006 of the same EBITDA and fixed charge coverage covenants discussed above.

As of November 30, 2006, we were in violation of a financial covenant that requires us to maintain a certain senior debt to trailing EBITDA ratio. On January 12, 2007 we were granted a waiver of the non-compliance with this covenant from the lenders.

At November 30, 2006 the rate was Libor (5.27%) plus 2.25% and we had borrowed approximately \$24.5 million and had \$4.1 million available for future borrowings under our revolving loan facility net of approximately \$0.4 million in outstanding letters of credit.

International Credit Facilities

Our Australian subsidiary has a payment facility that allows it to borrow against a certain percentage of inventory and accounts receivable. At November 30, 2006, the maximum permitted borrowing was approximately \$2.3 million of which \$1.7 was outstanding. The facility is considered a demand note and carries with it a rate of the Australian Commercial Bill Rate (6.5%) plus 2%.

In connection with the purchase of the assets of Vitrex Ltd., our United Kingdom subsidiary entered into two financing arrangements with HSBC Bank in the United Kingdom. The first financing arrangement allows for borrowing up to £1.0 million (approximately U.S. \$1.9 million) based on the advancement of up to 80% of the value of accounts receivable. In addition, the subsidiary may borrow up to £0.4 million (approximately U.S. \$0.8 million) against the value of the inventory. Both of these facilities are collateralized by substantially all of the assets of the subsidiary (approximately \$8.1 million) as well as a parent company guaranty. On November 30, 2006, \$2.0 million was borrowed under these facilities. Both are considered short-term demand notes and have an interest rate of 7.0%.

Term Loan Facilities

As discussed previously, in March 2005, we amended our term loan agreements by consolidating the then existing two term facilities into one three year term facility. In addition, we received approximately \$3.0 million of additional term financing under the amendment. The amendment provides for repayment of this facility at a rate of \$0.2 million per month at an interest rate of Libor plus 2.13% to Libor plus 2.63% through April 2008. The amendment also formally released our Chairman and Chief Executive Officer of his guaranty of one of the term loans. In June 2006, the loan agreements were amended to increase the interest rate to Libor plus 2.13% to Libor plus 2.88%. The balance on this term note was \$2.8 million at November 30, 2006.

Our Australian subsidiary has entered into three term loan facilities with an Australian financial institution to provide financing of up to AUD 1.7 million (US \$1.4 million). These facilities expire in April 2007, June 2008 and October 2008. The loans require quarterly payments of AUD 0.2 million (US \$0.1 million) and a final balloon payment. The balance of these term notes was US \$0.9 million at November 30, 2006. The term loan is collateralized by substantially all of the assets of the subsidiary (approximately \$11.6 million) as well as a guaranty by the parent company.

NOTE G Stock Based Compensation

We grant stock options for a fixed number of shares to employees and directors with an exercise price equal to at least 85% of the fair market value of the shares at the date of grant. Option term, vesting and exercise periods vary, except that the term of an option may not exceed 10 years. As of the current date, however, no options have been issued at a discount to market price.

We also grant stock appreciation rights for a fixed number of shares to various members of management. These rights vest three years after the grant date. The exercise price of the stock appreciation rights is equal to the fair market value of the shares at the date of grant.

In the first quarter of fiscal 2007, we adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*, which revises SFAS 123, *Accounting for Stock-Based Compensation*. Prior to the adoption we applied Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for stock options. Because we granted stock options to employees at exercise prices equal to fair market value on the date of grant, no compensation cost was recognized for option grants in periods prior to fiscal 2007.

Under SFAS No. 123R, we are required to select a valuation technique or option-pricing model that meets the criteria as stated in the standard, which includes a binomial model and the Black-Scholes model. At present, we are continuing to use the Black-Scholes model, which requires the input of subjective assumptions. These assumptions include estimating the length of time employees will

retain their vested stock options and stock appreciation rights before exercising, the risk-free interest rate, the estimated volatility of our common stock price over the expected term and the number of options and stock appreciation rights that will ultimately not complete their vesting requirements. For fiscal 2007, the expected stock price volatility is based primarily on the historical volatility of our stock. Changes in the subjective assumptions can materially affect the estimate of fair value of stock-based compensation. The following table represents the assumptions used to estimate the fair value of options issued during the second quarter of the 2007 fiscal year and stock appreciation rights outstanding as of November 30, 2006:

Expected stock price volatility	39.3%
Expected lives of options:	
Directors and officers	3 years
Employees	3 years
Risk-free interest rate	4.8%
Expected dividend yield	0.0%

No options or stock appreciation rights were issued in the first or third quarter of fiscal 2007.

The adoption of SFAS No. 123R, applying the modified prospective method, as elected, requires us to recognize stock options and stock appreciation rights granted prior to the adoption of SFAS No. 123 under the fair value method and expense these amounts over the remaining vesting period of the award. In the three and nine months ended November 30, 2006, we recognized compensation expense of \$0.1 million and \$0.2 million, respectively, related to stock options issued and stock appreciation rights granted in previous periods. If the underlying assumptions do not change, the total compensation cost related to non-vested awards not yet recognized is \$0.6 million and is expected to be recognized over three years.

Stock Option Information

The following table summarizes information about stock options as of November 30, 2006.

Range of exercise prices	Number outstanding	Weighted average		Number exercisable	Weighted average exercise price
		remaining contractual life	exercise price		
\$ 3.65 - \$ 5.55	67,250	4.6	\$ 4.13	67,250	\$ 4.13
\$ 5.56 - \$ 7.25	131,375	5.4	\$ 6.76	71,375	\$ 6.77
\$ 7.26 - \$ 15.66	87,000	8.6	\$ 9.62	23,667	\$ 11.89
Total	285,625			162,292	

Activity under our stock option plan as of November 30, 2006 and changes during the nine months ended November 30, 2006 are as follows:

	Shares	Weighted Average Exercise Price
Options outstanding at February 28, 2006	326,375	\$ 7.65
Exercised	(55,000)	\$ 4.71
Granted	110,000	\$ 7.25
Cancelled or forfeited	(95,750)	\$ 10.79

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Options outstanding at November 30, 2006	285,625	\$ 7.01
Intrinsic value of exercisable options	\$ 178,943	
Weighted average term of exercisable options	5.9	

As of November 30, 2006, 1.0 million shares were authorized to be issued under our current option plan. The intrinsic value of the options exercised during fiscal 2007 was less than \$0.1 million and the intrinsic value of options outstanding as of November 30, 2006 was \$0.5 million.

Stock Appreciation Rights

As of November 30, 2006, there are 168,500 stock appreciation rights outstanding that were granted to various members of management from fiscal 2005 through fiscal 2007, 76,500 of which were issued in the second quarter of fiscal 2007. The rights vest 100% three years after their grant date. As a result, none of the stock appreciation rights are exercisable on November 30, 2006. The exercise price associated with these grants ranges from \$7.05 to \$14.20 per share.

Comparison to Pro Forma Information

The following table reflects net income and basic and diluted earnings per share for the three and nine months ended November 30, 2005, had compensation cost been determined in accordance with the fair value-based method prescribed by SFAS No. 123R (in thousands except per share data):

	Three Months Ended	Nine Months Ended
	November 30, 2005	November 30, 2005
Net income (loss) as reported under APB 25	\$ 345	\$ 2,587
Subtract stock-based compensation expense determined under fair value-based method, net of related tax effect	(34)	(103)
Net income (loss) including stock-based compensation expense	\$ 311	\$ 2,484
Income (loss) per share:		
Basic, as reported for prior periods	\$ 0.10	\$ 0.75
Basic, including the effect of stock based compensation expense	\$ 0.09	\$ 0.72
Diluted, as reported for prior periods	\$ 0.09	\$ 0.67
Diluted, including the effect of stock based compensation expense	\$ 0.08	\$ 0.65

NOTE H Income Taxes

We recorded a provision for income taxes in the three and nine months ended November 30, 2006 of approximately \$0.2 million and \$0.5 million, respectively. This compares with a provision for \$0.2 million and \$1.0 million in the same periods in fiscal 2006. In all periods presented, the change in the put warrant liability is non-deductible for tax purposes. In the jurisdictions that have been affected by the impairment loss on goodwill, a valuation allowance has been recorded for any deferred tax benefit associated with the loss. After removing the put warrant expense, the non-taxable accumulated foreign currency translation related to our disposition of assets in Holland and the impairment loss on goodwill from the calculation, the effective tax rate in the three and nine months ended November 30, 2006 was 40% and 43%, respectively. The effective rate for the nine months ended November, 30 2006, was in excess of our statutory rate due to an adjustment to a prior year tax assessment in the second quarter of fiscal 2007. This rate compares with 37% and 39% in the three and nine months ended November 30, 2005. The fiscal 2007 provision was based upon the statutory tax rates available in every jurisdiction in which we operate.

NOTE I Earnings Per Share

Basic earnings per share is computed by dividing net income, after deducting preferred stock dividends accumulated during the period, by the weighted average number of shares of common stock outstanding. Diluted earnings per share is computed by dividing net income, after deducting preferred stock dividends accumulated during the period, by the weighted average number of shares of

common and dilutive common stock equivalent shares outstanding. The amount of preferred stock dividends is immaterial in all periods presented. There were 0.3 million and 0.8 million of common stock equivalent shares excluded from the dilutive earnings per share calculation because they were anti-dilutive in the three and nine month periods ended November 30, 2006. In both periods presented for fiscal 2006, the amount of antidilutive shares was less than 0.1 million. The following is a reconciliation of the number of shares used in the basic and diluted computation of income per shares (in thousands)

	For the Three Months		For the Nine Months	
	Ended November 30, 2006	2005	Ended November 30, 2006	2005
Weighted average number of common shares outstanding - basic	3,423	3,387	3,402	3,387
Dilution from stock options and warrants	200	354		369
Weighted average number of common shares outstanding - diluted	3,623	3,741	3,402	3,756

NOTE J Comprehensive Income

We record foreign currency translation adjustments as other comprehensive income. For the three and nine months ended November 30, 2006, our comprehensive income (loss) totaled less than \$0.1 million and \$(5.5) million, respectively. This compares with \$0.1 million and \$1.4 million for the same periods in fiscal 2006.

Note K Segment Information

After discussions with the SEC, we have reconsidered the economic characteristics of operations in our geographic regions and have included segment disclosure in accordance with Statement of Financial Accounting Standards No. 131 *Disclosures About Segments of an Enterprise and Related Information* in this report. We have determined we operate in five business segments: Domestic, Canada, Europe, Australia/New Zealand and Other. Management has chosen to organize the operations into geographic segments, with each segment being the responsibility of a segment manager. Each segment markets and sells flooring-related products to the residential, new construction, do-it-yourself and professional remodeling and renovation markets and home centers. The European segment is made up of our operations in the UK, France, Holland and Germany. The Australia/New Zealand segment is made up of our operations in Australia and New Zealand. The Other segment is made up of operations in Latin America and other geographic areas.

The performance of the business is evaluated at the segment level. We manage cash, debt and income taxes centrally. Accordingly, we evaluate performance of our segments based on operating earnings exclusive of financing activities and income taxes. Segment results were as follows (in thousands):

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	For the Three Months Ended November 30,		For the Nine Months Ended November 30,	
	2006	2005	2006	2005
Revenues				
Domestic	\$ 36,972	\$ 35,916	\$ 111,165	\$ 107,929
Canada	5,669	5,279	16,505	14,186
Europe	4,977	5,252	16,098	15,627
Australia/New Zealand	6,061	5,554	17,070	15,811
Other	776	821	2,225	2,088
	\$ 54,455	\$ 52,822	\$ 163,063	\$ 155,641
Operating income (loss)				
Domestic	\$ 394	\$ 525	\$ 967	\$ 1,623
Canada	734	783	2,145	2,009
Europe	(152)	(691)	(928)	(1,296)
Australia/New Zealand	371	312	870	689
Other	(157)	50	(265)	51
Subtotal	1,190	979	2,789	3,076
Other (income) expense	(2)	(111)	(5)	(1,275)
Impairment loss on goodwill and other intangibles	(78)		7,520	
Operating income (loss)	\$ 1,270	\$ 1,090	\$ (4,726)	\$ 4,351
Change in put warrant liability	3	88	1,319	1,050
Interest expense, net	(711)	(681)	(2,167)	(1,811)
Income (loss) before provision for income taxes	\$ 562	\$ 497	\$ (5,574)	\$ 3,590

	As of November 30, 2006	As of February 28, 2006
Total assets		
Domestic	\$ 52,589	\$ 66,771
Canada	8,699	9,104
Europe	10,694	11,818
Australia/New Zealand	12,457	11,347
Other	2,648	2,046
	\$ 87,087	\$ 101,086

The results from the Canadian operations are included as their own segment according to the provisions of Statement of Financial Accounting Standards No. 131 *Disclosures about Segments of an Enterprise and Related Information*. The reported results do not contain allocations of corporate expenses and sales infrastructure and their product costs are not burdened based on Canada's level of sales to external customers.

Amounts are attributed to the country of the legal entity that recognized the sale or holds the assets. The intercompany sales are billed at prices we have established. The price takes into account the product cost and overhead of the selling location.

NOTE L Contingencies

We are involved in litigation from time to time in the course of business. In the opinion of management, ba