

SCOTTS LIQUID GOLD INC
Form 10-Q
November 14, 2017

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 September 30, 2017

OR

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

For the transition period from _____ to _____

Commission File Number: 001-13458

SCOTT'S LIQUID GOLD-INC.

(Exact name of registrant as specified in its charter)

Colorado
(State or other jurisdiction of
incorporation or organization)

84-0920811
(I.R.S.
Employer
Identification

No.)

4880 Havana Street, Suite 400, Denver, CO
(Address of principal executive offices)

80239
(Zip Code)

Registrant's telephone number, including area code: (303) 373-4860

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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth 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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 November 13, 2017, the Registrant had 11,885,839 of its common stock, \$0.10 par value per share, outstanding.

CAUTIONARY NOTE ON FORWARD-LOOKING INFORMATION

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

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

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

TABLE OF CONTENTS

	Page
<u>PART I</u>	
Item 1. <u>Condensed Consolidated Financial Statements</u>	1
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	19
Item 4. <u>Controls and Procedures</u>	19
<u>PART II</u>	
Item 1A. <u>Risk Factors</u>	20
Item 6. <u>Exhibits</u>	20

PART I

ITEM 1. FINANCIAL STATEMENTS.

Condensed Consolidated Statements of Income (Unaudited)

Scott's Liquid Gold-Inc. & Subsidiaries

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Net sales	\$ 10,340,600	\$ 9,936,900	\$ 30,657,000	\$ 24,274,800
Operating costs and expenses:				
Cost of sales	5,420,000	5,830,600	16,649,000	13,454,600
Advertising	109,800	91,700	531,100	1,426,600
Selling	1,583,400	1,717,300	4,878,600	4,184,300
General and administrative	1,062,700	1,218,800	3,166,300	3,433,000
Total operating costs and expenses	8,175,900	8,858,400	25,225,000	22,498,500
Income from operations	2,164,700	1,078,500	5,432,000	1,776,300
Other income	-	1,000	-	12,600
Interest expense	(26,400)	(60,400)	(101,500)	(77,500)
Income before income taxes	2,138,300	1,019,100	5,330,500	1,711,400
Income tax expense	(663,500)	(415,500)	(1,899,300)	(697,900)
Net income	\$ 1,474,800	\$ 603,600	\$ 3,431,200	\$ 1,013,500
Net income per common share				
Basic	\$ 0.12	\$ 0.05	\$ 0.29	\$ 0.09
Diluted	\$ 0.12	\$ 0.05	\$ 0.28	\$ 0.08
Weighted average shares outstanding:				
Basic	11,885,839	11,747,612	11,840,957	11,730,759
Diluted	12,360,079	12,027,956	12,217,890	11,969,167

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

Condensed Consolidated Balance Sheets

Scott's Liquid Gold-Inc. & Subsidiaries

	September 30, 2017 (Unaudited)	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 2,389,000	\$ 2,097,300
Accounts receivable, net	3,152,200	3,456,400
Inventories, net	9,483,900	5,641,300
Income taxes receivable	-	7,000
Prepaid expenses	396,800	319,600
Total current assets	15,421,900	11,521,600
Property and equipment, net	823,900	578,400
Deferred tax asset	563,400	1,392,600
Goodwill	1,520,600	1,520,600
Intangible assets, net	6,303,600	6,769,100
Other assets	49,100	51,000
Total assets	\$ 24,682,500	\$ 21,833,300
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 2,376,900	\$ 1,939,400
Accrued expenses	860,900	964,800
Income taxes payable	197,300	-
Current maturities of long-term debt	800,000	800,000
Total current liabilities	4,235,100	3,704,200
Line-of-credit	-	750,000
Long-term debt, net of current maturities and debt issuance costs	556,100	1,137,300
Total liabilities	4,791,200	5,591,500
Shareholders' equity:		
Preferred stock, no par value, authorized 20,000,000 shares; no shares issued and outstanding	-	-
Common stock; \$0.10 par value, authorized 50,000,000 shares; issued and outstanding 11,885,839 shares (2017) and 11,749,589 shares (2016)	1,188,600	1,175,000
Capital in excess of par	6,382,500	6,177,800
Retained earnings	12,320,200	8,889,000
Total shareholders' equity	19,891,300	16,241,800
Total liabilities and shareholders' equity	\$ 24,682,500	\$ 21,833,300

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

Condensed Consolidated Statements of Cash Flows (Unaudited)

Scott's Liquid Gold-Inc. & Subsidiaries

	Nine Months Ended September 30,	
	2017	2016
Cash flows from operating activities:		
Net income	\$3,431,200	\$1,013,500
Adjustment to reconcile net income to net cash provided (used) by operating activities:		
Depreciation and amortization	591,400	264,900
Stock-based compensation	183,500	189,500
Deferred income taxes	829,200	649,600
Change in operating assets and liabilities:		
Accounts receivable	304,200	(2,774,700)
Inventories	(3,842,600)	(305,500)
Prepaid expenses and other assets	(75,300)	(54,200)
Income taxes payable (receivable)	204,300	(13,400)
Accounts payable and accrued expenses	333,600	906,300
Total adjustments to net income	(1,471,700)	(1,137,500)
Net cash provided (used) by operating activities	1,959,500	(124,000)
Cash flows from investing activities:		
Cash paid for Acquisition	-	(9,000,000)
Purchase of property and equipment	(352,600)	(223,600)
Net cash used by investing activities:	(352,600)	(9,223,600)
Cash flows from financing activities:		
Borrowing under line-of-credit	-	3,694,100
Repayments under line-of-credit	(750,000)	(1,794,100)
Proceeds from issuance of long-term debt	-	2,400,000
Repayments of long-term debt	(600,000)	(200,000)
Debt issuance costs	-	(75,200)
Proceeds from exercise of stock options	34,800	30,500
Net cash (used) provided by financing activities:	(1,315,200)	4,055,300
Net increase (decrease) in cash and cash equivalents	291,700	(5,292,300)
Cash and cash equivalents, beginning of period	2,097,300	7,165,100
Cash and cash equivalents, end of period	\$2,389,000	\$1,872,800
Supplemental disclosures:		
Cash paid during the period for interest	\$101,500	\$77,500
Cash paid during the period for income taxes	\$865,700	\$-

Supplemental disclosure of non-cash activity:

In connection with the Company's Acquisition (defined in Note 5) during the nine months ended September 30, 2016, the Company acquired \$400,000 of inventory, intangible assets of \$7,079,400, and goodwill of \$1,520,600 for a total of \$9,000,000.

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

Notes to Condensed Consolidated Financial Statements (Unaudited)

Scott's Liquid Gold-Inc. & Subsidiaries

Note 1. Organization and Summary of Significant Accounting Policies

(a) Company Background

Scott's Liquid Gold-Inc. (a Colorado corporation) was incorporated on February 15, 1954. Scott's Liquid Gold-Inc. and its wholly-owned subsidiaries (collectively, the "Company," "we," "our," or "us") develop, manufacture, market and sell quality household and skin and hair care products. We are also a distributor in the United States of Montagne Jeunesse skin sachets and Batiste Dry Shampoo manufactured by two other companies. Our business is comprised of two segments, household products and skin and hair care products.

(b) Principles of Consolidation

Our Condensed Consolidated Financial Statements (Unaudited) include our accounts and those of our wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated.

(c) Basis of Presentation

The Condensed Consolidated Statements of Income, Condensed Consolidated Balance Sheets, and the Condensed 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 September 30, 2017 and results of operations and cash flows for all periods have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). These Condensed Consolidated Financial Statements (Unaudited) 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, 2016. The results of operations for the period ended September 30, 2017 are not necessarily indicative of the operating results for the full year.

(d) Use of Estimates

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

(e) Cash Equivalents

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

(f) Sale of Accounts Receivable

On March 16, 2011, we entered into a financing agreement with Wells Fargo Bank, National Association ("Wells Fargo") for the purpose of lowering the cost of borrowing associated with the financing of our accounts receivable. Pursuant to this agreement, we were able to sell accounts receivable from Wal-Mart Stores, Inc. ("Wal-Mart") at a discount to Wells Fargo. On January 29, 2016 we terminated our agreement with Wells Fargo due to Wal-Mart changing its accounts payable policy.

During the nine months ended September 30, 2017 and 2016, we sold approximately \$0 and \$306,800, respectively, of our relevant accounts receivable to Wells Fargo for approximately \$0 and \$305,200, respectively. The difference between the invoiced amount of the receivable and the cash that we received from Wells Fargo is a cost to us. This cost is in lieu of any cash discount our customer would have been allowed and, thus, is treated in a manner consistent with standard trade discounts granted to our customers.

4

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

(g) Inventories Valuation and Reserves

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:

	September 30, 2017	December 31, 2016
Finished goods	\$ 7,364,900	\$ 2,668,700
Raw materials	2,133,600	3,035,000
Inventory reserve for obsolescence	(14,600)	(62,400)
	\$ 9,483,900	\$ 5,641,300

(h) Property and Equipment

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

(i) Intangible Assets

Intangible assets consist of customer relationships, trade names, formulas and batching processes and a non-compete agreement. The fair value of the intangible assets is amortized over their estimated useful lives and range from a period of five to 15 years and are reviewed for impairment when changes in market circumstances occur and written down to fair value if impaired.

(j) Goodwill

Goodwill consists of the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired in the Acquisition discussed in Notes 5 and 6. Goodwill and intangible assets deemed to have indefinite lives are not amortized but are subject to annual impairment tests, and in certain circumstances these assets are written down to fair value if impaired.

(k) Financial Instruments

Financial instruments which potentially subject us to concentrations of credit risk include cash and cash equivalents and accounts receivable. We maintain our cash balances in the form of bank demand deposits with financial institutions that we believe are creditworthy. During the nine months ended September 30, 2017, 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, accrued expenses, and current maturities of long-term debt approximate fair value due to the short-term nature of these financial instruments. The recorded amount of long-term debt approximates fair value and is estimated primarily based on current market rates for debt with similar terms and remaining maturities. At September 30, 2017, we had long-term debt of \$1,400,000 and no outstanding balance on our line-of-credit. At December 31, 2016 we had long-term debt of \$2,000,000 and a \$750,000 outstanding balance on our line-of-credit.

(l) Income Taxes

Income taxes reflect the tax effects of transactions reported in the financial statements and consist of taxes currently payable plus deferred income taxes related to certain income and expenses recognized in different periods for financial and income tax reporting purposes. Deferred income tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective income tax bases. A valuation allowance is provided when it is more-likely-than-not that some portion or all of a deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the period in which related temporary differences become deductible. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

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

The effective tax rate for the nine months ended September 30, 2017 and 2016 was 35.6% and 40.8% respectively, which differs from the statutory income tax rate due to permanent book to tax differences.

(m) Revenue Recognition

Our revenue recognition policy is significant because the amount and timing of revenue is a key component of our results of operations. Certain criteria are required to be met in order to recognize revenue. If these criteria are not met, then the associated revenue is deferred until it is met. In our case, the criteria generally are met when: (i) we have an arrangement to sell a product; (ii) we have delivered the product in accordance with that arrangement; (iii) the sales price of the product is determinable; and (iv) 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, slotting fees and other merchandising of our products to our customers. The actual level of returns and customer allowances is influenced by several factors, including the promotional efforts of our customers, changes in mix of our customers, changes in the mix of the products we sell and the maturity of the product. We may change our estimates based on actual results and consideration of other factors that cause returns and allowances. In the event that actual results differ from our estimates, the results of future periods may be impacted.

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

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

At September 30, 2017 and December 31, 2016 approximately \$831,400 and \$1,184,700, respectively, had been reserved as a reduction of accounts receivable. Trade promotions to our customers and incentives such as coupons to our consumers are deducted from gross sales and totaled \$1,854,100 and \$1,584,500 for the nine months ended September 30, 2017 and 2016, respectively, and totaled \$522,300 and \$616,300 for the three months ended September 30, 2017 and 2016, respectively.

(n) Advertising Costs

Advertising costs are expensed as incurred.

(o) Stock-based Compensation

The Company accounts for share based payments by recognizing compensation expense based upon the estimated fair value of the awards on the date of grant. The Company determines the estimated grant-date fair value of stock options using the Black-Scholes option pricing model. In order to calculate the fair value of the options, certain assumptions are made regarding the components of the model, including the estimated fair value of underlying common stock, risk-free interest rate, volatility, expected dividend yield and expected option life. Changes to the assumptions could cause significant adjustments to the valuation. The Company recognizes compensation costs ratably over the vesting period using the straight-line method.

(p) 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 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 \$1,864,400 and \$1,149,600 for the nine months ended September 30, 2017 and 2016, respectively, and totaled \$611,200 and \$439,000 for the three months ended September 30, 2017 and 2016, respectively.

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.

(q) Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers (Topic 606)” (“ASU 2014-09”). This guidance, as amended by subsequent ASUs on the topic, outlines a comprehensive model for determining revenue recognition for contracts with customers, which replaces numerous industry-specific requirements and converges areas under this topic with those of the International Financial Reporting Standards. This guidance implements a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. The new guidance also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts and customers. Other major provisions include the capitalization and amortization of certain contract costs, ensuring the time value of money is considered in the transaction price, and allowing estimates of variable consideration to be recognized before contingencies are resolved in certain circumstances. The new guidance is effective for reporting periods beginning after December 15, 2017, and early adoption is permitted. Entities can transition to the new guidance either retrospectively or as a cumulative-effect adjustment as of the date of the adoption. We have substantially completed our assessment of the new guidance and continue to make progress on its implementation. We plan to adopt the new guidance on January 1, 2018, on a “full retrospective” basis. Currently, we believe that the new guidance is not expected to have a material impact on our financial statements and we are currently assessing the need for expanded financial disclosures, if any.

In August 2016, the FASB issued ASU 2016-15, “Statement of Cash Flows: Classification of Certain Cash Receipts and Payments” (“ASU 2016-15”), which provides guidance on eight specific cash flow issues with the objective of reducing diversity in practice. Application of ASU 2016-15, which should be applied prospectively, is required for the annual and interim periods beginning after December 15, 2017. Early adoption is permitted. ASU 2016-15 is not expected to have a material impact on our financial statements.

In January 2017, the FASB issued ASU 2017-01, “Business Combinations (Topic 805): Clarifying the Definition of a Business” (“ASU 2017-01”), which provides a more defined framework to use in determining when a set of assets and activities is a business. ASU 2017-01 also provides greater consistency in applying the guidance, making the

definition of a business more operable. ASU 2017-01 is effective for public companies for annual periods, including interim periods, beginning after December 15, 2017. ASU 2017-01 is not expected to have a material impact on our financial statements.

In May 2017, the FASB issued ASU 2017-09, “Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting” (“ASU 2017-09”), clarifying when a change to the terms or conditions of a share-based payment award must be accounted for as a modification. The new guidance requires modification accounting if the fair value, vesting condition or the classification of the award is not the same immediately before and after a change to the terms and conditions of the award. ASU 2017-09 is effective for public companies for annual periods, including interim periods, beginning after December 15, 2017, with early adoption permitted. ASU 2017-09 is not expected to have a material impact on our financial statements.

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842)” (“ASU 2016-02”), which requires a lessee to record a right-of-use asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. We anticipate that most of our operating leases will result in recognition of additional assets and the corresponding liabilities on the Consolidated Balance Sheets. We have not determined the amount of these transactions or the final impact to our earnings as the actual impact will depend on the Company’s lease portfolio at the time of adoption.

In June 2016, FASB issued ASU No. 2016-13, “Financial Instruments —Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments” (“ASU 2016-13”). Among other things, these amendments require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 (i.e., January 1, 2020, for calendar year entities). ASU 2016-13 is not expected to have a material impact on our financial statements.

In January 2017, the FASB issued ASU 2017-04, “Simplifying the Test for Goodwill Impairment” (“ASU 2017-04”). ASU 2017-04 simplifies the accounting for goodwill impairment by elimination of the Step 2 requirement to calculate the implied fair value of goodwill. Instead, if a reporting unit’s carrying amount exceeds its fair value, an impairment charge will be recorded based on that difference. The impairment charge will be limited to the amount of goodwill allocated to that reporting unit. ASU 2017-04 will be applied prospectively and is effective for impairment tests performed after December 15, 2019, with early adoption permitted. ASU 2017-04 is not expected to have a material impact on our financial statements.

Note 2. Stock-Based Compensation

During the nine months ended September 30, 2017, we granted: (i) options to acquire 16,560 shares of our common stock to employees at prices ranging between \$1.80 and \$2.25 per share; and (ii) options to acquire 30,000 shares of our common stock to a non-employee board member at a price of \$2.25 per share. During the nine months ended September 30, 2016, we granted options to acquire 3,000 shares of our common stock to an employee at a price of \$1.20 per share.

The weighted average fair market value of the options granted in the nine months ended September 30, 2017 and 2016 was estimated on the date of grant, using a Black-Scholes option pricing model with the following assumptions:

	September 30, 2017	September 30, 2016
Expected life of options (using the “simplified” method)	4 years	6 years
Average risk-free interest rate	1.44%	1.50%
Average expected volatility of stock	78%	134%
Expected dividend rate	None	None
Fair value of options granted	\$55,100	\$3,488

Compensation cost related to stock options recognized in operating results (included in general and administrative expenses) totaled \$183,500 and \$189,500 in the nine months ended September 30, 2017 and 2016, respectively, and totaled \$71,500 and \$61,600 in the three months ended September 30, 2017 and 2016, respectively. Approximately \$495,000 of total unrecognized compensation costs related to non-vested stock options is expected to be recognized over the next 12-60 months, depending on the vesting provisions of the options. There was no tax benefit from recording the non-cash expense as it relates to the options granted to employees, as these were qualified stock options which are not normally tax deductible.

In 2005, we adopted a stock option plan for our employees, officers and directors (the “2005 Plan”). In 2015, we adopted a stock option plan for our employees, officers and directors (the “2015 Plan”) to replace the 2005 Plan, which expired on March 31, 2015.

Activity under our two stock option plans is as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
2005 Plan				
Outstanding, December 31, 2016	628,313	\$ 0.63	3.8 years	\$ 510,000
Granted	-			
Exercised	(136,250)			
Cancelled/Expired	-			
Outstanding, September 30, 2017	492,063	\$ 0.73	4.0 years	\$ 865,300
Exercisable, September 30, 2017	378,158	\$ 0.69	3.3 years	\$ 679,000
2015 Plan				
Outstanding, December 31, 2016	787,615	\$ 1.27	7.2 years	\$ 136,000
Granted	46,560			
Exercised	-			
Cancelled/Expired	(49,491)			
Outstanding, September 30, 2017	784,684	\$ 1.32	6.6 years	\$ 916,500
Exercisable, September 30, 2017	380,205	\$ 1.31	6.2 years	\$ 449,200

Note 3. 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.

Basic earnings per share include no dilution and are computed by dividing income available to common shareholders by the weighted-average number of shares outstanding during the period. Diluted earnings per share reflect the potential of securities that could share in our earnings.

A reconciliation of the weighted average number of common shares outstanding is as follows:

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Common shares outstanding, beginning of the period	11,885,839	11,742,329	11,749,589	11,710,745
Weighted average common shares issued	-	5,283	91,368	20,014
Weighted average number of common shares outstanding	11,885,839	11,747,612	11,840,957	11,730,759
Dilutive effect of common share equivalents	474,240	280,344	376,933	238,408
Diluted weighted average number of common shares outstanding	12,360,079	12,027,956	12,217,890	11,969,167

Common stock equivalents that have been excluded from the calculation of earnings per share because they would have been anti-dilutive:

	Three Months		Nine Months	
	Ended		Ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Stock options	46,600	579,500	89,100	659,000

Note 4. 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 and manufacturer's representatives, to mass merchandisers, drugstores, supermarkets, hardware stores, e-commerce retailers, 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 nine months ended September 30:

	Three Months Ended September 30,			
	2017		2016	
	Household Products	Skin and Hair Care Products	Household Products	Skin and Hair Care Products
Net sales	\$1,409,000	\$8,931,600	\$1,453,400	\$8,483,500
Operating costs and expenses:				
Cost of sales	661,600	4,758,400	690,000	5,140,600
Advertising expenses	37,700	72,100	10,300	81,400
Selling expenses	332,000	1,251,400	276,800	1,440,500
General and administrative expenses	367,200	695,500	328,900	889,900
Total operating costs and expenses	1,398,500	6,777,400	1,306,000	7,552,400
Income from operations	10,500	2,154,200	147,400	931,100
Other (expense) income	-	-	(1,100)	2,100
Interest expense	-	(26,400)	-	(60,400)
Income before income taxes	\$10,500	\$2,127,800	\$146,300	\$872,800

	Nine Months Ended September 30,			
	2017		2016	
	Household Products	Skin and Hair Care Products	Household Products	Skin and Hair Care Products
Net sales	\$4,189,400	\$26,467,600	\$4,490,300	\$19,784,500
Operating costs and expenses:				
Cost of sales	2,010,600	14,638,400	2,148,500	11,306,100
Advertising expenses	353,900	177,200	889,100	537,500
Selling expenses	977,000	3,901,600	1,118,400	3,065,900
General and administrative expenses	1,046,400	2,119,900	1,136,900	2,296,100
Total operating costs and expenses	4,387,900	20,837,100	5,292,900	17,205,600
(Loss) income from operations	(198,500)	5,630,500	(802,600)	2,578,900
Other income	-	-	2,300	10,300
Interest expense	-	(101,500)	(3,500)	(74,000)

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

(Loss) income before income taxes \$(198,500) \$5,529,000 \$(803,800) \$2,515,200

The following is a reconciliation of segment information to consolidated information:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net sales	\$10,340,600	\$9,936,900	\$30,657,000	\$24,274,800
Consolidated income before income taxes	\$2,138,300	\$1,019,100	\$5,330,500	\$1,711,400

10

	September 30, 2017	December 31, 2016
Assets:		
Household Products	\$ 2,133,600	\$ 1,850,000
Skin and Haircare Products	21,883,700	18,371,500
Corporate	665,200	1,611,800
Consolidated	\$ 24,682,500	\$ 21,833,300

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

Note 5. Acquisition

On June 30, 2016, Neoteric Cosmetics, Inc. (“Neoteric”), a wholly-owned subsidiary of the Company, entered into an Asset Purchase Agreement (the “Purchase Agreement”) with Ultimark Products, Inc. (“Ultimark”) and consummated the transaction contemplated thereby (the “Acquisition”), pursuant to which Neoteric purchased from Ultimark all intellectual property assets and certain related assets owned by Ultimark as well as inventory of finished goods owned by Ultimark and used in connection with the manufacture, sale and distribution of the Prell[®], Denorex[®], and Zincon[®] brands of hair and scalp care products (collectively, the “Brands”). The total consideration Neoteric paid for the Brands was approximately \$9.0 million, plus the assumption by Neoteric of certain specific liabilities of Ultimark related to the performance of certain purchase orders and contracts following June 30, 2016.

Note 6. Goodwill and Intangible Assets

Intangible assets consisted of the following:

	As of September 30, 2017			As of December 31, 2016		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value
Intangible assets:						
Customer relationships	\$4,022,100	\$ 502,800	\$ 3,519,300	\$4,022,100	\$ 201,100	\$ 3,821,000
Trade names	2,362,400	196,800	2,165,600	2,362,400	78,700	2,283,700
Formulas and batching processes	668,600	69,800	598,800	668,600	27,900	640,700
Non-compete agreement	26,300	6,400	19,900	26,300	2,600	23,700
	7,079,400	775,800	6,303,600	7,079,400	310,300	6,769,100
Goodwill			1,520,600			1,520,600
Total intangible assets			\$7,824,200			\$8,289,700

The amortization expense for the three and nine months ended September 30, 2017 was \$155,100 and \$465,500, respectively. Amortization expense for the three and nine months ended September 30, 2016 was \$155,200.

Estimated amortization expense for 2017 and subsequent years is as follows:

2017 (remaining)	\$ 155,200
2018	620,700
2019	620,700
2020	620,700
2021	617,600
Thereafter	3,668,700
Total	\$6,303,600

Note 7. Long-Term Debt and Line-of-Credit

On June 30, 2016, Neoteric and the Company, as borrowers, entered into the Credit Agreement (the “Credit Agreement”) with JPMorgan Chase Bank, N.A. (“Chase”), as lender, pursuant to which Chase provided a term loan and a revolving credit facility that was used to finance a portion of the Acquisition and for the Company’s general corporate purposes and working capital. The term loan amount is \$2.4 million with quarterly payments fully amortized over three years and interest of: (i) the LIBO Rate + 3.75%; or (ii) the Prime Rate + 1.00%, with a floor of the one month LIBO Rate + 2.5%. At September 30, 2017, our rate was 4.98%. The revolving credit facility amount is \$4 million with interest of: (i) the LIBO Rate + 3.00%; or (ii) the Prime Rate + 0.25%, with a floor of the one month LIBO Rate + 2.5%. At September 30, 2017, our rate was 4.23%. The revolving credit facility will terminate on June 30, 2019 or any earlier date on which the revolving commitment is otherwise terminated pursuant to the Credit Agreement. Under the Credit Agreement we are obligated to pay quarterly an unused commitment fee equal to 0.5% per annum on the daily amount of the undrawn portion of the revolving line-of-credit. The loans are collateralized by all of the assets of the Company and all of its subsidiaries.

The Credit Agreement requires, among other things, that beginning on December 31, 2016 and subsequently on a quarterly basis, the Company maintain a Debt Service Coverage Ratio of no less than 1.25 to 1.0 and a Funded Indebtedness to Adjusted EBITDA Ratio of no greater than 3.0 to 1.0. The Credit Agreement also contains covenants typical of transactions of this type, including among others, limitations on the Company’s ability to: create, incur or assume any indebtedness or lien on Company assets; pay dividends or make other distributions; redeem, retire or acquire the Company’s outstanding common stock, options, warrants or other rights; make fundamental changes to the Company’s corporate structure or business; make investments or asset sales; or engage in certain other activities as set forth in the Credit Agreement. The Company was in compliance with the covenants in the Credit Agreement as of September 30, 2017 and December 31, 2016. Capitalized terms used but not defined shall have the meanings provided in the Credit Agreement.

Maturities of long-term debt are as follows as of September 30, 2017:

2017 (remaining)	\$200,000
2018	800,000
2019	400,000
	1,400,000
Less unamortized debt issuance costs	(43,900)
Total	\$1,356,100

Debt issuance costs recognized as a component of interest expense for the three and nine months ended September 30, 2017 were \$6,300 and \$18,800, respectively. Debt issuance costs recognized as a component of interest expense for the three and nine months ended September 30, 2016 were \$6,200. These costs are amortized using the effective interest method over the term of the loan.

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

Results of Operations

Our consolidated net sales for the first nine months ended September 30, 2017 were \$30,657,000 versus \$24,274,800 for the first nine months ended September 30, 2016, an increase of \$6,382,200 or 26.3%. We saw a 76.5% increase in net sales of our own lines of skin and hair care products and a 17.4% increase in net sales of the skin and hair care products that we distribute for other companies. We saw a 6.7% decrease in net sales of our household products. The reasons for the foregoing changes in net sales are described below.

Our consolidated net sales for the three months ended September 30, 2017 were \$10,340,600 versus \$9,936,900 for the three months ended September 30, 2016, an increase of \$403,700 or 4.1%. We saw a 37.5% increase in net sales of our own line of skin care products and an 11.0% decrease in net sales of the skin and hair care products that we distribute for other companies. We saw a 3.1% decrease in net sales of our household products. The reasons for the foregoing changes in net sales are described below.

Our net income for the first nine months ended September 30, 2017 was \$3,431,200 versus net income of \$1,013,500 in the first nine months ended September 30, 2016. Our net income for the third quarter of 2017 was \$1,474,800 versus net income of \$603,600 in the third quarter of 2016. The increase in net income for the first nine months ended September 30, 2017 compared to the net income for the same period in 2016 resulted primarily from: (1) increased sales as a result of the Acquisition and further growth of the skin and hair care products that we distribute; (2) an increase in the sales of Alpha[®] Skin Care products; and (3) the incurrence of professional fees in the first nine months of 2016 related to the Acquisition. These increases were offset in part by an increase in income tax expense and the amortization of the acquired intangible assets. Our income tax expense for the first nine months ended September 30, 2017 was \$1,899,300 versus an income tax expense of \$697,900 in the first nine months ended September 30, 2016. Our income tax expense in the third quarter of 2017 was \$663,500 versus an income tax expense of \$415,500 in the third quarter of 2016.

Summary of Results as a Percentage of Net Sales

	Year		Nine Months	
	Ended		Ended	
	December		September 30,	
	31,		September 30,	
	2016		2017	2016
Net sales				
Household products	17.0	%	13.7	% 18.5 %
Skin and hair care products	83.0	%	86.3	% 81.5 %
Total net sales	100.0	%	100.0	% 100.0 %
Cost of sales	56.9	%	54.3	% 55.4 %
Gross profit	43.1	%	45.7	% 44.6 %
Other revenue	0.0	%	0.0	% 0.1 %
	43.1	%	45.7	% 44.7 %
Operating expenses	34.0	%	28.0	% 37.3 %
Interest expense	0.4	%	0.3	% 0.3 %
	34.4	%	28.3	% 37.6 %
Income before income taxes	8.7	%	17.4	% 7.1 %

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

13

Nine Months Ended September 30, 2017 Compared to Nine Months Ended September 30, 2016

Comparative Net Sales

	Nine Months Ended September 30,		Percentage Increase (Decrease)	
	2017	2016		
Total household products	\$4,189,400	\$4,490,300	(6.7	%)
Total skin and hair care products	26,467,600	19,784,500	33.8	%
Total net sales	\$30,657,000	\$24,274,800	26.3	%

Sales of household products for the first nine months of 2017 accounted for 13.7% of consolidated net sales compared to 18.5% for the same period in 2016. The net sales of these products were \$4,189,400 in the first nine months of 2017 compared to \$4,490,300 for the same period in 2016, a decrease of \$300,900 or 6.7%. This decrease is primarily attributable to: (1) lower sales of our Scott's Liquid Gold® Floor Restore product due to the first nine months of 2016 including sales at one of our customers who discontinued the product in the second quarter of 2016; and (2) lower sales of our other household products.

Sales of skin and hair care products for the first nine months of 2017 accounted for 86.3% of consolidated net sales compared to 81.5% for the same period in 2016. The net sales of these products were \$26,467,600 in the first nine months ended September 30, 2017 compared to \$19,784,500 for the same period in 2016, an increase of \$6,683,100 or 33.8%, primarily as a result of the addition of the net sales of Prell®, Denorex®, and Zincon®, which we acquired in the Acquisition on June 30, 2016, and increases in the sales of Alpha® Skin Care products and Montagne Jeunesse face masque sachets, and offset by a decrease in the sales of Batiste Dry Shampoo due to changes in our distribution agreement with Church & Dwight Co., Inc. ("Church & Dwight"), as previously disclosed in two Form 8-K filings dated July 17, 2017 and September 7, 2016.

The net sales of our own skin and hair care products were \$9,694,800 in the first nine months of 2017 compared to \$5,492,800 for the same period in 2016, an increase of \$4,202,000 or 76.5%. This increase is primarily attributable to: (1) an increase in the sales of Alpha® Skin Care products; and (2) the addition of the net sales of Prell®, Denorex®, and Zincon®. The net sales of Prell®, Denorex®, and Zincon® were \$4,709,800 in the first nine months ended September 30, 2017.

The net sales of Montagne Jeunesse and Batiste Dry Shampoo were \$16,772,800 in the first nine months of 2017 compared to \$14,291,700 for the same period in 2016, an increase of \$2,481,100 or 17.4%. This increase is primarily attributable to increased sales of Montagne Jeunesse face masque sachets.

We paid our customers a total of \$1,854,100 in the first nine months of 2017 for trade promotions to support price features, displays, slotting fees and other merchandising of our products compared to \$1,584,500 for the same period in 2016, an increase of \$269,600 or 17.0%. This increase is primarily attributable to the addition of the sales of Prell®, Denorex®, and Zincon® as well as increased sales of Montagne Jeunesse face masque sachets.

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 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 sales price plus a handling charge ranging from 8-10% of the original sales price. Our product returns (as a percentage of net sales) were 0.2% for the first nine months of 2017 and 0.1% for the same period in 2016.

On a consolidated basis, cost of sales was \$16,649,000 during the first nine months of 2017 compared to \$13,454,600 for the same period in 2016, an increase of \$3,194,400 or 23.7%, on a net sales increase of 26.3%. As a percentage of consolidated net sales, cost of sales was 54.3% in the first nine months of 2017 compared to 55.4% for the same period in 2016.

As a percentage of net sales of our household products, the costs of sales for our household products increased to 48.0% in the first nine months of 2017 compared to 47.8% for the same period in 2016.

As a percentage of net sales of our skin and hair care products, the cost of sales for our skin and hair care products decreased to 55.3% in the first nine months of 2017 compared to 57.1% for the same period in 2016. This change varies from period to period based on product mix and trade promotions of the products we make versus the products we distribute for other companies, which have higher costs and higher trade promotions. The underlying costs of the products did not significantly change in the first nine months of 2017 compared to the same period in 2016, except for an increase in certain overhead costs incurred from leasing additional warehouse space starting in the second quarter of 2016.

Operating Expenses, Interest Expense and Other Income

	Nine Months Ended September 30,		Percentage Increase (Decrease)
	2017	2016	
Operating expenses			
Advertising	\$531,100	\$1,426,600	(62.8 %)
Selling	4,878,600	4,184,300	16.6 %
General and administrative	3,166,300	3,433,000	(7.8 %)
Total operating expenses	\$8,576,000	\$9,043,900	(5.2 %)
Other income	\$-	\$12,600	(100.0 %)
Interest expense	\$101,500	\$77,500	31.0 %

Our operating expenses for the first nine months of 2017 were \$8,576,000 compared to \$9,043,900 for the same period in 2016, a decrease of \$467,900 or 5.2%. These expenses consist primarily of advertising, selling, and general and administrative expenses.

Advertising expenses for the first nine months of 2017 were \$531,100 compared to \$1,426,600 for the same period in 2016, a decrease of \$895,500 or 62.8%. This decrease is primarily due to: (1) the one-time expenses we incurred during the first nine months of 2016 relating to the repositioning of our Alpha[®] Skin Care products and Scott's Liquid Gold[®] household products in the marketplace, which were not repeated in 2017; and (2) spending less on a national television campaign in the first nine months of 2017 compared to the same period in 2016 on our Scott's Liquid Gold[®] Wood Care product.

Selling expenses for the first nine months of 2017 were \$4,878,600 compared to \$4,184,300 for the same period in 2016, an increase of \$694,300 or 16.6%. This increase is primarily attributable to: (1) an increase in the commissions that we paid our sales brokers and an increase in our costs of freight-out to our customers due to higher sales volume; and (2) an increase in the accrual of probable bonus payments to personnel within our sales and marketing organization compared to the first nine months of 2016. This increase was offset primarily by a reduction in certain marketing and promotional activities compared to the first nine months of 2016.

General and administrative expenses for the first nine months of 2017 were \$3,166,300 compared to \$3,433,000 for the same period of 2016, a decrease of \$266,700 or 7.8%. This decrease is due primarily to a decrease in professional fees in the first nine months of 2017 compared to higher fees in the same period of 2016 related to the Acquisition. This decrease was offset primarily by: (1) an increase in the accrual of probable bonus payments to our management and administrative personnel, compared to the first nine months of 2016; and (2) amortization of the acquired intangible assets.

Other income from interest earned on our cash reserves for the first nine months ended September 30, 2017 and 2016 was \$0 and \$12,600, respectively.

Interest expense for the first nine months of 2017 was \$101,500 compared to \$77,500 for the same period in 2016, an increase of \$24,000 or 31.0%. The increase is due to borrowings under the Credit Agreement entered into on June 30, 2016 to help fund the Acquisition.

Three Months Ended September 30, 2017 Compared to Three Months Ended September 30, 2016

Comparative Net Sales

	Three Months Ended September 30,		Percentage Increase (Decrease)	
	2017	2016		
Total household products	\$ 1,409,000	\$ 1,453,400	(3.1	%)
Total skin and hair care products	8,931,600	8,483,500	5.3	%
Total net sales	\$ 10,340,600	\$ 9,936,900	4.1	%

Sales of household products for the third quarter of 2017 accounted for 13.6% of consolidated net sales compared to 14.6% for the same period in 2016. The net sales of these products were \$1,409,000 in the third quarter of 2017 compared to \$1,453,400 for the same period in 2016, a decrease of \$44,400 or 3.1%. This decrease is primarily attributable to lower sales of certain household products, which were partially offset by a slight increase in sales of our Scott's Liquid Gold® Wood Care product.

Sales of skin and hair care products for the third quarter of 2017 accounted for 86.4% of consolidated net sales compared to 85.4% for the same period in 2016. The net sales of these products were \$8,931,600 in the third quarter of 2017 compared to \$8,483,500 for the same period in 2016, an increase of \$448,100 or 5.3%, primarily as a result of increases in the sales of Alpha® Skin Care products and Montagne Jeunesse face masque sachets, and offset by a decrease in the sales of Batiste Dry Shampoo due to changes in our distribution agreement with Church & Dwight.

The net sales of our own skin and hair care products were \$3,919,800 in the third quarter of 2017 compared to \$2,849,900 for the same period in 2016, an increase of \$1,069,900 or 37.5%. This increase is primarily attributable to an increase in the sales of Alpha® Skin Care products.

The net sales of Montagne Jeunesse and Batiste Dry Shampoo were \$5,011,800 in the third quarter of 2017 compared to \$5,633,600 for the same period in 2016, a decrease of \$621,800 or 11.0%. This decrease is primarily attributable to changes in our distribution agreement with Church & Dwight for Batiste Dry Shampoo, and was partially offset by an increase in sales of Montagne Jeunesse face masque sachets.

We paid our customers a total of \$522,300 in the third quarter of 2017 for trade promotions to support price features, displays, slotting fees and other merchandising of our products compared to \$616,300 for the same period in 2016, a decrease of \$94,000 or 15.3%. This decrease is primarily attributable to: (1) changes in our distribution agreement with Church & Dwight; and (2) a reduction in trade promotions related to Batiste Dry Shampoo.

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 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 sales price plus a handling charge ranging from 8-10% of the original sales price. Our product returns (as a percentage of net sales) were 0.3% for the third quarter of 2017 and 0.1% for the same period in 2016.

On a consolidated basis, cost of sales was \$5,420,000 during the third quarter of 2017 compared to \$5,830,600 for the same period in 2016, a decrease of \$410,600 or 7.0%, on a net sales increase of 4.1%. As a percentage of consolidated net sales, cost of sales was 52.4% in the third quarter of 2017 compared to 58.7% for the same period in 2016.

As a percentage of net sales of our household products, the costs of sales for our household products decreased to 47.0% in the third quarter of 2017 compared to 47.5% for the same period in 2016.

As a percentage of net sales of our skin and hair care products, the cost of sales for our skin and hair care products decreased to 53.3% in the third quarter of 2017 compared to 60.6% for the same period in 2016. This change varies from period to period based on product mix and trade promotions of the products we make versus the products we distribute for other companies, which have higher costs and higher trade promotions. The underlying costs of the products did not significantly change in the third quarter of 2017 compared to the same period in 2016.

Operating Expenses, Interest Expense and Other Income

	Three Months Ended September 30,		Percentage Increase (Decrease)	
	2017	2016		
Operating expenses				
Advertising	\$ 109,800	\$ 91,700	19.7	%
Selling	1,583,400	1,717,300	(7.8	%)
General and administrative	1,062,700	1,218,800	(12.8	%)
Total operating expenses	\$ 2,755,900	\$ 3,027,800	(9.0	%)
Other income	\$-	\$ 1,000	(100.0	%)
Interest expense	\$ 26,400	\$ 60,400	(56.3	%)

Our operating expenses for the third quarter of 2017 were \$2,755,900 compared to \$3,027,800 for the same period in 2016, a decrease of \$271,900 or 9.0%. These expenses consist primarily of advertising, selling, and general and administrative expenses.

Advertising expenses for the third quarter of 2017 were \$109,800 compared to \$91,700 for the same period in 2016, an increase of \$18,100 or 19.7%.

Selling expenses for the third quarter of 2017 were \$1,583,400 compared to \$1,717,300 for the same period in 2016, a decrease of \$133,900 or 7.8%. This decrease is primarily attributable to: (1) a reduction in certain marketing and promotional activities; and (2) a decrease in the accrual of probable bonus payments to personnel within our sales and marketing organization compared to the third quarter of 2016. This decrease was offset primarily by an increase in our costs of freight-out to our customers due to higher sales volume.

General and administrative expenses for the third quarter of 2017 were \$1,062,700 compared to \$1,218,800 for the same period of 2016, a decrease of \$156,100 or 12.8%. This decrease is due primarily to: (1) a decrease in professional fees in the third quarter of 2017 compared to higher fees in the same period of 2016 related to the Acquisition; and (2) a decrease in the accrual of probable bonus payments to our management and administrative personnel compared to the third quarter of 2016.

Other income from interest earned on our cash reserves for the third quarter of 2017 and 2016 was \$0 and \$1,000, respectively.

Interest expense for the third quarter of 2017 was \$26,400 compared to \$60,400 for the same period in 2016, a decrease of \$34,000 or 56.3%. The decrease is due to a lower balance on the term loan and no outstanding balance on the line-of-credit as of September 30, 2017. Both borrowings under the Credit Agreement had higher balances as of September 30, 2016 to help fund the Acquisition.

Liquidity and Capital Resources

Financing Agreements

Please see Note 7 to our Condensed Consolidated Financial Statements (Unaudited) for information on our Credit Agreement with Chase. Please see Note 1(f) to our Condensed Consolidated Financial Statements (Unaudited) for information on our financing agreement with Wells Fargo, which was terminated during 2016.

Liquidity

At September 30, 2017, we had approximately \$2.4 million in cash on hand, which was \$291,700 more compared to December 31, 2016, primarily due to cash provided by operating activities, and offset by: (1) our use of cash to reduce the outstanding balance on our line-of-credit to zero; (2) repayments of long-term debt; (3) payment of income taxes; and (4) the payment of performance bonuses in the first nine months of 2017 to our management, sales, administrative support and operations personnel that were accrued for in 2016. For the first nine months ended September 30, 2017, the primary components of working capital that significantly affected operating cash flows were the following: (1) net accounts receivable were \$304,200 less at September 30, 2017 than at December 31, 2016 due primarily to receivables related to the timing of receiving payment; (2) inventory at September 30, 2017 was \$3,842,600 more than at December 31, 2016 due primarily to higher sales volume and the timing of receiving certain inventory from our vendors and shipping our products to our customers; and (3) accounts payable and accrued expenses at September 30, 2017 were \$333,600 more than at December 31, 2016 due primarily to bonuses paid to certain employees and the timing of payments on our inventory.

We anticipate that our existing cash and our cash flow from operations, together with our current Credit Agreement with Chase, will be sufficient to meet our cash requirements for the 12 months following the filing date of this Report. During the first nine months of 2017, we spent \$352,600 to purchase production and warehouse equipment to improve our manufacturing capabilities and efficiencies and on additional production and warehouse equipment that is primarily related to the Acquisition, and paid an additional \$100,000 in deposits for future production and warehouse equipment to be received and placed in service in 2017. We expect to make additional capital expenditures of approximately \$90,000 in 2017 on additional production and warehouse equipment that is primarily related to the Acquisition.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

As of September 30, 2017, 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 (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of September 30, 2017.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting during the nine months ended September 30, 2017 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, 2016 and subsequent quarterly reports on Form 10-Q, which could materially affect our business, financial condition or future results.

ITEM 6. EXHIBITS

Exhibit Number Document

10.1 Amendment to the Exclusive Distribution Agreement, dated April 1, 2015, between Montagne Jeunesse International Limited and Neoteric Cosmetics, Inc.

10.2 Second Amendment to the Exclusive Distribution Agreement, dated September 5, 2017, between Montagne Jeunesse International Limited and Neoteric Cosmetics, Inc.

10.3 Second Amendment to the Customer Agreement, dated as of July 17, 2017, between Church & Dwight Co., Inc. and Neoteric Cosmetics, Inc. incorporated by reference to Exhibit 10.1 of the Company’s Current Report on Form 8-K filed with the SEC on July 18, 2017.

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.
XBRL Taxonomy Extension Calculation Linkbase Document.

101.CAL

101.LAB XBRL Taxonomy Extension Label Linkbase Document.

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document.

101.DEF XBRL Taxonomy Extension Definition Linkbase Document.

*Furnished, not filed.

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
(Principal Executive Officer)

By: /s/ Barry J. Levine
Barry J. Levine
Treasurer, Chief Financial Officer and Chief Operating Officer
(Principal Financial and Chief Accounting Officer)

Date: November 14, 2017