

STARRETT L S CO  
Form 10-K  
August 24, 2016

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-K**

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**(check one)**

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

**For the fiscal year ended June 30, 2016**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File No. 1-367**

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**THE L.S. STARRETT COMPANY**

**(Exact name of registrant as specified in its charter)**

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

**121 CRESCENT STREET, ATHOL, MASSACHUSETTS 01331**  
(Address of principal executive offices)    (Zip Code)

**Registrant's telephone number, including area code 978-249-3551**

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**Securities registered pursuant to Section 12(b) of the Act:**

| <b>Title of each class</b>                         | <b>Name of each exchange on which registered</b> |
|--|--|
| <b>Class A Common - \$1.00 Per Share Par Value</b> | <b>New York Stock Exchange</b>                   |
| <b>Class B Common - \$1.00 Per Share Par Value</b> | <b>Not applicable</b>                            |

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Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes      No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes      No



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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one)

Large Accelerated Filer      Accelerated Filer

Non-Accelerated Filer (Do not check if smaller reporting company)    Smaller Reporting Company

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

The Registrant had 6,239,083 and 780,474 shares, respectively, of its \$1.00 par value Class A and B common stock outstanding on December 31, 2015. On December 31, 2015, the last business day of the Registrant's second fiscal quarter, the aggregate market value of the common stock held by nonaffiliates was approximately \$60,338,455.

There were 6,255,894 and 770,101 shares, respectively, of the Registrant's \$1.00 par value Class A and Class B common stock outstanding as of August 19, 2016.

The exhibit index is located on pages 53-54.

DOCUMENTS INCORPORATED BY REFERENCE

The Registrant intends to file a definitive Proxy Statement for the Company's 2016 Annual Meeting of Stockholders within 120 days of the end of the fiscal year ended June 30, 2016. Portions of such Proxy Statement are incorporated by reference in Part III.

**THE L.S. STARRETT COMPANY**

**FORM 10-K**

**FOR THE YEAR ENDED JUNE 30, 2016**

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All references in this Annual Report to “Starrett”, the “Company”, “we”, “our” and “us” mean The L.S. Starrett Company and subsidiaries.

## **PART I**

### **Item 1 - Business**

#### **General**

Founded in 1880 by Laroy S. Starrett and incorporated in 1929, The L.S. Starrett Company (the “Company”) is engaged in the business of manufacturing over 5,000 different products for industrial, professional and consumer markets. The Company has a long history of global manufacturing experience and currently operates 5 major global manufacturing plants. Domestic locations are Athol, Massachusetts (1880) and Mt. Airy, North Carolina (1985) with international operations located in Itu, Brazil (1956) Jedburgh, Scotland (1958) and Suzhou, China (1997). All subsidiaries principally serve the global manufacturing industrial base with concentration in the metalworking, construction, machinery, equipment, aerospace and automotive markets.

The Company offers its broad array of measuring and cutting products to the market through multiple channels of distribution throughout the world. The Company’s products include precision tools, electronic gages, gage blocks, optical vision and laser measuring equipment, custom engineered granite solutions, tape measures, levels, chalk products, squares, band saw blades, hole saws, hacksaw blades, jig saw blades, reciprocating saw blades, M1® lubricant and precision ground flat stock. The Company primarily distributes its precision hand tools, saw and construction products through distributors or resellers both domestically and internationally. Starrett® is brand recognized around the world for precision, quality and innovation.

In accordance with the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 280, *Segment Reporting*, for the fiscal year ended June 30, 2016 (fiscal 2016), we determined that we have two reportable operating segments (North America and International). Refer to Note 17, *Financial Statement Information by Segment & Geographical Area*, contained in the Notes to Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K, for more information on our reportable segments.

#### **Products**

The Company’s tools and instruments are sold throughout North America and in over 100 other countries. By far the largest consumer of these products is the manufacturing industry including metalworking, aerospace, medical, and automotive but other important consumers are marine and farm equipment shops, do-it-yourselfers and tradesmen such as builders, carpenters, plumbers and electricians.



For 136 years the Company has been a recognized leader in providing measurement and cutting solutions to industry. Measurement tools consist of precision instruments such as micrometers, vernier calipers, height gages, depth gages, electronic gages, dial indicators, steel rules, combination squares, custom, non-contact and in-process gaging such as optical, vision and laser measurement systems. The Company has expanded its product offering in the field of test and measurement equipment, with force measurement and material test equipment. Skilled personnel, superior products, manufacturing expertise, innovation and unmatched service has earned the Company its reputation as the “Best in Class” provider of measuring application solutions for industry. During fiscal 2015, the Company introduced material test systems consisting of hardware and cutting edge software with capacities up to 50KN, in addition to new manual and automated FOV (Field of View) measurement systems. These systems we believe will be attractive to industry to reduce measurement and inspection time and are ideal for quality assurance, inspection labs, manufacturing and research facilities.

The Company’s saw product lines enjoy strong global brand recognition and market share. These products encompass a breadth of uses. The Company introduced several new products in the recent past including a new line of hand tools for measuring, marking and layout that include tapes, levels, chalk lines and other products for the building trades. In fiscal 2016, the Company introduced new products to its hand tool portfolio to extend its reach into the construction and retail trades. The continued focus on high performance, production band saw applications has resulted in the development of two new ADVANZ carbide tipped products MC5 and MC7 ideal for cutting ferrous materials (MC7) and non-ferrous metals and castings (MC5). These actions are aimed at positioning Starrett for global growth in wide band products for production applications.

As one of the premier industrial brands, the Company continues to be focused on every touch point with its customers. To that end, the Company now offers modern, easy-to-use interfaces for distributors and end-users including interactive catalogs and several online applications.

## **Personnel**

At June 30, 2016, the Company had 1,694 employees, approximately 52% of whom were domestic. This represents a net decrease from June 30, 2015 of 110 employees. The headcount change included a decrease of 56 domestically and a decrease of 54 internationally.

None of the Company’s operations are subject to collective bargaining agreements. In general, the Company considers relations with its employees to be excellent. Domestic employees hold a large share of Company stock resulting from various stock purchase plans and employee stock ownership plans. The Company believes that this dual role of owner-employee has strengthened employee morale over the years.

## **Competition**

The Company competes on the basis of its reputation as the best in class for quality, precision and innovation combined with its commitment to customer service and strong customer relationships. To that end, Starrett is increasingly focusing on providing customer centric solutions. Although the Company is generally operating in highly competitive markets, the Company's competitive position cannot be determined accurately in the aggregate or by specific market since none of its competitors offer all of the same product lines offered by the Company or serve all of the markets served by the Company.

The Company is one of the largest producers of mechanics' hand measuring tools and precision instruments. In the United States, there are three major foreign competitors and numerous small companies in the field. As a result, the industry is highly competitive. During fiscal 2016, there were no material changes in the Company's competitive position. The Company's products for the building trades, such as tape measures and levels, are under constant margin pressure due to a channel shift to large national home and hardware retailers. The Company is responding to such challenges by expanding its manufacturing operations in China. Certain large customers also offer their own private labels ("own brand") that compete with Starrett branded products. These products are often sourced directly from low cost countries.

Saw products encounter competition from several domestic and international sources. The Company's competitive position varies by market and country. Continued research and development, new patented products and processes, strategic acquisitions and investments and strong customer support have enabled the Company to compete successfully in both general and performance oriented applications.

## **Foreign Operations**

The operations of the Company's foreign subsidiaries are consolidated in its financial statements. The subsidiaries located in Brazil, Scotland and China are actively engaged in the manufacturing and distribution of precision measuring tools, saw blades, optical and vision measuring equipment and hand tools. Subsidiaries in Canada, Australia, New Zealand, Mexico, Germany and Singapore are engaged in distribution of the Company's products. The Company expects its foreign subsidiaries to continue to play a significant role in its overall operations. A summary of the Company's foreign operations is contained in Note 17 to the Company's fiscal 2016 financial statements.

## **Orders and Backlog**

The Company generally fills orders from finished goods inventories on hand. Sales order backlog of the Company at any point in time is not significant. Total inventories amounted to \$56.3 million at June 30, 2016 and \$63.0 million at June 30, 2015.

## **Intellectual Property**

When appropriate, the Company applies for patent protection on new inventions and currently owns a number of patents. Its patents are considered important in the operation of the business, but no single patent is of material importance when viewed from the standpoint of its overall business. The Company relies on its continuing product research and development efforts, with less dependence on its current patent position. It has for many years maintained engineers and supporting personnel engaged in research, product development and related activities. The expenditures for these activities during fiscal years 2016, 2015, and 2014 were approximately \$1.8 million, \$1.7 million, and \$1.4 million, respectively.

The Company uses trademarks with respect to its products and considers its trademark portfolio to be one of its most valuable assets. All of the Company's important trademarks are registered and rigorously enforced.

## **Environmental**

Compliance with federal, state, local, and foreign provisions that have been enacted or adopted regulating the discharge of materials into the environment or otherwise relating to protection of the environment is not expected to have a material effect on the capital expenditures, earnings and competitive position of the Company. Specifically, the Company has taken steps to reduce, control and treat water discharges and air emissions. The Company takes seriously its responsibility to the environment, has embraced renewable energy alternatives and received approval from federal and state regulators in fiscal 2013 to begin using its new hydro – generation facility at its Athol, MA plant to reduce its carbon footprint and energy costs, an investment in excess of \$1.0 million.

## **Strategic Activities**

Globalization has had a profound impact on product offerings and buying behaviors of industry and consumers in North America and around the world, forcing the Company to adapt to this new, highly competitive business environment. The Company continuously evaluates most aspects of its business, aiming for new world-class ideas to set itself apart from its competition.

Our strategic concentration is on global brand building and providing unique customer value propositions through technically supported application solutions for our customers. Our job is to recommend and produce the best suited standard product or to design and build custom solutions. The combination of the right tool for the job with value added service gives us a competitive advantage. The Company continues its focus on lean manufacturing, plant consolidations, global sourcing, new software and hardware technologies, and improved logistics to optimize its value chain.

The execution of these strategic initiatives has expanded the Company's manufacturing and distribution in developing economies, resulting in international sales revenues totaling 43% of consolidated sales for fiscal 2016.

### **SEC Filings and Certifications**

The Company makes its public filings with the Securities and Exchange Commission ("SEC"), including its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and all exhibits and amendments to these reports, available free of charge at its website, [www.starrett.com](http://www.starrett.com), as soon as reasonably practicable after the Company files such material with the SEC. Information contained on the Company's website is not part of this Annual Report on Form 10-K.

### **Item 1A – Risk Factors**

#### **SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

This Annual Report on Form 10-K and the Company's 2016 Annual Report to Stockholders, including the President's letter, contain forward-looking statements about the Company's business, competition, sales, gross margins, capital expenditures, foreign operations, plans for reorganization, interest rate sensitivity, debt service, liquidity and capital resources, and other operating and capital requirements. In addition, forward-looking statements may be included in future Company documents and in oral statements by Company representatives to security analysts and investors. The Company is subject to risks that could cause actual events to vary materially from such forward-looking statements, including the following risk factors:

#### **Economic and world events could affect our operating results.**

The Company's results of operations may be materially affected by the conditions in the global economy. These include both world - wide and regional economic conditions and geo-political events. These conditions may affect financial markets, consumer and customer confidence. The recovery from the recession has been slow in North

America. Latin America has experienced inflation resulting in weaker local currencies compared to the U. S. dollar. China's growth has slowed and the European economic union face multiple threats. The Company can provide no assurance that these economic trends will not continue.

**Technological innovation by competitors could adversely affect financial results.**

Although the Company's strategy includes investment in research and development of new and innovative products to meet technology advances, there can be no assurance that the Company will be successful in competing against new technologies developed by competitors.

**International operations and our financial results in those markets may be affected by legal, regulatory, political, currency exchange and other economic risks.**

During 2016, international sales revenues were \$90.7 million, representing approximately 43% of total net sales. In addition, a significant amount of our manufacturing and production operations are located, or our products are sourced from, outside the United States. As a result, our business is subject to risks associated with international operations. These risks include the burdens of complying with foreign laws and regulations, unexpected changes in tariffs, taxes or regulatory requirements, and political unrest and corruption. Regulatory changes could occur in the countries in which we sell, produce or source our products or significantly increase the cost of operating in or obtaining materials originating from certain countries. Restrictions imposed by such changes can have a particular impact on our business when, after we have moved our operations to a particular location, new unfavorable regulations are enacted in that area or favorable regulations currently in effect are changed.

Countries in which our products are manufactured or sold may from time to time impose additional new regulations, or modify existing regulations, including:

- changes in duties, taxes, tariffs and other charges on imports;
- limitations on the quantity of goods which may be imported into the United States from a particular country;
- requirements as to where products and/or inputs are manufactured or sourced;
- creation of export licensing requirements, imposition of restrictions on export quantities or specification of minimum export pricing and/or export prices or duties;
- limitations on foreign owned businesses; or
- government actions to cancel contracts, re-denominate the official currency, renounce or default on obligations, renegotiate terms unilaterally or expropriate assets.

In addition, political and economic changes or volatility, geopolitical regional conflicts, terrorist activity, political unrest, civil strife, acts of war, public corruption and other economic or political uncertainties could interrupt and negatively affect our business operations. All of these factors could result in increased costs or decreased revenues and could materially and adversely affect our product sales, financial condition and results of operations.

We are also subject to the U.S. Foreign Corrupt Practices Act, in addition to the anti-corruption laws of the foreign countries in which we operate. Although we implement policies and procedures designed to promote compliance with these laws, our employees, contractors and agents, as well as those companies to which we outsource certain of our business operations, may take actions in violation of our policies. Any such violation could result in sanctions or other penalties and have an adverse effect on our business, reputation and operating results.

**Economic weakness in the industrial manufacturing sector could adversely affect the Company's financial results.**

The market for most of the Company's products is subject to economic conditions affecting the industrial manufacturing sector, including the level of capital spending by industrial companies and the general movement of manufacturing to low cost foreign countries where the Company does not have a substantial market presence. Accordingly, economic weakness in the industrial manufacturing sector may, and in some cases has, resulted in decreased demand for certain of the Company's products, which adversely affects sales and performance. Economic weakness in the consumer market will also adversely impact the Company's performance. In the event that demand for any of the Company's products declines significantly, the Company could be required to recognize certain costs as well as asset impairment charges on long-lived assets related to those products.

**Volatility in the price of energy and raw materials could negatively affect our margins.**

Steel is the principal raw material used in the manufacture of the Company's products. The price of steel has historically fluctuated on a cyclical basis and has often depended on a variety of factors over which the Company has no control. The cost of producing the Company's products is also sensitive to the price of energy. The selling prices of the Company's products have not always increased in response to raw material, energy or other cost increases, and the Company is unable to determine to what extent, if any, it will be able to pass future cost increases through to its customers. The Company's inability to pass increased costs through to its customers could materially and adversely affect its financial condition or results of operations.

**The inability to meet expected investment returns and changes to interest rates could have a negative impact on Pension plan assets and liabilities.**

Currently, the Company's U.S. defined benefit pension plan is underfunded primarily due to lower discount rates. The Company made contributions of \$3.4 million in fiscal 2016, and \$4.8 million in fiscal 2015 and will be required to make additional contributions in fiscal 2017 of \$4.0 million. The Company could be required to provide more funding to the domestic plan in the future. The Company's UK plan, which is also underfunded, required Company

contributions of \$1.1 million, \$1.2 million and \$1.2 million during fiscal 2016, 2015 and 2014 respectively. The Company will be required to make a \$1.0 million contribution to its UK pension plan in fiscal 2017.

**Businesses that we may acquire may fail to perform to expectations.**

Acquisitions involve special risks, including the potential assumption of unanticipated liabilities and contingencies, difficulty in assimilating the operations and personnel of the acquired businesses, disruption of the Company's existing business, dissipation of the Company's limited management resources, and impairment of relationships with employees and customers of the acquired business as a result of changes in ownership and management. While the Company believes that strategic acquisitions can improve its competitiveness and profitability, the failure to successfully integrate and realize the expected benefits of such acquisitions could have an adverse effect on the Company's business, financial condition and operating results.

**We are subject to certain risks as a result of our financial borrowings.** Under the Company's credit facility with TD Bank, N.A., the Company is required to comply with certain financial covenants, including: 1) funded debt to EBITDA, excluding non-cash and retirement benefit expenses ("maximum leverage"), cannot exceed 2.25 to 1; 2) annual capital expenditures cannot exceed \$15.0 million; 3) maintain a Debt Service Coverage Rate of a minimum of 1.25 to 1 and 4) maintain consolidated cash plus liquid investments of not less than \$10.0 million at any time. The Company believes that it will be able to service its debt and comply with the financial covenants in future periods; however, it can not be assured of results of operations or future credit and financial markets conditions. An event of default under the credit facility, if not waived, could prevent additional borrowing and could result in the acceleration of the Company's debt. As of June 30, 2016, the Company was in compliance with all the covenants. The credit facility expires in April of 2018.

**Any inadequacy, interruption, integration failure or security failure with respect to our information technology could harm our ability to effectively operate our business.**

The efficient operation of the Company's business is dependent on its information systems, including its ability to operate them effectively and to successfully implement new technologies, systems, controls and adequate disaster recovery systems. In addition, the Company must protect the confidentiality of data of its business, employees, customers and other third parties. The failure of the Company's information systems to perform as designed or its failure to implement and operate them effectively could disrupt the Company's business or subject it to liability and thereby harm its profitability. The Company continues to enhance the applications contained in the Enterprise Resource Planning (ERP) system as well as improvements to other operating systems.

**Failure to comply with laws, rules and regulations could negatively affect our business operations and financial performance.**

Our business is subject to federal, state, local and international laws, rules and regulations, such as state and local wage and hour laws, the U.S. Foreign Corrupt Practices Act, the False Claims Act, the Employee Retirement Income Security Act (“ERISA”), securities laws, import and export laws (including customs regulations) and many others. The complexity of the regulatory environment in which we operate and the related cost of compliance are both increasing due to changes in legal and regulatory requirements, increased enforcement and our ongoing expansion into new markets and new channels. In addition, as a result of operating in multiple countries, we must comply with multiple foreign laws and regulations that may differ substantially from country to country and may conflict with corresponding U.S. laws and regulations. We may also be subject to investigations or audits by governmental authorities and regulatory agencies, which can occur in the ordinary course of business or which can result from increased scrutiny from a particular agency towards an industry, country or practice. If we fail to comply with laws, rules and regulations or the manner in which they are interpreted or applied, we may be subject to government enforcement action, class action litigation or other litigation, damage to our reputation, civil and criminal liability, damages, fines and penalties, and increased cost of regulatory compliance, any of which could adversely affect our results of operations and financial performance.

**Our tax rate is dependent upon a number of factors, a change in any of which could impact our future tax rates and net income.**

Our future tax rates may be adversely affected by a number of factors, including the enactment of certain tax legislation being considered in the U.S.; other changes in tax laws or the interpretation of such tax laws; changes in the estimated realization of our net deferred tax assets; the jurisdictions in which profits are determined to be earned and taxed; the repatriation of non-U.S. earnings for which we have not previously provided for U.S. income and non-U.S. withholding taxes; adjustments to estimated taxes upon finalization of various tax returns; increases in expenses that are not deductible for tax purposes, including impairment of goodwill in connection with acquisitions; changes in available tax credits; and the resolution of issues arising from tax audits with various tax authorities. Losses for which no tax benefits can be recorded could materially impact our tax rate and its volatility from one quarter to another. Any significant change in our jurisdictional earnings mix or in the tax laws in those jurisdictions could impact our future tax rates and net income in those periods.

**Item 1B – Unresolved Staff Comments**

None.



**Item 2 - Properties**

The Company's principal plant and its corporate headquarters are located in Athol, MA on approximately 15 acres of Company-owned land. The plant consists of 25 buildings, mostly of brick construction of varying dates, with approximately 535,000 square feet.

The Company's Webber Gage Division in Cleveland, OH, owns and occupies two buildings totaling approximately 50,000 square feet.

The Company-owned facility in Mt. Airy, NC consists of one building totaling approximately 320,000 square feet. It is occupied by the Company's Saw Division, Ground Flat Stock Division and a distribution center.

The Company's subsidiary in Itu, Brazil owns and occupies several buildings totaling 209,000 square feet.

The Company's subsidiary in Jedburgh, Scotland owns and occupies a 175,000 square foot building.

A wholly owned manufacturing subsidiary in The People's Republic of China leases a 133,000 square foot building in Suzhou and leases a sales office in Shanghai.

The Tru-Stone Division owns and occupies a 106,000 square foot facility in Waite Park, MN.

The Kinematic Engineering Division occupies a 18,000 square foot leased facility in Laguna Hills, CA.

The Bytewise Division occupies a 10,000 square foot leased facility in Columbus, GA.

In addition, the Company operates warehouses and/or sales-support offices in the U.S., Canada, Australia, New Zealand, Mexico, Germany, Singapore and Japan.

In the Company's opinion, all of its property, plant and equipment are in good operating condition, well maintained and adequate for its current and foreseeable needs.

### **Item 3 - Legal Proceedings**

In the ordinary course of business the Company is involved from time to time in litigation that is not considered material to its financial condition or operations.

### **Item 4 – Mine Safety Disclosures**

Not applicable.

## **PART II**

### **Item 5 - Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The Company's Class A common stock is traded on the New York Stock Exchange. Quarterly dividend and high/low closing market price information is presented in the table below. The Company's Class B common stock is generally nontransferable, except to lineal descendants of stockholders, and thus has no established trading market, but it can be converted into Class A common stock at any time. The Class B common stock was issued on October 5, 1988, and the Company has paid the same dividends thereon as have been paid on the Class A common stock since that date. On June 30, 2016, there were approximately 1,196 registered holders of Class A common stock and approximately 991 registered holders of Class B common stock.

| <b>Quarter Ended</b> | <b>Dividends</b> | <b>High</b> | <b>Low</b> |
|----------------------|------------------|-------------|------------|
| September 2014       | 0.10             | 18.23       | 13.84      |
| December 2014        | 0.10             | 19.99       | 13.15      |
| March 2015           | 0.10             | 21.80       | 18.88      |
| June 2015            | 0.10             | 20.30       | 14.75      |
| September 2015       | 0.10             | 17.53       | 11.81      |

|               |      |       |      |
|---------------|------|-------|------|
| December 2015 | 0.10 | 13.31 | 9.04 |
| March 2016    | 0.10 | 10.74 | 8.46 |
| June 2016     | 0.10 | 12.87 | 9.76 |

The Company's dividend policy is subject to periodic review by the Board of Directors. Based upon economic conditions, the Board of Directors decided to maintain the quarterly dividend at \$0.10 for all quarters of fiscal 2016.

The Company repurchased 1,614 shares of class B stock in the fourth quarter of fiscal 2016.

## PERFORMANCE GRAPH

The following graph sets forth information comparing the cumulative total return to holders of the Company's Class A common stock based on the market price of the Company's Class A common stock over the last five fiscal years with (1) the cumulative total return of the Russell 2000 Index ("Russell 2000") and (2) a peer group index (the "Peer Group") reflecting the cumulative total returns of certain small cap manufacturing companies as described below. The peer group is comprised of the following companies: Acme United, Q.E.P. Co. Inc., Badger Meter, National Presto Industries, Regal-Beloit Corp., Tennant Company, The Eastern Company and WD-40.

|              | <b>BASE</b>   | <b>FY2012</b> | <b>FY2013</b> | <b>FY2014</b> | <b>FY2015</b> | <b>FY2016</b> |
|--------------|---------------|---------------|---------------|---------------|---------------|---------------|
| STARRETT     | <b>100.00</b> | <b>116.73</b> | <b>106.97</b> | <b>165.72</b> | <b>165.57</b> | <b>136.33</b> |
| RUSSELL 2000 | <b>100.00</b> | <b>97.92</b>  | <b>121.63</b> | <b>150.38</b> | <b>160.13</b> | <b>149.35</b> |
| PEER GROUP   | <b>100.00</b> | <b>98.32</b>  | <b>109.11</b> | <b>140.37</b> | <b>141.52</b> | <b>137.85</b> |

### **Item 6 - Selected Financial Data**

The following selected financial data have been derived from and should be read in conjunction with “Management Discussion and Analysis of Financial Condition and Results of Operations” and our Consolidated Financial Statements and notes thereto, included elsewhere in this Annual Report on Form 10-K.

|                                   | <b>Years ended June 30 (in \$000s except per share data)</b> |             |             |             |             |
|-----------------------------------|--|-------------|-------------|-------------|-------------|
|                                   | <b>2016</b>  | <b>2015</b> | <b>2014</b> | <b>2013</b> | <b>2011</b> |
| Net sales                         | \$209,685  | \$241,550   | \$247,134   | \$243,797   | \$260,148   |
| Net earnings (loss)               | (14,130 )  | 5,244       | 6,712       | (162 )      | 888         |
| Basic earnings (loss) per share   | (2.01 )  | 0.75        | 0.97        | (0.02 )     | 0.13        |
| Diluted earnings (loss) per share | (2.01 )  | 0.75        | 0.97        | (0.02 )     | 0.13        |
| Long-term debt                    | 17,109   | 18,552      | 10,804      | 24,252      | 29,387      |
| Total assets                      | 201,598  | 212,272     | 231,443     | 230,794     | 252,166     |
| Dividends per share               | 0.40   | 0.40        | 0.40        | 0.40        | 0.40        |

**Items 7 and 7A- Management's Discussion and Analysis of Financial Condition and Results of Operations and Quantitative and Qualitative Disclosures about Market Risk**

**RESULTS OF OPERATIONS**

**Fiscal 2016 Compared to Fiscal 2015**

**Overview**

L. S. Starrett, as a global company, was negatively impacted by political, economic and currency issues during fiscal 2016. The recession, corruption and currency problems in Brazil significantly reduced the sales and profits of our largest international subsidiary compared to fiscal 2015. The slowdown in China and stagnation in Europe resulted in lower sales compared to fiscal 2015 in both regions, while North America suffered from the cost reductions implemented in the oil industry.

The financial markets, including the timing of Brexit, also reduced earnings in fiscal 2016 as the flight to safety increased the demand for bonds and the associated decrease in interest rates, which significantly contributed to a \$17.5 million non-cash pension expense due to higher liabilities. The pension liability is based upon the ten year Corporate Bond Rate and is set on the last day of the fiscal year. This generally accepted accounting principle coupled with the volatility of interest rates results in fourth quarter financial variations which management cannot control. The pension discount rate as of June 30, 2016 was 3.77% compared to 4.00% at the end of May 2016 and 4.49% at the end of June 2015 the total consolidated expense in fiscal 2016 was \$21.4 million. Excluding the fourth quarter adjustment of \$17.5 million, normal annual pension expense is \$3.9 million.

In addition, due to excess saw manufacturing capacity, the Company decided to reduce its manufacturing footprint resulting in a \$4.1 million non-cash charge in the fourth quarter of fiscal 2016.

Net sales for fiscal 2016 were \$209.7 million, a decline of \$31.9 million or 13% compared to \$241.6 in fiscal 2015, with North America and International posting decreases of \$7.0 million and \$24.9 million, respectively. Price increases, particularly in Brazil, and new products represented sales gains of \$6.5 and \$4.7 million, respectively, which were offset by volume declines of \$24.3 million and unfavorable exchange rates of \$18.9 million. Gross margins declined \$29.7 million from \$76.7 million, or 31.8%, of sales in fiscal 2015 to \$47.0 million, or 22.4% of sales, in fiscal 2016 with North America and International posting decreases of \$19.3 and \$10.4 million respectively. Selling, general and administrative expenses decreased \$4.8 million, or 7%, from \$68.1 million in fiscal 2015 to \$63.3 million

in fiscal 2016 principally due to reduced International expenses expressed in U. S. dollars. Operating income, including a \$4.1 asset impairment charge, declined \$29.0 million from profit of \$8.6 million in fiscal 2015 to a loss of \$20.4 million in fiscal 2016.

### **Net Sales**

Net sales in North America decreased \$7.0 million or 5% from \$137.1 million in fiscal 2015 to \$130.1 million in fiscal 2016 with a 9% decline in precision hand tools offsetting high end metrology gains of 8%. International sales decreased \$24.9 million or 24% from \$104.5 million in fiscal 2015 to \$79.6 million in fiscal 2015 with the weak Brazilian Real translated to the strong U. S. dollar representing \$16.0 million and the recession in Brazil accounting for a \$10.0 million volume decline.

### **Gross Margin**

Gross margin in North America decreased \$20.7 million from \$43.6 million in fiscal 2015 to \$22.9 million in fiscal 2016 with a non-cash pension charge representing \$12.4 million or 60% of the margin erosion. Lower sale volume and level fixed overhead costs accounted for the majority of the additional \$8.3 million in the deficit. International gross margins decreased \$10.4 million from \$33.1 million in fiscal 2015 to \$22.7 million in fiscal 2016 with unfavorable exchange rates representing \$5.3 million. A United Kingdom non-cash pension charge of \$1.8 million coupled with a \$3.3 million associated with lower sales volume accounted for the additional \$5.1 million in the decline.

### **Selling, General and Administrative Expenses**

North American selling, general and administrative expenses increased \$1.0 million or 3% as savings in salaries, incentive payments, travel and entertainment of \$2.3 million was offset by a \$3.0 million non-cash pension charge and higher professional fees. International selling, general and administrative expenses decreased \$6.0 million or 19% with a \$5.5 million savings due to the stronger U. S. dollar. Reduced sales commissions due to lower sales, particularly in Brazil, accounted for the additional \$0.5 million in savings.

### **Operating Profit**

The operating profit declined \$29.0 million with a non-cash fourth quarter pension expense of \$17.5 million and a \$4.1 million non-cash asset impairment charge representing \$21.6 million or 75% of the difference. Lower sales and associated gross margins contributed to the remaining \$7.4 million decline.

### **Other Income, Net**

Other income in fiscal 2016 decreased \$1.2 million compared to fiscal 2015 principally due to \$0.3 million of lower interest income and a \$1.1 million loss related to dollar denominated debt of our Chinese subsidiary as a result of the Chinese Yuan currency declining in value relative to the U. S. dollar.

### **Income Taxes**

The income tax rate for fiscal 2016 was 30.7% on pre-tax losses of \$20.4 million. This compares to a normalized statutory U.S. federal and state tax rate of 38%. The primary reason for the lower tax benefit is due to losses in certain foreign subsidiaries for which no tax benefit is taken due to the uncertainty of future profits in those entities.

The income tax rate for fiscal 2015 was 47.2% on pre-tax profits of \$9.9 million. This compares to a normalized statutory U.S. federal and state tax rate of 38%. The primary reason for the higher tax cost is due to losses in certain foreign subsidiaries for which no tax benefit is taken due to the uncertainty of future profits in those entities.

The Company continues to recognize the benefit of most U.S. deferred tax assets as, after weighing the positive and negative evidence, it believes it is more likely than not that those benefits will be recognized. The valuation allowances relating to carryforwards for foreign NOLs increased by \$0.5 million and to foreign tax credits increased by \$0.2 million.

### **Fiscal 2015 Compared to Fiscal 2014.**

## **Overview**

North America was the strongest market for the Company in FY 2015. This was driven by a U.S economy that exhibited the most buoyance of any of the major global economies. This was driven by an improved labor market and a steady recovery in overall economic performance coupled with new product introductions and new and enhanced channel partner relationships. This resulted in increased demand for precision hand tools and continued growth in shipments for high-end capital equipment. Internationally, sales declined as result of the strong U.S. dollar. This negatively impacted most all international operating facilities. Other significant factors hurting international performance were accelerating inflation and a deepening recession in Brazil, a European market still suffering with Eurozone financial instability and a Chinese economy experiencing slower expansion.

Net sales for fiscal 2015 declined \$5.6 million, or 2%, compared to fiscal 2014, as gains in North America were offset by lower International sales, principally caused by the strong U.S. dollar. Price increases, particularly in Brazil and new products, representing sales gains of \$6.5 million and \$2.7 million respectively, were offset by unfavorable exchange rates of \$14.1 million and volume declines of \$0.77 million. Gross margins declined \$4.4 million from \$81.1 million, or 32.8 % of sales, in fiscal 2014 to \$76.7 million or 31.8% of sales in fiscal 2015 as a \$3.7 million improvement in North America was offset by an \$8.1 million decline in International. Selling, general and administrative expenses decreased \$1.1 million or 2% from \$69.2 million in fiscal 2014 to \$68.1 million in fiscal 2015 principally due to reduced International expenses expressed in U.S. dollars. Operating income declined \$3.3 million, from \$11.9 million in fiscal 2014, to \$8.6 million in fiscal 2015.

## **Net Sales**

Net sales in North America increased \$7.9 million, or 6%, from \$129.4 million in fiscal 2014 to \$137.3 million in fiscal 2015 with precision hand tools and capital equipment posting gains of 6% and 13%, respectively. International sales decreased \$13.4 million, or 11%, from \$117.8 million in fiscal 2014 to \$104.4 million in fiscal 2015 with the weak Brazilian Real translated to the strong U.S. dollar representing \$12.1 million, or 90%, of the decline.

## **Gross Margin**

Gross margin in North America increased \$3.8 million, or 10%, from \$39.8 million in fiscal 2014 to \$43.6 million in fiscal 2015 and improved as a percentage of sales from 30.8% in fiscal 2014 to 31.8% in fiscal 2015. The improvement was due to a favorable product mix and increased sales volume. International gross margins decreased \$8.2 million, or 20%, from \$41.3 million in fiscal 2014 to \$33.1 million in fiscal 2015 with unfavorable exchange rates representing \$4.4 million and reduced sales volume \$3.7 million.





### **Selling, General and Administrative Expenses**

North American selling, general and administrative expenses increased \$0.5 million, or 1%, as higher travel and entertainment, professional fees and commissions more than offset savings in salaries and employee benefits. International selling, general and administrative expenses decreased \$1.6 million, or 5%, with a \$4.0 million savings due to the stronger U. S. dollar. Higher spending in local currencies for salaries and benefits, commissions, professional fees and marketing expenses represented the major factors for a \$2.4 million cost increase as measured if currency exchange rate remained constant.

### **Operating Profit**

The operating profit declined \$3.3 million from \$11.9 million in fiscal 2014 to \$8.6 million in fiscal 2015 as a \$3.2 million North American profit improvement was more than offset by \$6.5 million reduction in International.

### **Other Income, Net**

Other income in fiscal 2015 increased \$1.2 million compared to fiscal 2014 principally due to a strong dollar in fiscal 2015 that increased the local currency value of dollar denominated assets, especially export receivables in Brazil, compared to fiscal 2014 when the Brazilian Real was consistent with fiscal 2013 and the strength of the Pound Sterling to the U. S. dollar resulted in foreign exchange losses in Scotland.

### **Income Taxes**

The effective tax rate was 47.2% for fiscal 2015 and 44.3% for fiscal 2014. The rate reflects federal, state and foreign adjustments for permanent book to tax differences. The principal reason for the rate being significantly greater than the US normalized combined federal and state tax rate of approximately 38% was significant losses in foreign operations which could not reduce tax expense based upon the uncertainty of future profits in those entities.

The Company continues to recognize the benefit of most U.S. deferred tax assets as, after weighing the positive and negative evidence, it believes it is more likely than not that those benefits will be recognized. The valuation allowances relating to carryforwards of foreign net operating losses (NOLs) increased by \$0.7 million and to foreign tax credits increased by \$0.5 million. There was no change in the valuation allowance related to certain state NOLs.

## FINANCIAL INSTRUMENT MARKET RISK

Market risk is the potential change in a financial instrument's value caused by fluctuations in interest and currency exchange rates, and equity and commodity prices. The Company's operating activities expose it to risks that are continually monitored, evaluated and managed. Proper management of these risks helps reduce the likelihood of earnings volatility.

The Company does not engage in tracking, market-making or other speculative activities in derivatives markets. The Company does not enter into long-term supply contracts with either fixed prices or quantities. The Company engages in an immaterial amount of hedging activity to minimize the impact of foreign currency fluctuations and had \$0.9 million in forward currency contracts outstanding at June 30, 2016. Net foreign monetary assets are approximately \$21.9 million as of June 30, 2016.

A 10% change in interest rates would not have a significant impact on the aggregate net fair value of the Company's interest rate sensitive financial instruments or the cash flows or future earnings associated with those financial instruments. A 10% increase in interest rates would not have a material impact on our borrowing costs. See Note 13 to the Consolidated Financial Statements for details concerning the Company's long-term debt outstanding of \$17.1 million.

## LIQUIDITY AND CAPITAL RESOURCES

|                                       | <b>Years ended June 30</b> |             |             |
|---------------------------------------|----------------------------|-------------|-------------|
|                                       | <b>(\$000)</b>             |             |             |
|                                       | <b>2016</b>                | <b>2015</b> | <b>2014</b> |
| Cash provided by operating activities | \$14,336                   | \$6,800     | \$11,175    |
| Cash used in investing activities     | (619 )                     | (5,544)     | (8,347 )    |
| Cash used in financing activities     | (4,294 )                   | (3,547)     | (6,669 )    |

The Company has a working capital ratio of 5.5 as of June 30, 2016 as compared to 5.7 as of June 30, 2015 with the decrease attributable to lower accounts receivables and inventories at the end of fiscal 2016. Cash, short-term investments, accounts receivable and inventories represent 91% of current assets in fiscal 2016 and 92% in fiscal 2015. The Company had accounts receivable turnover of 5.6 in fiscal 2016 and 5.8 in fiscal 2015, and had an inventory turnover ratio of 2.7 in fiscal 2016 and 2.6 in fiscal 2015.



Net cash provided by operations of \$14.3 million in fiscal 2016 was the result of non-cash pension and asset impairment charges and changes in working capital, in the form of reduced accounts receivable and inventory, more than offsetting a net earnings loss.

The Company generated an \$8.7 million cash flow surplus in fiscal 2016 as \$14.3 million provided by operation was only partially offset by \$0.6 million in investing and \$4.3 million in financing activities.

Effects of translation rate changes on cash primarily result from the movement of the U.S. dollar against the British Pound, the Euro and the Brazilian Real. The Company uses a limited number of forward contracts to hedge some of this activity and a natural hedge strategy of paying for foreign purchases in local currency when economically advantageous.

### **Liquidity and Credit Arrangements**

The Company believes it maintains sufficient liquidity and has the resources to fund its operations in the near term. In addition to its cash and short-term investments, the Company has maintained a \$23.0 million line of credit, of which, \$0.9 million is reserved for letters of credit and \$9.4 million was outstanding as of June 30, 2016.

On June 30, 2009, The L.S. Starrett Company (the “Company”) and certain subsidiaries of the Company (the “Subsidiaries”) entered into a Loan and Security Agreement (the “Credit Facility”) with TD Bank, N.A.. The amended Credit Facility is scheduled to mature on April 30, 2018 and bears interest at LIBOR plus 1.50%.

The obligations under the Credit Facility are unsecured. However, in the event of certain triggering events, the obligations under the Credit Facility will become secured by the assets of the Company and the subsidiaries party to the Credit Facility. Triggering events are two consecutive quarters of failure to achieve the financial covenants outlined in Note 13.

Availability under the Credit Facility is subject to a borrowing base comprised of accounts receivable and inventory. The Company believes that the borrowing base will consistently produce availability under the Credit Facility in excess of \$23.0 million. As of July 31, 2016, the Company had borrowings of \$9.4 million under the Credit Facility.

The Credit Facility contains financial covenants with respect to leverage, tangible net worth, and interest coverage, and also contains customary affirmative and negative covenants, including limitations on indebtedness, liens, acquisitions, asset dispositions, and fundamental corporate changes, and certain customary events of default. Upon the occurrence and continuation of an event of default, the lender may terminate the revolving credit commitment and require immediate payment of the entire unpaid principal amount of the Credit Facility, accrued interest and all other obligations. As of June 30, 2016, the Company was in compliance with all covenants under the Credit Facility.

## **OFF-BALANCE SHEET ARRANGEMENTS**

The Company does not have any material off-balance sheet arrangements as defined under the Securities and Exchange Commission rules.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect the amounts reported in the consolidated financial statements and accompanying notes. Note 2 to the Company's Consolidated Financial Statements describes the significant accounting policies and methods used in the preparation of the consolidated financial statements.

Judgments, assumptions, and estimates are used for, but not limited to, the allowance for doubtful accounts receivable and returned goods; inventory allowances; income tax reserves; long lived assets and goodwill impairment; as well as employee turnover, discount and return rates used to calculate pension obligations.

Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the Company's Consolidated Financial Statements. The following sections describe the Company's critical accounting policies.

Revenue Recognition and Accounts Receivable: Sales of merchandise and freight billed to customers are recognized when products are shipped, title and risk of loss has passed to the customer, no significant post-delivery obligations remain and collection of the resulting receivable is reasonably assured. Sales are net of provisions for cash discounts, returns, customer discounts (such as volume or trade discounts), and other sales related discounts. Cooperative advertising payments made to customers are included as advertising expense in selling, general and administrative in the Consolidated Statements of Operations. While the Company does allow its customers the right to return in certain

circumstances, revenue is not deferred, but rather a reserve for sales returns is provided based on experience, which historically has not been significant.

The allowance for doubtful accounts of \$0.9 million and \$0.6 million at the end of fiscal 2016 and 2015 respectively, is based on our assessment of the collectability of specific customer accounts and the aging of our accounts receivable. While the Company believes that the allowance for doubtful accounts is adequate, if there is a deterioration of a major customer's credit worthiness, actual write-offs are higher than our previous experience, or actual future returns do not reflect historical trends, the estimates of the recoverability of the amounts due the Company and net sales could be adversely affected.

Inventory Valuation: The Company values inventories at the lower of the cost of inventory or net realizable value, with cost determined by either the last-in, first-out ("LIFO") method for most U.S. inventories or the first-in, first-out ("FIFO") method for all other inventories. The Company establishes reserves for excess, slow moving, and obsolete inventory based on inventory levels, expected product life, and forecasted sales demand. In assessing the ultimate realization of inventories, we are required to make judgments as to future demand requirements compared with inventory levels. Reserve requirements are developed according to our projected demand requirements based on historical demand, competitive factors, and technological and product life cycle changes. It is possible that an increase in our reserve may be required in the future if there is a significant decline in demand for our products and we do not adjust our production schedule accordingly.

Property Plant and Equipment: The Company accounts for property, plant and equipment (PP&E) at historical cost less accumulated depreciation. Impairment losses are recorded when indicators of impairment, such as plant closures, are present and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount. The Company continually reviews for such impairment and believes that PP&E is being carried at its appropriate value.

The Company groups PP&E for impairment analysis by division and/or product line. PP&E are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of such an asset may not be recoverable. Such events or circumstances include, but are not limited to, a significant decrease in the fair value of the underlying business or change in utilization of property and equipment.

Recoverability of the net book value of property, plant and equipment is determined by comparison of the carrying amount to estimated future undiscounted net cash flows the assets are expected to generate. Those cash flows include an estimated salvage value based on a hypothetical sale at the end of the assets' depreciation period. Estimating these cash flows and terminal values requires management to make judgments about the growth in demand for our products, sustainability of gross margins, and our ability to achieve economies of scale. If assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the long-lived asset exceeds its fair value. In fiscal 2016 the Company determined that the carrying value of a building exceeded its fair value. Consequently, the Company recorded an impairment loss of \$4,114,000, which represents the excess of the carrying value of the building over its fair value. See also Impairment of Assets (Note 9 to the Consolidated Financial Statements.)



Depreciation is included in cost of goods sold or selling, general and administrative expenses in the Consolidated Statement of Operations based upon the function or use of the specific asset. Depreciation of equipment used in the manufacturing process is a component of inventory cost and included in costs of goods sold upon sale. Depreciation of equipment used for office and administrative functions is an expense in selling, general and administrative expenses.

Intangible Assets: Identifiable intangible assets are recorded at cost and are amortized on a straight-line basis over a 5-15 year period. The estimated useful lives of the intangible assets subject to amortization are: 15 years for patents, 14 years for trademarks and trade names, 10 years for completed technology, 8 years for non-compete agreements, 8 years for customer relationships and 5 years for software development.

Recoverability of the net book value of intangible assets is determined by comparison of the carrying amount to estimated future undiscounted net cash flows the assets are expected to generate. Estimating these cash flows requires management to make judgments about the growth in demand for our products, sustainability of gross margins, and our ability to achieve economies of scale. If assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the long-lived asset exceeds its fair value. No events or circumstances arose in fiscal 2016 which required management to perform an impairment analysis.

Goodwill: The Company assesses annually, or anytime when events suggest impairment may have occurred, the fair value of its goodwill to determine if the carrying amount of the goodwill is greater than the fair value. An impairment charge would be recognized to the extent the recorded goodwill exceeds the implied fair value of goodwill.

The Company performed a qualitative analysis in accordance with ASU 2011-08 of its Bytewise reporting unit for its October 1, 2015 annual assessment of goodwill (commonly referred to as “Step Zero”). From a qualitative perspective, in evaluating whether it is more likely than not that the fair value of the reporting unit is not less than its carrying amount, relevant events and circumstances were taken into account, with greater weight assigned to events and circumstances that most affect the fair value of Bytewise or the carrying amounts of its assets. Items that were considered included, but were not limited to, the following: macroeconomic conditions, industry and market conditions, cost factors, overall financial performance, changes in management or key personnel, and other Bytewise specific events. After assessing these and other factors the Company determined that it was more likely than not that the fair value of the Bytewise reporting unit was not less than the carrying amount as of October 1, 2015.

Income Taxes: Accounting for income taxes requires estimates of future benefits and tax liabilities. Due to temporary differences in the timing of recognition of items included in income for accounting and tax purposes, deferred tax assets or liabilities are recorded to reflect the impact arising from these differences on future tax payments. With respect to recorded tax assets, the Company assesses the likelihood that the asset will be realized by evaluating the positive and negative evidence to determine whether realization is more likely than not to occur. Realization of our deferred tax assets is primarily dependent on future taxable income, the timing and amount of which are uncertain, in part, due to the variable profitability of certain subsidiaries. A valuation allowance is recognized if it is “more likely than not” that some or all of a deferred tax asset will not be realized. In the event that we were to determine that we would not be able to realize our deferred tax assets in the future, an increase in the valuation allowance would be required. In the event we were to determine that we are able to use our deferred tax assets and a valuation allowance had been recorded against the deferred tax assets, a decrease in the valuation allowance would be required. Should any significant changes in the tax law or the estimate of the necessary valuation allowance occur, the Company would record the impact of the change, which could have a material effect on our financial position or results of operations. See also Income Taxes (Note 11 to the Consolidated Financial Statements.)

Defined Benefit Plans: The Company has two defined benefit pension plans, one for U.S. employees and another for U.K. employees. The Company also has a postretirement medical and life insurance benefit plan for U.S. employees.

Under our current accounting method, both plans use fair value as the market-related value of plan assets and continue to recognize actuarial gains or losses within the corridor in other comprehensive income but instead of amortizing net actuarial gains or losses in excess of the corridor in future periods, excess gains and losses are recognized in net periodic benefit cost as of the plan measurement date, which is the same as the fiscal year end of the Company (*MTM adjustment*). This accounting method is a permitted option which results in immediate recognition of excess net actuarial gains and losses in net periodic benefit cost instead of in other comprehensive income. Immediate recognition in net periodic benefit cost could potentially increase the volatility of net periodic benefit cost. The MTM adjustments to net periodic benefit cost for 2016, 2015 and 2014 were \$17.8 million, \$1.3 million, and \$0.4 million, respectively.

Calculation of pension and postretirement medical costs and obligations are dependent on actuarial assumptions. These assumptions include discount rates, healthcare cost trends, inflation, salary growth, long-term

return on plan assets, employee turnover rates, retirement rates, mortality and other factors. These assumptions are made based on a combination of external market factors, actual historical experience, long-term trend analysis, and an analysis of the assumptions being used by other companies with similar plans. Significant differences in actual experience or significant changes in assumptions would affect pension and other postretirement benefit costs and obligations. Effective December 31, 2013, the Company terminated eligibility for employees 55-64 years old in the Postretirement Medical Plan. See also Employee Benefit Plans (Note 12 to the Consolidated Financial Statements).

**Cost of Goods Sold:** The Company includes costs of materials, direct and indirect labor and manufacturing overhead in cost of goods sold. Included in these costs are inbound freight, personnel (manufacturing plants only), receiving costs, internal transferring, employee benefits (including pension expense), depreciation and inspection costs.

**Selling General and Administrative Expenses:** The Company includes distribution expenses in selling, general and administrative expenses. Distribution expenses include shipping labor and warehousing costs associated with the storage of finished goods at each manufacturing facility. The Company also includes costs for our dedicated distribution centers as selling expenses. Employee benefits, including pension expense attributable to personnel not involved in the manufacturing process, are also included in selling, general and administrative expenses.

## CONTRACTUAL OBLIGATIONS

The following table summarizes future estimated payment obligations by period.

|  | <b>Fiscal Year (in millions)</b> |             |                  |                  |                   |
|--|----------------------------------|-------------|------------------|------------------|-------------------|
|  | <b>Total</b>                     | <b>2017</b> | <b>2018-2019</b> | <b>2020-2021</b> | <b>Thereafter</b> |
| Debt obligations                       | \$18.7                           | \$1.5       | \$12.7           | \$3.7            | \$ 0.8            |
| Estimated interest on debt obligations | 1.5                              | 0.6         | 0.7              | 0.2              | -                 |
| Operating lease obligations            | 11.6                             | 2.2         | 3.9              | 3.3              | 2.2               |
| Purchase obligations                   | 11.2                             | 11.1        | 0.1              | -                | -                 |
| Total                                  | \$43.0                           | \$15.4      | \$17.4           | \$7.2            | \$ 3.0            |

Estimated interest on debt obligations are based on a standard 10 year loan amortization schedule for the \$15.5 million term loan, and the current outstanding balance of the Company's credit line at the current effective interest rate through April 2018 when the current credit line agreement ends. See Note 13 for additional details on these debt instruments.

While our purchase obligations are generally cancellable without penalty, certain vendors charge cancellation fees or minimum restocking charges based on the nature of the product or service.

#### **ANNUAL NYSE CEO CERTIFICATION AND SARBANES-OXLEY SECTION 302 CERTIFICATIONS**

In fiscal 2016, the Company submitted an unqualified "Annual CEO Certification" to the New York Stock Exchange as required by Section 303A.12(a) of the New York Stock Exchange Listed Company Manual. Further, the Company is filing with the Securities and Exchange Commission the certifications required by Section 302 of the Sarbanes-Oxley Act of 2002 as exhibits to the Company's Annual Report on Form 10-K.

**Item 8 - Financial Statements and Supplementary Data**

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders

The L.S. Starrett Company

We have audited the accompanying consolidated balance sheets of The L.S. Starrett Company (a Massachusetts corporation) and subsidiaries (the “Company”) as of June 30, 2016 and 2015, and the related consolidated statements of operations, comprehensive income (loss), stockholders’ equity, and cash flows for each of the three years in the period ended June 30, 2016. Our audits of the basic consolidated financial statements included the financial statement schedule listed in the index appearing under Item 15 (2) of this Form 10-K. These financial statements and financial statement schedule are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The L.S. Starrett Company and subsidiaries as of June 30, 2016 and 2015, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2016 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company’s internal control over financial reporting as of June 30, 2016, based on criteria established in the 2013 *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated August 24, 2016 expressed an unqualified opinion.

/s/ Grant Thornton LLP

Boston, Massachusetts

August 24, 2016

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## THE L.S. STARRETT COMPANY

## Consolidated Balance Sheets

(in thousands except share data)

|  | <b>June 30,</b> | <b>June 30,</b> |
|--|-----------------|-----------------|
|  | <b>2016</b>     | <b>2015</b>     |
| <b>ASSETS</b>  |                 |                 |
| Current assets:  |                 |                 |
| Cash   | \$19,794        | \$11,108        |
| Short-term investments   | -               | 7,855           |
| Accounts receivable (less allowance for doubtful accounts of \$887 and \$612, respectively)  | 34,367          | 40,311          |
| Inventories  | 56,321          | 63,003          |
| Current deferred tax asset   | 4,518           | 4,554           |
| Prepaid expenses and other current assets  | 5,911           | 6,582           |
| Total current assets   | 120,911         | 133,413         |
| Property, plant and equipment, net   | 41,010          | 44,413          |
| Taxes receivable   | 2,655           | 3,383           |
| Deferred tax assets, net   | 25,284          | 18,803          |
| Intangible assets, net   | 6,490           | 7,125           |
| Goodwill   | 3,034           | 3,034           |
| Other assets   | 2,214           | 2,101           |
| Total assets   | \$201,598       | \$212,272       |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                 |                 |
| Current liabilities:   |                 |                 |
| Notes payable and current maturities of long-term debt   | \$1,543         | \$1,552         |
| Accounts payable   | 8,981           | 9,471           |
| Accrued expenses   | 6,372           | 7,011           |
| Accrued compensation   | 4,922           | 5,565           |
| Total current liabilities  | 21,818          | 23,599          |
| Deferred tax liabilities   | 187             | 1,548           |
| Other tax obligations  | 3,813           | 4,607           |
| Long-term debt, net of current portion   | 17,109          | 18,552          |
| Postretirement benefit and pension obligations   | 67,158          | 49,536          |
| Total liabilities  | 110,085         | 97,842          |
| Stockholders' equity:  |                 |                 |
| Class A common stock \$1 par (20,000,000 shares authorized; 6,249,563 outstanding at June 30, 2016 and 6,223,558 outstanding at June 30, 2015) | 6,250           | 6,224           |
| Class B common stock \$1 par (10,000,000 shares authorized; 772,742 outstanding at June 30, 2016 and 789,069 outstanding at June 30, 2015)     | 773             | 789             |
| Additional paid-in capital   | 55,227          | 54,869          |
| Retained earnings  | 81,228          | 98,164          |



|  |           |           |
|--|-----------|-----------|
| Accumulated other comprehensive loss       | (51,965 ) | (45,616 ) |
| Total stockholders' equity                 | 91,513    | 114,430   |
| Total liabilities and stockholders' equity | \$201,598 | \$212,272 |

See notes to consolidated financial statements

## THE L.S. STARRETT COMPANY

## Consolidated Statements of Operations

(in thousands except per share data)

|  | Years Ended |   |           |   |           |   |
|--|-------------|---|-----------|---|-----------|---|
|  | 6/30/16     |   | 6/30/15   |   | 6/30/14   |   |
| Net sales  | \$209,685   |   | \$241,550 |   | \$247,134 |   |
| Cost of goods sold   | 162,697     |   | 164,855   |   | 166,038   |   |
| Gross margin   | 46,988      |   | 76,695    |   | 81,096    |   |
| % of net sales   | 22.4        | % | 31.8      | % | 32.8      | % |
| Selling, general and administrative expenses               | 63,319      |   | 68,092    |   | 69,181    |   |
| Impairment of assets                                       | 4,114       |   | -         |   | -         |   |
| Operating income (loss)                                    | (20,445 )   |   | 8,603     |   | 11,915    |   |
| Other income, net  | 70          |   | 1,339     |   | 142       |   |
| Earnings (loss) before income taxes                        | (20,375 )   |   | 9,942     |   | 12,057    |   |
| Income tax expense (benefit)                               | (6,245 )    |   | 4,698     |   | 5,345     |   |
| Net earnings (loss)  | \$(14,130 ) |   | \$5,244   |   | \$6,712   |   |
| Basic and diluted earnings (loss) per share                | \$(2.01 )   |   | \$0.75    |   | \$0.97    |   |
| Average outstanding shares used in per share calculations: |             |   |           |   |           |   |
| Basic  | 7,017       |   | 6,983     |   | 6,926     |   |
| Diluted  | 7,017       |   | 7,023     |   | 6,955     |   |
| Dividends per share  | \$0.40      |   | \$0.40    |   | \$0.40    |   |

See notes to consolidated financial statements

## THE L. S. STARRETT COMPANY

## Consolidated Statements of Comprehensive Income (Loss)

(in thousands)

|   | <b>Years Ended</b> |                |                |
|---|--------------------|----------------|----------------|
|   | <b>6/30/16</b>     | <b>6/30/15</b> | <b>6/30/14</b> |
| Net earnings (loss)   | \$(14,130)         | \$5,244        | \$6,712        |
| Other comprehensive income (loss):  |                    |                |                |
| Translation gain (loss)   | (4,585 )           | (18,989)       | 3,323          |
| Pension and postretirement plans, net of tax of \$(1,371), \$(3,857) and \$1,212 respectively | (1,764 )           | (6,202 )       | 728            |
| Other comprehensive income (loss)   | (6,349 )           | (25,191)       | 4,051          |
| Total comprehensive income (loss)   | \$(20,479)         | \$(19,947)     | \$10,763       |

See notes to consolidated financial statements

## THE L.S. STARRETT COMPANY

## Consolidated Statements of Stockholders' Equity

(in thousands except per share data)

|  | Common<br>Stock           |                           | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss |   | Total     |
|--|---------------------------|---------------------------|----------------------------------|----------------------|---|---|-----------|
|  | Class<br>A<br>Outstanding | Class<br>B<br>Outstanding |                                  |                      |   |   |           |
| Balance, June 30, 2013                         | \$6,077                   | \$750                     | \$ 52,613                        | \$91,778             | \$ (24,476                                    | ) | \$126,742 |
| Total comprehensive income                     |                           |                           |                                  | 6,712                | 4,051   |   | 10,763    |
| Dividends (\$0.40 per share)                   |                           |                           |                                  | (2,775 )             |   |   | (2,775 )  |
| Issuance of stock                              | 30                        | 104                       | 1,296                            |                      |   |   | 1,430     |
| Stock-based compensation                       |                           |                           | 154                              |                      |   |   | 154       |
| Conversion                                     | 59                        | (59 )                     |                                  |                      |   |   | -         |
| Balance, June 30, 2014                         | 6,166                     | 795                       | 54,063                           | 95,715               | (20,425                                       | ) | 136,314   |
| Total comprehensive income                     |                           |                           |                                  | 5,244                | (25,191                                       | ) | (19,947 ) |
| Dividends (\$0.40 per share)                   |                           |                           |                                  | (2,795 )             |   |   | (2,795 )  |
| Repurchase of shares                           | (1 )                      | (3 )                      | (64 )                            |                      |   |   | (68 )     |
| Issuance of stock                              | 23                        | 33                        | 632                              |                      |   |   | 688       |
| Stock-based compensation                       |                           |                           | 238                              |                      |   |   | 238       |
| Conversion                                     | 36                        | (36 )                     |                                  |                      |   |   | -         |
| Balance, June 30, 2015                         | 6,224                     | 789                       | 54,869                           | 98,164               | (45,616                                       | ) | 114,430   |
| Total comprehensive income                     |                           |                           |                                  | (14,130 )            | (6,349  | ) | (20,479 ) |
| Dividends (\$0.40 per share)                   |                           |                           |                                  | (2,806 )             |   |   | (2,806 )  |
| Repurchase of shares                           | (37 )                     | (5 )                      | (421 )                           |                      |   |   | (463 )    |
| Issuance of stock                              | 34                        | 18                        | 530                              |                      |   |   | 582       |
| Stock-based compensation                       |                           |                           | 249                              |                      |   |   | 249       |
| Conversion                                     | 29                        | (29 )                     |                                  |                      |   |   | -         |
| Balance, June 30, 2016                         | \$6,250                   | \$773                     | \$ 55,227                        | \$81,228             | \$ (51,965                                    | ) | \$91,513  |
| Cumulative balance:                            |                           |                           |                                  |                      |   |   |           |
| Translation loss, net of taxes                 |                           |                           |                                  |                      | \$ (41,886                                    | ) |           |
| Pension and postretirement plans, net of taxes |                           |                           |                                  |                      | (10,079                                       | ) |           |
|  |                           |                           |                                  |                      | \$ (51,965                                    | ) |           |

See notes to consolidated financial statements



## THE L. S. STARRETT COMPANY

## Consolidated Statements of Cash Flows

(in thousands)

|  | <b>Years Ended</b> |                |                |
|--|--------------------|----------------|----------------|
|  | <b>6/30/16</b>     | <b>6/30/15</b> | <b>6/30/14</b> |
| <b>Cash flows from operating activities:</b>   |                    |                |                |
| Net earnings (loss)                            | \$(14,130)         | \$5,244        | \$6,712        |
| <b>Non cash operating activities:</b>          |                    |                |                |
| Depreciation                                   | 5,832              | 7,434          | 8,177          |
| Amortization                                   | 1,382              | 1,283          | 1,181          |
| Impairment of building                         | 4,114              | -              | -              |
| Stock-based compensation                       | 404                | 362            | 251            |
| Net long-term tax obligations                  | (256 )             | 2,414          | 780            |
| Deferred taxes                                 | (6,888 )           | 985            | 1,329          |
| Income on equity method investment             | (118 )             | (203 )         | (257 )         |
| Loss on disposal of building                   |                    | -              | 89             |
| <b>Working capital changes:</b>                |                    |                |                |
| Accounts receivable                            | 2,774              | (2,615 )       | (4,491 )       |
| Inventories                                    | 3,615              | (6,185 )       | (7,526 )       |
| Other current assets                           | 309                | 483            | 818            |
| Other current liabilities                      | 1,443              | 780            | 1,871          |
| Postretirement benefit and pension obligations | 15,833             | (3,426 )       | 2,073          |
| Other  | 22                 | 244            | 168            |
| Net cash provided by operating activities      | 14,336             | 6,800          | 11,175         |
| <b>Cash flows from investing activities:</b>   |                    |                |                |
| Additions to property, plant and equipment     | (7,493 )           | (5,052 )       | (8,464 )       |
| Software development                           | (747 )             | (648 )         | (372 )         |
| Purchase of short-term investments             | -                  | (45 )          | (107 )         |
| Proceeds from sale of short-term investments   | 7,621              | 201            | -              |
| Proceeds from sale of building                 | -                  | -              | 596            |
| Net cash used in investing activities          | (619 )             | (5,544 )       | (8,347 )       |
| <b>Cash flows from financing activities:</b>   |                    |                |                |
| Proceeds from borrowings                       | 750                | 900            | 500            |
| Short-term debt repayments                     | -                  | -              | (425 )         |
| Long-term debt repayments                      | (2,202 )           | (2,148 )       | (4,529 )       |
| Proceeds from common stock issued              | 427                | 564            | 560            |
| Repurchase of shares                           | (463 )             | (68 )          | -              |
| Dividends paid                                 | (2,806 )           | (2,795 )       | (2,775 )       |
| Net cash used in financing activities          | (4,294 )           | (3,547 )       | (6,669 )       |
| Effect of translation rate changes on cash     | (737 )             | (2,834 )       | 319            |
| Net increase (decrease) in cash                | 8,686              | (5,125 )       | (3,522 )       |

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|   |          |          |          |
|---|----------|----------|----------|
| Cash beginning of year                          | 11,108   | 16,233   | 19,755   |
| Cash end of year                                | \$19,794 | \$11,108 | \$16,233 |
| Supplemental cash flow information:             |          |          |          |
| Interest paid                                   | \$654    | \$724    | \$813    |
| Taxes paid, net                                 | 1,113    | 2,169    | 3,476    |
| Supplemental disclosure of non-cash activities: |          |          |          |
| Issuance of stock under 2013 ESOP               | \$-      | \$-      | \$773    |

See notes to consolidated financial statements

THE L.S. STARRETT COMPANY

Notes to Consolidated Financial Statements

June 30, 2016 and 2015

**1. DESCRIPTION OF BUSINESS**

The L. S. Starrett Company (the “Company”) is incorporated in the Commonwealth of Massachusetts and is in the business of manufacturing industrial, professional and consumer measuring and cutting tools and related products. The Company’s manufacturing operations are primarily in North America, Brazil, China and the United Kingdom. The largest consumer of these products is the metalworking industry, but others include automotive, aviation, marine, farm, do-it-yourselfers and tradesmen such as builders, carpenters, plumbers and electricians.

**2. SIGNIFICANT ACCOUNTING POLICIES**

Principles of consolidation: The consolidated financial statements include the accounts of The L. S. Starrett Company and its subsidiaries, all of which are wholly-owned. All significant intercompany items have been eliminated in consolidation.

Financial instruments and derivatives: The Company’s financial instruments include cash, investments and debt and are valued using level 1 inputs. Investments are stated at cost which approximates fair market value. The carrying value of debt, which is at current market interest rates, also approximates its fair value. The Company’s U.K. subsidiary utilizes forward exchange contracts to reduce currency risk. The fair value of contracts outstanding as of June 30, 2016 and June 30, 2015 amounted to \$0.9 million and \$1.3 million, respectively.

Accounts receivable: Accounts receivable consist of trade receivables from customers. The expense for bad debts amounted to \$0.3, \$0.2, and \$0.0 million in fiscal 2016, 2015 and 2014, respectively. In establishing the allowance for doubtful accounts, management considers historical losses, the aging of receivables and existing economic conditions.

Inventories: Inventories are stated at the lower of cost or market. Substantially all United States inventories are valued using the last-in-first-out (“LIFO”) method. All non-U.S. subsidiaries use the first-in-first-out (“FIFO”) method or the



average cost method. LIFO is not a permissible method of inventory costing for tax purposes outside the U.S.

Property Plant and Equipment: The cost of buildings and equipment is depreciated using straight-line and accelerated methods over their estimated useful lives as follows: buildings and building improvements 10 to 50 years, machinery and equipment 3 to 12 years. Leases are capitalized under the criteria set forth in Accounting Standards Codification (ASC) 840, "Leases" which establishes the four criteria of a capital lease. At least one of the four following criteria must be met for a lease to be considered a capital lease: a transfer of ownership of the property to the lessee by the end of the lease term; a bargain purchase option; a lease term that is greater than or equal to 75 percent of the economic life of the leased property; present value of the future minimum lease payments equals or exceeds 90 percent of the fair market value of the leased property. If none of the aforementioned criteria are met, the lease will be treated as an operating lease. Property plant and equipment to be disposed of are reported at the lower of carrying amount or fair value less cost to sell. A gain or loss is recorded on individual fixed assets when retired or disposed of. Included in buildings and building improvements and machinery and equipment at June 30, 2016 and June 30, 2015 were \$2.9 million and \$1.3 million, respectively, of construction in progress. Repairs and maintenance of equipment are expensed as incurred. A decision to reduce saw manufacturing capacity arose in fiscal 2016 which required management to perform an impairment analysis. Consequently, the Company recorded an impairment loss of \$4,114,000, which represents the excess of the carrying value of the building over its fair value. See also Impairment of Assets (Note 9 to the Consolidated Financial Statements.)

Intangible assets: Identifiable intangibles are recorded at cost and are amortized on a straight-line basis over a 5-15 year period. The estimated useful lives of the intangible assets subject to amortization are: 15 years for patents, 14 years for trademarks and trade names, 10 years for completed technology, 8 years for non-compete agreements, 8 years for customer relationships and 5 years for software development. The Company tests identifiable intangible assets for impairment whenever events or circumstances indicate they may be impaired.

Goodwill:

Goodwill represents costs in excess of fair values assigned to the underlying net assets of acquired businesses. Goodwill is not subject to amortization but is tested for impairment annually and at any time when events suggest impairment may have occurred. The Company annually tests the goodwill associated with the November 2011 acquisition of Bytewise in October. As of October 1, 2015, the Company performed an analysis of qualitative factors to determine whether it is more likely than not that the fair value of the Bytewise business is less than its carrying amount as a basis for determining whether it is necessary to perform a two-step goodwill impairment test. Based on the Company's analysis of qualitative factors, the Company determined that it was not necessary to perform a two-step goodwill impairment test.

Revenue recognition: Sales of merchandise and freight billed to customers are recognized when title and risk of loss has passed to the customer, no significant post-delivery obligations remain and collection of the resulting receivable is reasonably assured. Sales are presented net of provisions for cash discounts, returns, customer discounts (such as volume or trade discounts), and other sales related discounts. Cooperative advertising payments made to customers are included in selling, general and administrative expenses in the Consolidated Statements of Operations. While the Company does allow its customers the right to return in certain circumstances, revenue is not deferred, but rather a reserve for sales returns is provided based on experience, which historically has not been significant.

Advertising costs: The Company's policy is to generally expense advertising costs as incurred, except catalogs costs, which are deferred until mailed. Advertising costs were expensed as follows: \$5.0 million in fiscal 2016, \$5.7 million in fiscal 2015 and \$5.5 million in fiscal 2014 and are included in selling, general and administrative expenses.

Freight costs: The cost of outbound freight and the cost for inbound freight included in material purchase costs are both included in cost of sales.

Warranty expense: The Company's warranty obligation is generally one year from shipment to the end user and is affected by product failure rates, material usage, and service delivery costs incurred in correcting a product failure. Historically, the Company has not incurred significant warranty expense and consequently its warranty reserves are not material.

Pension and Other Postretirement Benefits: The Company has two defined benefit pension plans, one for U.S. employees and another for U.K. employees. The Company also has defined contribution plans. The Company amended its Postretirement Medical Plan effective December 31, 2013, whereby the Company terminated eligibility for employees under the age of 65.

The Company sponsors funded U.S. and non-U.S. defined benefit pension plans covering the majority of our U.S. and U.K. employees. The Company also sponsors an unfunded postretirement benefit plan that provides health care benefits and life insurance coverage to eligible U.S. retirees. Under the Company's current accounting method, both pension plans use fair value as the market-related value of plan assets and continue to recognize actuarial gains or losses within the corridor in other comprehensive income (loss) but instead of amortizing net actuarial gains or losses in excess of the corridor in future periods, such excess gains and losses, if any, are recognized in net periodic benefit cost as of the plan measurement date, which is the same as the fiscal year end of the Company (MTM adjustment). This method is a permitted option which results in immediate recognition of excess net actuarial gains and losses in net periodic benefit cost instead of in other comprehensive income (loss). Such immediate recognition in net periodic benefit cost increases the volatility of net periodic benefit cost. The MTM adjustments to net periodic benefit cost for 2016, 2015 and 2014 were \$17.8 million, \$1.3 million, and \$0.4 million, respectively.

Income taxes: Deferred tax expense results from differences in the timing of certain transactions for financial reporting and tax purposes. Deferred taxes have not been recorded on approximately \$67 million of undistributed earnings of foreign subsidiaries as of June 30, 2016 and the related unrealized translation adjustments because such amounts are considered permanently invested. In addition, it is possible that remittance taxes, if any, would be reduced by U.S. foreign tax credits to the extent available. Valuation allowances are recognized if, based on the available evidence, it is more likely than not that some portion of the deferred tax assets will not be realized.

Research and development: Research and development costs are expensed, primarily in selling, general and administrative expenses, and were as follows: \$1.8 million in fiscal 2016, \$1.7 million in fiscal 2015, and \$1.4 million in fiscal 2014 and are included in selling general and administrative expenses in the Consolidated Statements of Operations.

Earnings per share (EPS): Basic EPS is computed by dividing earnings (loss) available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution by securities that could share in the earnings. The Company had 32,833, 40,214, and 29,951, of potentially dilutive common shares in fiscal 2016, 2015 and 2014, respectively, resulting from shares issuable under its stock option plans. These additional shares are not used in the diluted EPS calculation in loss years.

Translation of foreign currencies: The financial statements of our foreign subsidiaries, where the local currency is the functional currency, are translated at exchange rates in effect on reporting dates, and income and expense items are translated at average rates or rates in effect on transaction dates as appropriate. The resulting foreign currency translation adjustments are charged or credited directly to the other comprehensive income (loss) as noted in the Consolidated Statements of Comprehensive Income (Loss). Net foreign currency gains (losses) are disclosed in Note 10.

Use of accounting estimates: The preparation of the financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of net sales and expenses during the reporting period. Judgments, assumptions and estimates are used for, but not limited to: the allowances for doubtful accounts receivable and returned goods; inventory allowances; income tax valuation allowances, uncertain tax positions and pension obligations. Amounts ultimately realized could differ from those estimates.

Recent Accounting Pronouncements:

In May 2014, the FASB issued a new standard related to the “Revenue from Contracts with Customers” which amends the existing accounting standards for revenue recognition. The standard requires entities to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services. This standard is applicable for fiscal years beginning after December 15, 2017 and for interim periods within those years. Earlier application will be permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company expects to adopt this standard on July 1, 2017. The Company is currently evaluating the impact of the adoption of this standard on its consolidated financial statements.

In November 2015, the FASB issued Accounting Standards Update No. 2015-17 ("ASU 2015-17") regarding ASC Topic 470 "Income Taxes: Balance Sheet Classification of Deferred Taxes." The amendments in ASU 2015-17 eliminate the requirement to bifurcate Deferred Taxes between current and non-current on the balance sheet and requires that all deferred tax liabilities and assets be classified as noncurrent on the balance sheet. The amendments for ASU-2015-17 can be applied retrospectively or prospectively and early adoption is permitted. The Company plans to adopt the new guidance prospectively in the first quarter of fiscal 2017. Implementation will have no effect on the Consolidated Statement of Operations but is expected to result in a change in classification for \$4.5 million of tax assets from short-term to long-term.

In July 2015, the FASB issued ASU No. 2015-11, "Inventory (Topic 330): Simplifying the Measurement of Inventory." Previous to the issuance of this ASU, ASC 330 required that an entity measure inventory at the lower of cost or market. ASU 2015-11 specifies that “market” is defined as “net realizable value,” or the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This ASU is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2016. Application is to be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. The adoption of ASU No. 2015-11 will not have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842)”. The ASU requires that organizations that lease assets recognize assets and liabilities on the balance sheet for the rights and obligations created by those leases. The ASU will affect the presentation of lease related expenses on the income statement and statement of cash flows and will increase the required disclosures related to leases. This ASU is effective for annual periods ending after December 15, 2018, and interim periods thereafter, with early adoption permitted. The Company is currently evaluating the impact of ASU No. 2016-02 on its consolidated financial statements. It is expected that a key change upon adoption will be the balance sheet recognition of leased assets and liabilities and that any changes in income statement recognition will not be material.

In March 2016, the FASB issued ASU No. 2016-09, "Compensation - Stock Compensation (Topic 718), Improvements to Employee Share-Based Payment Accounting." The ASU affects the accounting for employee share-based payment transactions as it relates to accounting for income taxes, accounting for forfeitures, and statutory tax withholding requirements. This ASU is effective for annual periods ending after December 15, 2016, and interim periods within those periods with early adoption permitted. The Company is currently evaluating the impact of ASU No. 2016-09 on its consolidated financial statements.

### **3. INVESTMENT**

In fiscal 2010, the Company entered into an agreement with a private software development company to invest \$1.5 million in exchange for a 36% equity interest therein. The Company recorded other income of \$0.1 million in fiscal 2016, \$0.2 million in fiscal 2015 and \$0.3 million in fiscal 2014 based on the earnings of this entity as allocated under the equity method of accounting. The net carrying value of the investment included in other long-term assets in the Consolidated Balance Sheet as of June 30, 2016 and June 30, 2015 is \$2.2 million and \$2.1 million, respectively. In August 2011, the Company guaranteed a loan of \$0.5 million. The guarantee remains outstanding, between the private software development company and Starrett. There was no amount outstanding under the loan as of June 30, 2016.

### **4. STOCK-BASED COMPENSATION**

#### **Long-Term Incentive Plan**

During the quarter ended December 31, 2012, the Company implemented The L.S. Starrett Company 2012 Long-Term Incentive Plan (the "2012 Stock Incentive Plan"), which was adopted by the Board of Directors September 5, 2012 and approved by shareholders October 17, 2012. The 2012 Stock Incentive Plan permits the granting of the following types of awards to officers, other employees and non-employee directors: stock options; restricted stock awards; unrestricted stock awards; stock appreciation rights; stock units including restricted stock units; performance awards; cash-based awards; and awards other than previously described that are convertible or otherwise based on stock. The 2012 Stock Incentive Plan provides for the issuance of up to 500,000 shares of common stock.

Options granted vest in periods ranging from one year to three years and expire ten years after the grant date. Restricted stock units (“RSU”) granted generally vest from one year to three years. Vested restricted stock units will be settled in shares of common stock. As of June 30, 2016, there were 20,000 stock options and 73,367 restricted stock units outstanding. In addition, there were 391,600 shares available for grant under the 2012 Stock Incentive Plan as of June 30, 2016.

For the stock option grants, the fair value of each grant is estimated at the date of grant using the Binomial Options pricing model. The Binomial Options pricing model utilizes assumptions related to stock volatility, the risk-free interest rate, the dividend yield and employee exercise behavior. Expected volatilities utilized in the model are based on the historic volatility of the Company’s stock price. The risk free interest rate is derived from the U.S. Treasury yield curve in effect at the time of the grant. The expected life is determined using the average of the vesting period and contractual term of the options (simplified method). There were no stock options granted during fiscal years 2016, 2015 or 2014.

The weighted average contractual term for stock options outstanding as of June 30, 2016 was 6.5 years. The aggregate intrinsic value of stock options outstanding as of June 30, 2016 was less than \$0.1 million. There were 20,000 options exercisable as of June 30, 2016. In recognizing stock compensation expense for the 2012 Stock Incentive Plan management has estimated that there will be no forfeitures of options.

The Company accounts for RSU awards by recognizing the expense of the intrinsic value at the award date ratably over vesting periods generally ranging from one year to three years. The related expense is included in selling, general and administrative expenses. During the year ended June 30, 2016, the Company granted 40,200 RSU awards with fair values of \$15.11 per RSU award. During the year ended June 30, 2015, the Company granted 39,500 RSU awards with fair values of \$17.49 per RSU award. There were no RSU awards during the year ended June 30, 2014.

There were 9,067 and 2,733 RSU awards settled in fiscal years 2016 and 2015 respectively. The aggregate intrinsic value of RSU awards outstanding as of June 30, 2016 was \$0.9 million. The aggregate intrinsic value of RSU awards outstanding as of June 30, 2015 was \$0.8 million. Compensation expense related to the 2012 Stock Incentive Plan was \$214,000, \$146,000 and \$54,000 for fiscal 2016, 2015 and 2014 respectively. As of June 30, 2016 there was \$1.0 million of total unrecognized compensation costs related to outstanding stock-based compensation arrangements. Of this cost \$0.7 million relates to performance based RSU grants that are not expected to be awarded. The remaining \$0.3 million is expected to be recognized over a weighted average period of 1.5 years.

### **Employee Stock Purchase Plan**

The Company’s Employee Stock Purchase Plans (ESPP) give eligible employees an opportunity to participate in the success of the Company. The Board of Directors renews each Employee Stock Purchase Plan every five years. Under these plans the purchase price of the optioned stock is 85% of the lower of the market price on the date the option is

granted or the date it is exercised. Options become exercisable exactly two years from the date of grant and expire if not exercised on such date. No options were exercisable at fiscal year ends. The Board of Directors last approved an ESPP renewal in 2012 and authorized 500,000 shares available for grant. A summary of option activity is as follows:

|                        | <b>Shares</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Shares<br/>Available<br/>For<br/>Grant</b> |
|------------------------|---------------|--|---|
| Balance, June 30, 2013 | 88,728        |  | 448,544                                       |
| Options granted        | 43,643        | 10.91  | (43,643 )                                     |
| Options exercised      | (26,225)      | 9.83   | -   |
| Options canceled       | (30,758)      |  | 19,711  |
| Balance, June 30, 2014 | 75,388        |  | 424,612                                       |
| Options granted        | 35,208        | 13.97  | (35,208 )                                     |
| Options exercised      | (30,718)      | 8.82   | -   |
| Options canceled       | (25,571)      |  | 25,571  |
| Balance, June 30, 2015 | 54,307        |  | 414,975                                       |
| Options granted        | 52,836        | 9.37   | (52,836 )                                     |
| Options exercised      | (15,523)      | 9.57   | -   |
| Options canceled       | (27,705)      |  | 27,705  |
| Balance, June 30, 2016 | 63,915        |  | 389,844                                       |

The following information relates to outstanding options as of June 30, 2016:

|  |        |
|--|--------|
| Weighted average remaining life (years)                          | 1.3    |
| Weighted average fair value on grant date of options granted in: |        |
| 2014   | \$3.37 |
| 2015   | 4.68   |
| 2016   | 3.34   |

The fair value of each option grant was estimated on the date of grant based on the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility – 40.06% – 42.03%, interest – 0.75% – 0.77%, and expected lives - 2 years. Compensation expense of \$143,065, \$139,006 and \$138,677 has been recorded for fiscal 2016, 2015 and 2014, respectively.



## **Employee Stock Ownership Plan**

On February 5, 2013, the Board of Directors adopted The L.S. Starrett Company 2013 Employee Stock Ownership Plan (the “2013 ESOP”). The purpose of the plan is to supplement existing Company programs through an employer funded individual account plan dedicated to investment in common stock of the Company, thereby encouraging increased ownership of the Company while providing an additional source of retirement income. The plan is intended as an employee stock ownership plan within the meaning of Section 4975 (e) (7) of the Internal Revenue Code of 1986, as amended. U.S. employees who have completed a year of service as of December 31, 2012 are eligible to participate.

There was no compensation expense for the 2013 ESOP in 2014, 2015 or 2016. Shares of Class B common stock were contributed to the 2013 ESOP on July 30, 2013 in order to fund the 2013 liability.

## **5. CASH AND SHORT-TERM INVESTMENTS**

Cash and investments held by foreign subsidiaries amounted to \$10.2 million and \$12.0 million at June 30, 2016 and June 30, 2015, respectively. Of the June 30, 2016 balance, \$6.7 million in U.S. dollar equivalents was held in British Pounds Sterling and \$1.6 million in U.S. dollar equivalents was held in Brazilian Reals.

The Company plans to permanently reinvest cash held in foreign subsidiaries. Cash held in foreign subsidiaries is not available for use in the U.S. without the likely incurrence of U.S. federal and state income tax consequences.

As of June 30, 2015, the Company’s U.K. subsidiary held a \$7.9 million 12 month fixed term deposit with a financial institution.

## **6. INVENTORIES**

Inventories consist of the following (in thousands):

|                                     | June 30, | June 30, |
|-------------------------------------|----------|----------|
|                                     | 2016     | 2015     |
| Raw materials and supplies          | \$29,209 | \$32,784 |
| Goods in process and finished parts | 16,459   | 18,569   |
| Finished goods                      | 39,449   | 39,689   |
|                                     | 85,117   | 91,042   |
| LIFO reserve                        | (28,796) | (28,039) |
|                                     | \$56,321 | \$63,003 |

LIFO inventories were \$10.5 million and \$14.6 million at June 30, 2016 and June 30, 2015, respectively, such amounts being approximately \$28.8 million and \$28.0 million, respectively, less than if determined on a FIFO basis. The use of LIFO compared to FIFO on an annual basis resulted in a \$0.8 million increase in cost of goods sold in fiscal 2016 compared to an increase in cost of goods sold of \$0.7 million in fiscal 2015.

**7. GOODWILL AND INTANGIBLES**

The following tables present information about the Company's goodwill and identifiable intangible assets on the dates indicated (in thousands):

|                                | <b>June 30, 2016</b> |                             |         | <b>June 30, 2015</b> |                             |         |
|--------------------------------|----------------------|-----------------------------|---------|----------------------|-----------------------------|---------|
|                                | Cost                 | Accumulated<br>Amortization | Net     | Cost                 | Accumulated<br>Amortization | Net     |
| Goodwill                       | \$3,034              | \$ -                        | \$3,034 | \$3,034              | \$ -                        | \$3,034 |
| Identifiable intangible assets | 12,115               | (5,625 )                    | 6,490   | 11,368               | (4,243 )                    | 7,125   |

Identifiable intangible assets consist of the following (in thousands):

|                            | June 30,<br>2016 | June 30,<br>2015 |
|----------------------------|------------------|------------------|
| Non-compete agreements     | \$600            | \$600            |
| Trademarks and trade names | 1,480            | 1,480            |
| Completed technology       | 2,358            | 2,358            |
| Customer relationships     | 4,950            | 4,950            |
| Software development       | 2,402            | 1,655            |
| Other intangible assets    | 325              | 325              |
| Total                      | 12,115           | 11,368           |
| Accumulated amortization   | (5,625 )         | (4,243 )         |
| Total net balance          | \$6,490          | \$7,125          |

Identifiable intangible assets are being amortized on a straight-line basis over the period of expected economic benefit.

The estimated aggregate amortization expense for each of the next five years, and thereafter, is as follows (in thousands):

|             |         |
|-------------|---------|
| Fiscal Year |         |
| 2017        | \$1,581 |
| 2018        | 1,513   |
| 2019        | 1,434   |
| 2020        | 911     |
| 2021        | 508     |
| Thereafter  | 543     |

The Company performed a qualitative analysis in accordance with ASU 2011-08 of its Bytewise reporting unit for its October 1, 2015 annual assessment of goodwill (commonly referred to as “Step Zero”). From a qualitative perspective, in evaluating whether it is more likely than not that the fair value of the reporting units is not less than its carrying amount, relevant events and circumstances were taken into account, with greater weight assigned to events and circumstances that most affect the fair value of Bytewise or the carrying amounts of its assets. Items that were considered included, but were not limited to, the following: macroeconomic conditions, industry and market conditions, cost factors, overall financial performance, changes in management or key personnel, and other Bytewise specific events. After assessing these and other factors the Company determined that it was more likely than not that the fair value of the Bytewise reporting unit was not less than the carrying amount as of October 1, 2015. There were no triggering events identified from the annual assessment date through the fiscal year-end.

## 8. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of the following as of June 30, 2016 and 2015 (in thousands):

|                                     | As of June 30, 2016 |                             |          |
|-------------------------------------|---------------------|-----------------------------|----------|
|                                     | Cost                | Accumulated<br>Depreciation | Net      |
| Land                                | \$1,314             | \$ -                        | \$1,314  |
| Buildings and building improvements | 45,486              | (29,595 )                   | 15,891   |
| Machinery and equipment             | 126,882             | (103,077 )                  | 23,805   |
| Total                               | \$173,682           | \$ (132,672 )               | \$41,010 |

|                                     | <b>As of June 30, 2015</b> |                                     |            |
|-------------------------------------|----------------------------|-------------------------------------|------------|
|                                     | <b>Cost</b>                | <b>Accumulated<br/>Depreciation</b> | <b>Net</b> |
| Land                                | \$1,320                    | \$ -                                | \$1,320    |
| Buildings and building improvements | 45,434                     | (25,210 )                           | 20,224     |
| Machinery and equipment             | 132,788                    | (109,919 )                          | 22,869     |
| Total                               | \$179,542                  | \$ (135,129 )                       | \$44,413   |

No assets under capital leases are included in machinery and equipment as of June 30, 2016 or June 30, 2015.

Operating lease expense was \$2.3 million, \$2.2 million and \$1.9 million in fiscal 2016, 2015 and 2014, respectively. Future commitments under operating leases are as follows (in thousands):

| Fiscal Year |         |
|-------------|---------|
| 2017        | \$2,204 |
| 2018        | 2,040   |
| 2019        | 1,876   |
| 2020        | 1,614   |
| 2021        | 1,685   |
| Thereafter  | 2,191   |
|             | 11,610  |

## **9. IMPAIRMENT OF ASSETS**

In fiscal 2016, the Company adopted a plan to transfer the production of certain saw products from its facility in Mt. Airy, North Carolina to its facility in Itú, Brazil. The Company expects the transfer will be completed in fiscal 2017. Because the transfer will leave one of the buildings at the Mt. Airy facility vacant, the Company determined that the carrying value of the building exceeds its fair value. Consequently, the Company recorded an impairment loss of \$4,114,000, which represents the excess of the carrying value of the building over its fair value. The impairment loss is recorded as a separate line item (“Impairment of assets”) in the Consolidated Statement of Operations for fiscal 2016.

## **10. OTHER INCOME AND EXPENSE**

Other income and expense consists of the following (in thousands):

|                                   | <b>2016</b> | <b>2015</b> | <b>2014</b> |
|-----------------------------------|-------------|-------------|-------------|
| Interest income                   | \$504       | 828         | \$951       |
| Interest expense                  | (669)       | (713 )      | (800)       |
| Foreign currency gain (loss), net | (59 )       | 705         | (840)       |
| Income from equity investment     | 118         | 203         | 257         |
| Brazil recovery of export taxes   | -           | 232         | -           |
| Sale of scrap material            | 95          | 93          | 126         |
| Gain on resolution of contingency | -           | -           | 89          |
| Other income (expense), net       | 81          | (9 )        | 359         |
|                                   | \$70        | 1,339       | \$142       |

The gain on resolution of contingency represents damages awarded in a Brazilian lawsuit which the Company had filed as plaintiff in 2003.

**11. INCOME TAXES**

Components of earnings (loss) before income taxes are as follows (in thousands):

|                     | <b>2016</b> | <b>2015</b> | <b>2014</b> |
|---------------------|-------------|-------------|-------------|
| Domestic operations | \$(17,541)  | \$8,118     | \$5,793     |
| Foreign operations  | (2,834 )    | 1,824       | 6,264       |
|                     | \$(20,375)  | \$9,942     | \$12,057    |

The provision for income taxes consists of the following (in thousands):

|           | <b>2016</b> | <b>2015</b> | <b>2014</b> |
|-----------|-------------|-------------|-------------|
| Current:  |             |             |             |
| Federal   | \$(317 )    | \$1,744     | \$155       |
| Foreign   | 866         | 1,855       | 3,284       |
| State     | 94          | 114         | 86          |
| Deferred: |             |             |             |
| Federal   | (6,092)     | 670         | 2,175       |
| Foreign   | 47          | (71 )       | (426 )      |
| State     | (843 )      | 386         | 71          |
|           | \$(6,245)   | \$4,698     | \$5,345     |

Reconciliations of expected tax expense at the U.S. statutory rate to actual tax expense (benefit) are as follows (in thousands):

|  | <b>2016</b> | <b>2015</b> | <b>2014</b> |
|--|-------------|-------------|-------------|
| Expected tax expense                             | \$(6,928)   | \$3,380     | \$4,099     |
| State taxes, net of federal effect               | (740 )      | 378         | 269         |
| Foreign taxes, net of federal credits            | 278         | 235         | 123         |
| Change in valuation allowance                    | 196         | (51 )       | (428 )      |
| Tax reserve adjustments                          | 250         | 361         | 465         |
| Return to provision and other adjustments        | (167 )      | (332 )      | (265 )      |
| Losses not benefited                             | 885         | 701         | 350         |
| Tax rate change applied to deferred tax balances | -           | -           | 278         |
| Other permanent items                            | (19 )       | 26          | 454         |
| Actual tax expense (benefit)                     | \$(6,245)   | \$4,698     | \$5,345     |

Significant changes in tax expense reconciliation in the year ended June 30, 2016 relate primarily to losses in both domestic and foreign entities. Substantial benefit is reflected for US federal and state income taxes primarily as a result of increases in deferred tax assets related to pension expense and the write-down of fixed assets. In fiscal 2016, several of the subsidiaries in foreign countries reported financial losses. In these cases, no tax benefit from those losses was recognized and an additional valuation allowance was taken to reduce any deferred tax assets since future income is not more likely than not to be recognized.

The tax rate in fiscal 2015 was higher than in the previous year both because the losses that were not able to be benefitted for tax purposes were significantly higher and because the Company received no benefit from the lower statutory tax rate in those countries. There was a dividend of \$2.3 million paid from the Company's subsidiary in Brazil to the U.S. parent company out of the subsidiary's fiscal 2015 earnings. While the dividend is fully taxable in the U.S., the impact to tax expense was negligible due to the use of foreign tax credits.

In fiscal 2014, the tax authorities in China reviewed the intercompany transfer pricing of a Chinese subsidiary and made adjustments to the prices for tax purposes to the calendar years 2010 through 2012. The net result was a substantial reduction in the Company's carryforward tax losses and a small payment of tax and penalties; the net effect was to increase tax expense by \$0.2 million which is included in the tax reserve adjustments. Since the Company had a history of tax losses, there was a full valuation allowance reflected against the tax impact of the loss carryforward at June 30, 2013. The entity also had substantial profits in fiscal 2014. As a result, the full amount of its carryforward tax losses, after audit adjustments, were utilized and the valuation allowance reducing the deferred tax assets for those losses and other temporary differences was released. The effect was a reduction in the valuation allowance of \$0.4 million in fiscal 2014.

The Company recorded a \$0.3 million deferred income tax expense in the year ended June 30, 2014 to reflect the impact of a corporate tax rate reduction in the United Kingdom. The tax rate reduction from 23 percent to 20 percent received royal assent during fiscal 2014 and the impact of that reduction on our deferred tax assets was recorded in the first quarter of that year.



Total deferred tax assets net of deferred tax liabilities at June 30, 2016 are \$29.6 million. While these deferred tax assets reflect the tax effect of temporary differences between book and taxable income in all jurisdictions in which the Company has operations, the majority of the assets relate to operations in the U.S. where the Company had book losses in the current year. The Company has considered the positive and negative evidence to determine the need for a valuation allowance offsetting the deferred tax assets in the U.S. and has concluded that it is more likely than not that the deferred tax assets net of the recorded valuation allowance will be realized.

Key positive evidence considered include: a) Significant domestic book profits in 2014 and 2015; b) losses in fiscal 2016 are primarily due to one-time events including a \$19 million pension expense, most of which is not deductible for tax purposes until paid; c) cost saving plans are being implemented by the Company; d) prior year taxable income is available for carryback losses; e) tax planning opportunities, including an election to revoke the LIFO election; and f) forecasted domestic profits for future years. The negative evidence considered is that fiscal 2016 showed domestic book and tax losses.

A valuation allowance has been provided on certain foreign NOLs due to the uncertainty of generating future taxable income in those jurisdictions. Similarly, a valuation allowance has been provided on certain U.S. state NOLs as a result of their much shorter carryforward periods and the uncertainty of generating adequate taxable income at the entity and state level. In addition, a valuation allowance has been provided for foreign tax credit carryforwards due to the uncertainty of generating sufficient foreign source income in the future.

In fiscal 2016, the valuation allowance increased by \$0.7 million primarily due to the increase for foreign losses. In fiscal 2015, the valuation allowance increased by \$1.2 million - \$0.7 million due to the increase in foreign carryforward losses and \$0.5 million due to the increase in foreign tax credits in excess of the foreign source income limitation in fiscal 2015.

Deferred income taxes at June 30, 2016 and 2015 are attributable to the following (in thousands):

|  | <b>2016</b> | <b>2015</b> |
|--|-------------|-------------|
| Deferred tax assets (current):         |             |             |
| Inventories                            | \$2,888     | \$2,597     |
| Employee benefits (other than pension) | 988         | 1,016       |
| Book reserves                          | 1,347       | 818         |
| Other                                  | 308         | 687         |
| Total current deferred tax assets      | 5,531       | 5,118       |
| Valuation allowance                    | (1,013 )    | (564 )      |
| Current deferred tax asset             | \$4,518     | \$4,554     |

## Deferred tax assets (long-term):

|   |          |          |
|---|----------|----------|
| State NOL, various carryforward periods               | \$975    | \$801    |
| Foreign NOL, various carryforward periods             | 1,738    | 1,908    |
| Foreign tax credit carryforward, expiring 2017 – 2026 | 2,638    | 2,405    |
| Pension benefits                                      | 19,573   | 13,224   |
| Retiree medical benefits                              | 2,790    | 2,499    |
| Depreciation  | 286      | -        |
| Intangibles   | 1,243    | 1,713    |
| Other   | 274      | 190      |
| Total long-term deferred tax assets                   | 29,517   | 22,740   |
| Valuation allowance                                   | (4,233 ) | (3,937 ) |
| Long-term deferred tax asset                          | \$25,284 | \$18,803 |

## Deferred tax liabilities (long-term):

|                                    |          |          |
|------------------------------------|----------|----------|
| Depreciation                       | (187 )   | (1,548 ) |
| Long-term deferred tax liabilities | (187 )   | (1,548 ) |
| Net deferred tax assets            | \$29,615 | \$21,809 |

Foreign operations deferred tax assets relate primarily to inventory (current) and pension benefits (long term). Amounts related to foreign operations included in the long-term portion of deferred tax liabilities relate to depreciation.

The Company is subject to U.S. federal income tax and various state, local and foreign income taxes in numerous jurisdictions. The Company's domestic and international tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues and expenses. Additionally, the amount of income taxes paid is subject to the Company's interpretation of applicable tax laws in the jurisdictions in which it files.

Reconciliations of the beginning and ending amount of unrecognized tax benefits are as follows (in thousands):

|   |            |
|---|------------|
| Balance at June 30, 2013  | \$(10,978) |
| Increases for tax positions taken in prior years                | (204 )     |
| Increases for tax positions taken during the current period     | (259 )     |
| Effect of exchange rate changes                                 | (9 )       |
| Decrease relating to settlement                                 | 241        |
| Balance at June 30, 2014  | (11,209)   |
| Increases for tax positions taken during the current period     | (405 )     |
| Effect of exchange rate changes                                 | 440        |
| Decrease relating to lapse of applicable statute of limitations | 42         |
| Balance at June 30, 2015  | (11,132)   |
| Increases for tax positions taken during the current period     | (184 )     |
| Effect of exchange rate changes                                 | 82         |
| Decrease relating to lapse of applicable statute of limitations | 414        |
| Balance at June 30, 2016  | \$(10,820) |

The long-term tax obligations as of June 30, 2016 and 2015 relate primarily to transfer pricing adjustments. The Company has also recorded a non-current tax receivable for \$2.7 million and \$3.4 million at June 30, 2016 and 2015, respectively, representing the corollary effect of transfer pricing competent authority adjustments.

The Company has identified no new uncertain tax positions at June 30, 2016 for which it is currently likely that the total amount of unrecognized tax benefits will significantly increase or decrease within the next twelve months. The Company recognizes interest and penalties related to income tax matters in income tax expense and has booked an increase of \$0.1 million in fiscal 2016 for interest expense.

The Company's U.S. federal tax returns for years prior to fiscal 2013 are no longer subject to U.S. federal examination by the Internal Revenue Service; however, tax losses carried forward from earlier years are still subject to review and adjustment. In fiscal 2014, the tax authorities in China audited the transfer pricing of Starrett's subsidiary in that country for calendar years 2010 through 2012. Adjustments reduced the tax loss carryforward and required a tax and penalty payment for calendar 2011. As of June 30, 2016, the Company has resolved all open income tax audits. In international jurisdictions: Australia, Brazil, Canada, China, Germany, Japan, Mexico, New Zealand, Singapore and

the United Kingdom, the years that may be examined vary by country. The Company's most significant foreign subsidiary in Brazil is subject to audit for the calendar years 2011 through 2015.

The state tax loss carryforwards tax effected benefit of \$1.0 million expires at various times over the next 2 to 20 years. The foreign tax credit carryforward of \$2.6 million expires in the years 2017 through 2026 and has a full valuation allowance against it.

At June 30, 2016, the estimated amount of total unremitted earnings of foreign subsidiaries is \$67.0 million. The Company received a cash dividend from a foreign subsidiary of \$2.3 million in fiscal 2015 out of earnings for that year. The Company has no plans to repatriate prior year earnings of its foreign subsidiaries and, accordingly, no estimate of the unrecognized deferred taxes related to these earnings has been made. Cash held in foreign subsidiaries is not available for use in the U.S. without the likely incurrence of U.S. federal and state income tax consequences.

## 12. EMPLOYEE BENEFIT AND RETIREMENT PLANS

The Company has two defined benefit pension plans, one for U.S. employees and another for U.K. employees. The UK plan was closed to new entrants in fiscal 2009. The Company has a postretirement medical and life insurance benefit plan for U.S. employees. The Company also has defined contribution plans.

The Company amended its Postretirement Medical Plan effective December 31, 2013 whereby the Company terminated eligibility for employees ages 55-64. For retirees 65 and older, the Company's contribution is fixed at \$28.50 or \$23.00 per month depending upon the plan the retiree has chosen.

The total cost of all such plans for fiscal 2016, 2015 and 2014 was \$22.2 million, \$4.6 million and \$5.0 million, respectively. Included in these amounts are the Company's contributions to the defined contribution plans amounting to \$0.8 million, \$0.8 million and \$1.2 million in fiscal 2016, 2015 and 2014, respectively.

Under both U.S and U.K. defined benefit plans, benefits are based on years of service and final average earnings. Plan assets consist primarily of investment grade debt obligations, marketable equity securities and shares of the Company's common stock. The asset allocation of the Company's domestic pension plan is diversified, consisting primarily of investments in equity and debt securities. The Company seeks a long-term investment return that is reasonable given prevailing capital market expectations. Target allocations are 40% to 70% in equities (including 10% to 20% in Company stock), and 30% to 60% in cash and debt securities.

In fiscal 2017 the Company will use an expected long-term rate of return assumption of 5.0% for the U.S. domestic pension plan, and 3.6% for the U.K. plan. In determining these assumptions, the Company considers the historical returns and expectations for future returns for each asset class as well as the target asset allocation of the pension portfolio as a whole. In fiscal 2016 and 2015, the Company used a discount rate assumption of 3.77% and 4.49% for the U.S. plan and 3.00% and 3.90% for the U.K. plan, respectively. In determining these assumptions, the Company considers published third party data appropriate for the plans.

Other than the discount rate, pension valuation assumptions are generally long-term and not subject to short-term market fluctuations, although they may be adjusted as warranted by structural shifts in economic or demographic outlooks. Long-term assumptions are reviewed annually to ensure they do not produce results inconsistent with current market conditions. The discount rate is adjusted annually based on corporate investment grade (rated AA or better) bond yields, the maturities of which are correlated with the expected timing of future benefit payments, as of the measurement date.

Based upon the actuarial valuations performed on the Company's defined benefit plans as of June 30, 2016, the U.S. plan will require a \$4.1 million contribution in fiscal 2017 and the U.K. plan will require a \$1.0 million contribution in fiscal 2017.

The table below sets forth the actual asset allocation for the assets within the Company's plans.

|                         | <b>2016</b> |   | <b>2015</b> |   |
|-------------------------|-------------|---|-------------|---|
| Asset category:         |             |   |             |   |
| Cash equivalents        | 0           | % | 1           | % |
| Fixed income            | 18          | % | 17          | % |
| Equities                | 27          | % | 25          | % |
| Mutual and pooled funds | 55          | % | 57          | % |
|                         | 100         | % | 100         | % |

The Company determines its investments strategies based upon the composition of the beneficiaries in its defined benefit plans and the relative time horizons that those beneficiaries are projected to receive payouts from the plans. The Company engages an independent investment firm to manage the U.S. pension assets.

Cash equivalents are held in money market funds.

The Company's fixed income portfolio includes mutual funds that hold a combination of short-term, investment-grade fixed income securities and a diversified selection of investment-grade, fixed income securities, including corporate securities and U.S. government securities.

The Company invests in equity securities, which are diversified across a spectrum of value and growth in large, medium and small capitalization as appropriate to achieve the objective of a balanced portfolio and optimize the expected returns and volatility in the various asset classes.

Other assets include pooled investment funds whose underlying assets consist primarily of property holdings as well as financial instruments designed to offset the long-term impact of inflation and interest rate fluctuations.

In accordance with “ASC 820 Fair Value Measurement”, the Company has categorized its financial assets (including its pension plan assets), based on the priority of the inputs to the valuation technique, into a three-level fair value hierarchy as set forth below. If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

Financial assets are categorized based on the inputs to the valuation techniques as follows:

- Level 1 – Financial assets whose values are based on unadjusted quoted prices for identical assets or liabilities in an active market which the Company has the ability to access at the measurement date.
- Level 2 – Financial assets whose value are based on quoted market prices in markets where trading occurs infrequently or whose values are based on quoted prices of instruments with similar attributes in active markets.
- Level 3 – Financial assets whose values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs reflect management’s own view about the assumptions a market participant would use in pricing the asset.

The tables below show the portfolio by valuation category as of June 30, 2016 and June 30, 2015 (in thousands).

**June 30, 2016**

| <b>Asset Category</b> | <b>Level 1</b>  | <b>Level 2</b>  | <b>Level 3</b> | <b>Total</b>     | <b>%</b>    |
|-----------------------|-----------------|-----------------|----------------|------------------|-------------|
| Cash Equivalent       | \$672           | \$-             | \$-            | \$672            | 0 %         |
| Fixed Income          | -               | 20,342          | -              | 20,342           | 18 %        |
| Equities              | 28,639          | 2,435           | -              | 31,074           | 27 %        |
| Mutual & Pooled Funds | 30,057          | 30,060          | 2,810          | 62,927           | 55 %        |
| <b>Total</b>          | <b>\$59,368</b> | <b>\$52,837</b> | <b>\$2,810</b> | <b>\$115,015</b> | <b>100%</b> |

**June 30, 2015**

| <b>Asset Category</b> | <b>Level 1</b> | <b>Level 2</b> | <b>Total</b> | <b>%</b> |
|-----------------------|----------------|----------------|--------------|----------|
|-----------------------|----------------|----------------|--------------|----------|

|                       | <b>Level</b> |          |         |           |      |
|-----------------------|--------------|----------|---------|-----------|------|
|                       | <b>3</b>     |          |         |           |      |
| Cash Equivalent       | \$1,064      | \$-      | \$-     | \$1,064   | 1 %  |
| Fixed Income          | -            | 21,058   | -       | 21,058    | 17 % |
| Equities              | 27,960       | 3,210    | -       | 31,170    | 25 % |
| Mutual & Pooled Funds | 31,873       | 33,538   | 4,084   | 69,495    | 57 % |
| Total                 | \$60,897     | \$57,806 | \$4,084 | \$122,787 | 100% |

Included in equity securities at June 30, 2016 and 2015 are shares of the Company's common stock having a fair value of \$9.7 million and \$12.5 million, respectively.



A reconciliation of the beginning and ending balances of Level 3 assets is as follows (in thousands):

|                          | <b>Fair Value<br/>Measurement<br/>Using<br/><br/>Significant<br/>Unobservable<br/>Inputs<br/><br/>(Level 3)</b> |             |
|--------------------------|---|-------------|
|                          | <b>2016</b>   | <b>2015</b> |
| Beginning balance        | \$4,084   | \$3,895     |
| Actual returns on assets | (718 )  | 507         |
| Translation loss         | (556 )  | (318 )      |
| Ending balance           | \$2,810   | \$4,084     |

The Level 3 assets consist of units of a pooled investment fund which invests in a mix of properties selected from across retail, office, industrial and other sectors predominantly located in the U.K. In addition to direct investments, the fund may also invest indirectly in property through investment vehicles such as quoted and unquoted property companies or collective investment trusts. Redemptions from the fund are not readily available given the illiquid nature of its assets.

**U.S. and U.K. Plans Combined:**

The status of these defined benefit plans is as follows (in thousands):

|  | 2016        | 2015        | 2014        |
|--|-------------|-------------|-------------|
| Change in benefit obligation   |             |             |             |
| Benefit obligation at beginning of year  | \$ 166,189  | \$ 161,062  | \$ 141,316  |
| Service cost   | 2,757       | 2,663       | 2,709       |
| Interest cost  | 7,032       | 6,818       | 6,922       |
| Participant contributions  | -           | -           | 183         |
| Exchange rate changes  | (7,825 )    | (4,167 )    | 5,359       |
| Benefits paid  | (6,590 )    | (6,524 )    | (5,956 )    |
| Actuarial (gain) loss  | 13,670      | 6,337       | 10,529      |
| Benefit obligation at end of year  | \$ 175,233  | \$ 166,189  | \$ 161,062  |
| Change in plan assets  |             |             |             |
| Fair value of plan assets at beginning of year   | 122,787     | 122,924     | 109,326     |
| Actual return on plan assets   | 226         | 3,466       | 14,105      |
| Employer contributions   | 4,482       | 6,049       | 1,171       |
| Participant contributions  | -           | -           | 183         |
| Benefits paid  | (6,590 )    | (6,524 )    | (5,956 )    |
| Exchange rate changes  | (5,890 )    | (3,128 )    | 4,095       |
| Fair value of plan assets at end of year   | 115,015     | 122,787     | 122,924     |
| Funded status at end of year   | \$(60,218 ) | \$(43,402 ) | \$(38,138 ) |
| Amounts recognized in balance sheet  |             |             |             |
| Current liability  | \$(45 )     | \$(37 )     | \$(37 )     |
| Noncurrent liability   | (60,173 )   | (43,365 )   | (38,101 )   |
| Net amount recognized in balance sheet   | \$(60,218 ) | \$(43,402 ) | \$(38,138 ) |
| Amounts not yet reflected in net periodic benefit costs and included in accumulated other comprehensive loss |             |             |             |
| Prior service cost   | \$-         | \$-         | \$-         |
| Accumulated loss   | (17,849 )   | (16,795 )   | (8,686 )    |
| Amounts not yet recognized as a component of net periodic benefit cost                                       | (17,849 )   | (16,795 )   | (8,686 )    |
| Accumulated net periodic benefit cost in excess of contributions   | (42,369 )   | (26,607 )   | (29,452 )   |
| Net amount recognized  | \$(60,218 ) | \$(43,402 ) | \$(38,138 ) |
| Components of net periodic benefit cost  |             |             |             |
| Service cost   | \$2,757     | \$2,663     | \$2,709     |
| Interest cost  | 7,032       | 6,818       | 6,922       |
| Expected return on plan assets   | (6,268 )    | (6,966 )    | (6,332 )    |
| Amortization of prior service cost   | -           | -           | 116         |

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|   |           |           |           |
|---|-----------|-----------|-----------|
| Recognized actuarial loss   | 17,878    | 1,309     | 398       |
| Net periodic benefit cost   | \$21,399  | \$3,824   | \$3,813   |
| Estimated amounts that will be amortized from accumulated other comprehensive loss over the next year |           |           |           |
| Prior service cost  | \$-       | \$-       | \$(30 )   |
| Net loss  | (114 )    | (53 )     | -         |
| Information for pension plans with accumulated benefits in excess of plan assets                      |           |           |           |
| Projected benefit obligation  | \$175,233 | \$166,189 | \$161,062 |
| Accumulated benefit obligation  | 168,119   | 159,174   | 154,163   |
| Fair value of assets  | 115,015   | 122,787   | 122,924   |

**U.S. Plan:**

The status of the U.S. defined benefit plan is as follows (in thousands):

|   | <b>2016</b> |   | <b>2015</b> |   | <b>2014</b> |
|---|-------------|---|-------------|---|-------------|
| Change in benefit obligation  |             |   |             |   |             |
| Benefit obligation at beginning of year   | \$116,398   |   | \$110,054   |   | \$99,788    |
| Service cost  | 2,757       |   | 2,663       |   | 2,326       |
| Interest cost   | 5,248       |   | 4,839       |   | 4,868       |
| Benefits paid   | (4,593 )    |   | (4,372 )    |   | (4,263 )    |
| Actuarial loss  | 11,053      |   | 3,214       |   | 7,335       |
| Benefit obligation at end of year   | \$130,863   |   | \$116,398   |   | \$110,054   |
| Weighted average assumptions – benefit obligation   |             |   |             |   |             |
| Discount rate   | 3.77        | % | 4.49        | % | 4.29        |
| Rate of compensation increase   | Varies      |   | Varies      |   | Varies      |
| Change in plan assets   |             |   |             |   |             |
| Fair value of plan assets at beginning of year  | \$84,853    |   | \$84,629    |   | \$77,208    |
| Actual return on plan assets  | (1,730 )    |   | (274 )      |   | 11,661      |
| Employer contributions  | 3,380       |   | 4,870       |   | 23          |
| Benefits paid   | (4,593 )    |   | (4,372 )    |   | (4,263 )    |
| Fair value of plan assets at end of year  | 81,910      |   | 84,853      |   | 84,629      |
| Funded status at end of year  | \$(48,953 ) |   | \$(31,545 ) |   | \$(25,425 ) |
| Amounts recognized in balance sheet   |             |   |             |   |             |
| Current liability   | \$(45 )     |   | \$(37 )     |   | \$(37 )     |
| Noncurrent liability  | (48,908 )   |   | (31,508 )   |   | (25,388 )   |
| Net amount recognized in balance sheet  | \$(48,953 ) |   | \$(31,545 ) |   | \$(25,425 ) |
| Weighted average assumptions – net periodic benefit cost  |             |   |             |   |             |
| Discount rate   | 4.49        | % | 4.29        | % | 4.96        |
| Rate of compensation increase   | Varies      |   | Varies      |   | Varies      |
| Return on plan assets   | 5.50        | % | 6.00        | % | 6.00        |
| Amounts not yet reflected in net periodic benefit cost and included in accumulated other comprehensive loss |             |   |             |   |             |
| Prior service cost  | \$-         |   | \$-         |   | \$-         |
| Accumulated loss  | (13,412 )   |   | (11,817 )   |   | (3,585 )    |
| Amounts not yet recognized as a component of net periodic benefit cost                                      | (13,412 )   |   | (11,817 )   |   | (3,585 )    |
| Accumulated contributions less than net periodic benefit cost   | (35,541 )   |   | (19,728 )   |   | (21,840 )   |
| Net amount recognized   | \$(48,953 ) |   | \$(31,545 ) |   | \$(25,425 ) |
| Components of net periodic benefit cost   |             |   |             |   |             |

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|                                    |          |          |          |
|------------------------------------|----------|----------|----------|
| Service cost                       | \$2,757  | \$2,663  | \$2,326  |
| Interest cost                      | 5,248    | 4,839    | 4,868    |
| Expected return on plan assets     | (4,589 ) | (5,063 ) | (4,484 ) |
| Amortization of prior service cost | -        | -        | 116      |
| Recognized actuarial loss          | 15,779   | 319      | 12       |
| Net periodic benefit cost          | \$19,195 | \$2,758  | \$2,838  |

Estimated amounts that will be amortized from accumulated other comprehensive loss over the next year

|                    |        |       |         |
|--------------------|--------|-------|---------|
| Prior service cost | \$-    | \$-   | \$(30 ) |
| Net loss           | (114 ) | (53 ) | -       |

Information for plan with accumulated benefits in excess of plan assets

|                                |           |           |           |
|--------------------------------|-----------|-----------|-----------|
| Projected benefit obligation   | \$130,863 | \$116,398 | \$110,054 |
| Accumulated benefit obligation | 123,749   | 109,383   | 103,155   |
| Fair value of assets           | 81,910    | 84,853    | 84,629    |

**U.K. Plan:**

The status of the U.K. defined benefit plan is as follows (in thousands):

|   | <b>2016</b> | <b>2015</b> | <b>2014</b> |   |          |   |
|---|-------------|-------------|-------------|---|----------|---|
| <b>Change in benefit obligation</b>   |             |             |             |   |          |   |
| Benefit obligation at beginning of year   | \$49,791    | \$51,008    | \$41,528    |   |          |   |
| Service cost  | 0           | 0           | 383         |   |          |   |
| Interest cost   | 1,784       | 1,979       | 2,054       |   |          |   |
| Participant contributions   | -           | -           | 183         |   |          |   |
| Exchange rate changes   | (7,825 )    | (4,167 )    | 5,359       |   |          |   |
| Benefits paid   | (1,997 )    | (2,152 )    | (1,693 )    |   |          |   |
| Actuarial loss  | 2,617       | 3,123       | 3,194       |   |          |   |
| Benefit obligation at end of year   | \$44,370    | \$49,791    | \$51,008    |   |          |   |
| <b>Weighted average assumptions - benefit obligation</b>  |             |             |             |   |          |   |
| Discount rate   | 3.00        | %           | 3.90        | % | 4.30     | % |
| Rate of compensation increase   | n/a         |             | n/a         |   | n/a      | % |
| <b>Change in plan assets</b>  |             |             |             |   |          |   |
| Fair value of plan assets at beginning of year  | \$37,934    | \$38,295    | \$32,118    |   |          |   |
| Actual return on plan assets  | 1,956       | 3,740       | 2,444       |   |          |   |
| Employer contributions  | 1,102       | 1,179       | 1,148       |   |          |   |
| Participant contributions   | -           | -           | 183         |   |          |   |
| Benefits paid   | (1,997 )    | (2,152 )    | (1,693 )    |   |          |   |
| Exchange rate changes   | (5,890 )    | (3,128 )    | 4,095       |   |          |   |
| Fair value of plan assets at end of year  | 33,105      | 37,934      | 38,295      |   |          |   |
| Funded status at end of year  | \$(11,265)  | \$(11,857)  | (12,713)    |   |          |   |
| Amounts recognized in balance sheet   |             |             |             |   |          |   |
| Current liability   | \$—         | \$—         | \$—         |   |          |   |
| Noncurrent liability  | (11,265)    | (11,857)    | (12,713)    |   |          |   |
| Net amount recognized in balance sheet  | \$(11,265)  | \$(11,857)  | \$(12,713)  |   |          |   |
| <b>Weighted average assumptions – net periodic benefit cost</b>   |             |             |             |   |          |   |
| Discount rate   | 3.90        | %           | 4.30        | % | 4.70     | % |
| Rate of compensation increase   | n/a         |             | n/a         |   | 3.10     | % |
| Return on plan assets   | 4.77        | %           | 5.45        | % | 5.40     | % |
| <b>Amounts not yet reflected in net periodic benefit costs and included in accumulated other comprehensive loss</b> |             |             |             |   |          |   |
| Prior service cost  | \$—         |             | \$—         |   | \$—      |   |
| Accumulated loss  | (4,437 )    |             | (4,978 )    |   | (5,101 ) |   |
| Amounts not yet recognized as a component of net periodic benefit cost  | (4,437 )    |             | (4,978 )    |   | (5,101 ) |   |

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|   |            |            |            |
|---|------------|------------|------------|
| Accumulated net periodic benefit cost in excess of contributions                                      | (6,828 )   | (6,879 )   | (7,612 )   |
| Net amount recognized   | \$(11,265) | \$(11,857) | \$(12,713) |
| Components of net periodic benefit cost   |            |            |            |
| Service cost  | \$—        | \$—        | \$383      |
| Interest cost   | 1,784      | 1,979      | 2,054      |
| Expected return on plan assets  | (1,679 )   | (1,903 )   | (1,848 )   |
| Amortization of net loss  | 2,099      | 990        | 386        |
| Net periodic benefit cost   | \$2,204    | \$1,066    | \$975      |
| Estimated amounts that will be amortized from accumulated other comprehensive loss over the next year |            |            |            |
|   | \$—        | \$—        | \$—        |
| Information for plan with accumulated benefits in excess of plan assets                               |            |            |            |
| Projected benefit obligation  | \$44,370   | \$49,791   | \$51,008   |
| Accumulated benefit obligation  | 44,370     | 49,791     | 51,008     |
| Fair value of assets  | 33,104     | 37,934     | 38,295     |

**Postretirement Medical and Life Insurance Benefits:**

The status of the U.S. postretirement medical and life insurance benefit plan is as follows (in thousands):

|   | <b>2016</b> | <b>2015</b> | <b>2014</b> |  |  |
|---|-------------|-------------|-------------|--|--|
| Change in benefit obligation:   |             |             |             |  |  |
| Benefit obligation at beginning of year   | \$6,611     | \$5,867     | \$10,964    |  |  |
| Service cost  | 105         | 113         | 225         |  |  |
| Interest cost   | 287         | 244         | 396         |  |  |
| Plan amendments   | —           | —           | (5,730 )    |  |  |
| Benefits paid   | (772 )      | (647 )      | (429 )      |  |  |
| Actuarial (gain) loss   | 1,150       | 1,034       | 441         |  |  |
| Benefit obligation at end of year   | \$7,381     | \$6,611     | \$5,867     |  |  |
| Weighted average assumptions: benefit obligations   |             |             |             |  |  |
| Discount rate   | 3.77 %      | 4.49 %      | 4.29 %      |  |  |
| Rate of compensation increase   | 2.64 %      | 2.64 %      | 2.64 %      |  |  |
| Change in plan assets   |             |             |             |  |  |
| Fair value of plan assets at beginning of year  | \$—         | \$—         | \$—         |  |  |
| Employer contributions  | 772         | 647         | 429         |  |  |
| Benefits paid, net of employee contributions  | (772 )      | (647 )      | (429 )      |  |  |
| Fair value of plan assets at end of year  | —           | —           | —           |  |  |
| Amounts recognized in balance sheet   |             |             |             |  |  |
| Current postretirement benefit obligation   | \$(396 )    | \$(441 )    | \$(379 )    |  |  |
| Non-current postretirement benefit obligation   | (6,985)     | (6,170 )    | (5,488 )    |  |  |
| Net amount recognized in balance sheet  | \$(7,381)   | \$(6,611 )  | \$(5,867 )  |  |  |
| Weighted average assumptions – net periodic benefit cost  |             |             |             |  |  |
| Discount rate   | 4.49 %      | 4.29 %      | 4.96 %      |  |  |
| Rate of compensation increase   | 2.64 %      | 2.64 %      | 2.64 %      |  |  |
| Amounts not yet reflected in net periodic benefit cost and included in accumulated other comprehensive loss |             |             |             |  |  |
| Prior service credit  | \$4,523     | \$5,305     | \$6,104     |  |  |
| Accumulated gain (loss)   | (1,983)     | (850 )      | 185         |  |  |
| Amounts not yet recognized as a component of net periodic benefit cost                                      | 2,540       | 4,455       | 6,289       |  |  |
| Net periodic benefit cost in excess of accumulated contributions  | (9,921)     | (11,066)    | (12,156)    |  |  |
| Net amount recognized   | \$(7,381)   | \$(6,611 )  | \$(5,867 )  |  |  |
| Components of net periodic benefit cost   |             |             |             |  |  |
| Service cost  | \$105       | \$113       | \$225       |  |  |
| Interest cost   | 287         | 244         | 396         |  |  |



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|                                      |          |          |          |
|--------------------------------------|----------|----------|----------|
| Amortization of prior service credit | (781 )   | (799 )   | (771 )   |
| Amortization of accumulated loss     | 15       | —        | (1 )     |
| Net periodic benefit cost            | \$(374 ) | \$(442 ) | \$(151 ) |

Estimated amounts that will be amortized from accumulated other comprehensive loss over the next year

|                      |        |       |       |
|----------------------|--------|-------|-------|
| Prior service credit | \$673  | \$781 | \$799 |
| Net loss             | (120 ) | (15 ) | —     |
|                      | \$553  | \$766 | \$799 |

|  |        |        |        |
|--|--------|--------|--------|
| Healthcare cost trend rate assumed for next year                     | 6.90 % | 8.00 % | 8.30 % |
| Rate to which the cost trend rate gradually declines                 | 4.50 % | 4.50 % | 4.50 % |
| Year that the rate reaches the rate at which it is assumed to remain | 2027   | 2027   | 2026   |

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects (in thousands):

|  | <b>1% Increase</b> |             |             |
|--|--------------------|-------------|-------------|
|  | <b>2016</b>        | <b>2015</b> | <b>2014</b> |
| Effect on total of service and interest cost | \$-                | \$ -        | \$ 35       |
| Effect on postretirement benefit obligation  | 2                  | 4           | 7           |

|  | <b>1% Decrease</b> |             |             |
|--|--------------------|-------------|-------------|
|  | <b>2016</b>        | <b>2015</b> | <b>2014</b> |
| Effect on total of service and interest cost | \$-                | \$ -        | \$(30)      |
| Effect on postretirement benefit obligation  | (2)                | (4)         | (7)         |

For fiscal 2017, the Company expects to make a \$4.0 million contribution to the qualified domestic pension plan, \$45,000 to the nonqualified domestic pension plan, \$1.0 million to the U.K. pension plan, and \$396,000 to the postretirement medical and life insurance plan.

Future pension and other benefit payments are as follows (in thousands):

| <b>Fiscal Year</b> | <b>Pension</b> | <b>Other Benefits</b> |
|--------------------|----------------|-----------------------|
| 2017               | \$6,700        | \$ 396                |
| 2018               | 6,997          | 363                   |
| 2019               | 7,326          | 358                   |
| 2020               | 7,656          | 364                   |
| 2021               | 7,966          | 370                   |
| 2022-2026          | 45,924         | 1,926                 |

### 13. DEBT

Debt, including capitalized lease obligations, is comprised of the following (in thousands):

|   | June 30,<br>2016 | June 30,<br>2015 |
|---|------------------|------------------|
| <u>Short-term and current maturities</u>            |                  |                  |
| Loan and Security Agreement                         | \$1,543          | \$1,474          |
| Capitalized leases                                  | -                | 78               |
|   | \$1,543          | \$1,552          |
| <u>Long-term debt</u>                               |                  |                  |
| Loan and Security Agreement, net of current portion | \$17,109         | \$18,552         |
|   | 17,109           | 18,552           |
| Total debt  | \$18,652         | \$20,104         |

Future maturities of debt are as follows (in thousands):

| <b>Fiscal Year</b> |          |
|--------------------|----------|
| 2017               | \$1,543  |
| 2018               | 11,014   |
| 2019               | 1,688    |
| 2020               | 1,765    |
| 2021               | 1,846    |
| Thereafter         | 796      |
| Total              | \$18,652 |

The Company completed the negotiations for an amended Loan and Security Agreement and executed the new agreement as of April 25, 2015. Borrowings under this agreement may not exceed \$23.0 million. The agreement expires on April 30, 2018 and has an interest rate of LIBOR plus 1.5%. The effective interest rate under the agreement for fiscal 2016 was 2.20%.

The material financial covenants of the amended Loan and Security Agreement are: 1) funded debt to EBITDA, excluding non-cash and retirement benefit expenses (“maximum leverage”), cannot exceed 2.25 to 1; 2) annual capital expenditures cannot exceed \$15.0 million; 3) maintain a Debt Service Coverage Rate of a minimum of 1.25 to 1 and 4) maintain consolidated cash plus liquid investments of not less than \$10.0 million at any time. As of June 30, 2016, the Company was in compliance with all the covenants. The Company expects to be able to meet the covenants in future periods.

On November 22, 2011, in conjunction with the Bytewise acquisition, the Company entered into a new \$15.5 million term loan (the “Term Loan”) under the then existing Loan and Security Agreement. The term loan is a ten year loan bearing a fixed interest rate of 4.5% and is payable in fixed monthly payments of principal and interest of \$160,640. The \$15.5 million term loan is subject to the same financial covenants as the Loan and Security Agreement. As of June 30, 2016, \$9.3 million of the term loan was outstanding.

Availability under the Line of Credit is subject to a borrowing base comprised of accounts receivable and inventory. The Company believes that the borrowing base will consistently produce availability under the Line of Credit in excess of \$23.0 million. As of June 30, 2016, the Company had borrowings of \$9.4 million under this facility. A 0.25% commitment fee is charged on the unused portion of the Line of Credit.

The Company has one standby letter of credit totaling \$0.9 million which reduces the \$23.0 million available Line of Credit to \$22.1 million. As of June 30, 2016, the Company has approximately \$12.7 million available in the Line of Credit.

The obligations under the Credit Facility are unsecured. In the event of certain triggering events, such obligations would become secured by the assets of the Company’s domestic subsidiaries. A triggering event occurs when the Company fails to achieve any of the financial covenants noted above in consecutive quarters.

## **14. COMMON STOCK**

Class B common stock is identical to Class A except that it has 10 votes per share, is generally nontransferable except to lineal descendants of stockholders, cannot receive more dividends than Class A, and can be converted to Class A at any time. Class A common stock is entitled to elect 25% of the directors to be elected at each meeting with the remaining 75% being elected by Class A and Class B voting together.

## **15. CONTINGENCIES**

The Company is involved in certain legal matters which arise in the normal course of business, which are not expected to have a material impact on the Company's financial condition, results of operations and cash flows.

## **16. CONCENTRATIONS OF CREDIT RISK**

The Company believes it has no significant concentration of credit risk as of June 30, 2016. Trade receivables are dispersed among a large number of retailers, distributors and industrial accounts in many countries, with none exceeding 10% of consolidated sales.

## **17. FINANCIAL INFORMATION BY SEGMENT & GEOGRAPHIC AREA**

The Company offers its broad array of measuring and cutting products to the market through multiple channels of distribution throughout the world. The Company's products include precision tools, electronic gages, gage blocks, optical vision and laser measuring equipment, custom engineered granite solutions, tape measures, levels, chalk products, squares, band saw blades, hole saws, hacksaw blades, jig saw blades, reciprocating saw blades, M1® lubricant and precision ground flat stock. The Company reviews and manages its business geographically and has historically made decisions based on worldwide operations. In fiscal 2016, the Company changed its reportable business segment from one reportable segment to two reportable segments, specifically, North American Operations and International Operations. The Company has recast its segment information disclosure for all periods presented to conform to this segment presentation.

The North American segment's operations include all manufacturing and sales in the United States, Canada and Mexico. The International segment's operations include all locations outside North America, primarily in Brazil, United Kingdom and China. The chief operating decision maker reviews operations on a geographical basis and decisions about where to invest the Company's resources are made based on the current results and forecasts of operations in those geographies. Since the markets for the Company's products are sufficiently different in North America than they are in the rest of the world and in view of the significant impact that currency fluctuation plays outside the United States on the revenue of the Company, the Company's business review separates North America from operations outside North America. For this reason, the Company is reflecting two operating segments that align with management's review of operations and decisions to allocate resources.

Segment income is measured for internal reporting purposes by excluding corporate expenses, other income and expense including interest income and interest expense and income taxes. Corporate expenses consist primarily of executive compensation, certain professional fees, and costs associated with the Company's global headquarters. Financial results for each reportable segment are as follows (in thousands):

**Year Ended June 30, 2016**

**North**

|                                | <b>America</b> | <b>International</b> | <b>Unallocated</b> | <b>Total<sup>1</sup></b> |
|--------------------------------|----------------|----------------------|--------------------|--------------------------|
| Sales                          | \$130,108      | \$ 79,577            | \$                 | \$209,685                |
| Operating income               | (8,311 )       | (3,117 )             | (9,017 )           | (20,445 )                |
| Asset impairment               | (4,114 )       | -                    |                    | (4,114 )                 |
| Capital expenditures           | 5,040          | 3,200                |                    | 8,240                    |
| Depreciation and amortization  | 4,537          | 2,677                |                    | 7,214                    |
| Current assets <sup>4</sup>    | 33,787         | 62,810               | 24,314             | 120,911                  |
| Long-lived assets <sup>5</sup> | 36,539         | 13,995               | 30,153             | 80,687                   |

**Year Ended June 30, 2015**

**North**

|                                | <b>America</b> | <b>International</b> | <b>Unallocated</b> | <b>Total<sup>2</sup></b> |
|--------------------------------|----------------|----------------------|--------------------|--------------------------|
| Sales                          | \$137,085      | \$ 104,465           | \$                 | \$241,550                |
| Operating income               | 13,353         | 1,333                | (6,083 )           | 8,603                    |
| Capital expenditures           | 3,449          | 2,251                |                    | 5,700                    |
| Depreciation and amortization  | 5,604          | 3,113                |                    | 8,717                    |
| Current assets <sup>4</sup>    | 41,240         | 68,656               | 23,517             | 133,413                  |
| Long-lived assets <sup>5</sup> | 40,506         | 14,066               | 24,287             | 78,859                   |

**Year Ended June 30, 2014**

**North**

|  | <b>America</b> | <b>International</b> | <b>Unallocated</b> | <b>Total<sup>3</sup></b> |
|--|----------------|----------------------|--------------------|--------------------------|
|--|----------------|----------------------|--------------------|--------------------------|

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|                                |            |            |          |           |
|--------------------------------|------------|------------|----------|-----------|
| Sales                          | \$ 129,287 | \$ 117,847 | \$       | \$247,134 |
| Operating income               | 11,231     | 7,831      | (7,147 ) | 11,915    |
| Capital expenditures           | 3,116      | 5,720      |          | 8,836     |
| Depreciation and amortization  | 5,948      | 3,410      |          | 9,358     |
| Current assets <sup>4</sup>    | 40,716     | 75,193     | 30,993   | 146,902   |
| Long-lived assets <sup>5</sup> | 43,127     | 19,203     | 22,211   | 84,541    |

---

<sup>1</sup> Excludes \$8,259 of North American segment sales to the International segment and \$9,282 sales of the International segment to the North American segment.

<sup>2</sup> Excludes \$12,276 of North American segment sales to the International segment and \$9,842 sales of the International segment to the North American segment.

<sup>3</sup> Excludes \$17,692 of North American segment sales to the International segment and \$8,585 sales of the International segment to the North American segment.

<sup>4</sup> Current assets primarily consist of accounts receivable, inventories and prepaid expenses. Assets not allocated to the segments include cash and cash equivalents, deferred income taxes, and other non-current assets.

Geographic information about the Company's sales and long-lived assets are as follows (in thousands):

Sales

|                         | <b>Year Ended June 30,</b> |             |             |
|-------------------------|----------------------------|-------------|-------------|
|                         | <b>2016</b>                | <b>2015</b> | <b>2014</b> |
| North America           |                            |             |             |
| United States           | \$119,638                  | \$125,534   | \$117,249   |
| Canada & Mexico         | 10,470                     | 11,551      | 12,038      |
|                         | 130,108                    | 137,085     | 129,287     |
| International           |                            |             |             |
| Brazil                  | 43,283                     | 63,961      | 74,478      |
| United Kingdom          | 24,485                     | 26,691      | 28,322      |
| China                   | 7,207                      | 8,357       | 9,322       |
| Australia & New Zealand | 4,602                      | 5,456       | 5,725       |
|                         | 79,577                     | 104,465     | 117,847     |
| Total Sales             | \$209,685                  | \$241,550   | \$247,134   |

Long-lived Assets

|                         | <b>Year Ended June 30,</b> |             |             |
|-------------------------|----------------------------|-------------|-------------|
|                         | <b>2016</b>                | <b>2015</b> | <b>2014</b> |
| North America           |                            |             |             |
| United States           | \$36,189                   | \$40,146    | \$42,740    |
| Canada & Mexico         | 350                        | 360         | 387         |
|                         | 36,539                     | 40,506      | 43,127      |
| International           |                            |             |             |
| Brazil                  | 8,818                      | 7,986       | 12,334      |
| United Kingdom          | 2,143                      | 2,647       | 3,093       |
| China                   | 2,887                      | 3,291       | 3,558       |
| Australia & New Zealand | 147                        | 142         | 218         |
|                         | 13,995                     | 14,066      | 19,203      |
| Total Long Lived Assets | \$50,534                   | \$54,572    | \$62,330    |

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<sup>5</sup> Long lived assets consist of property, plant and equipment, goodwill, and other intangible assets. Long term deferred and other tax assets not allocated to the segments.





**18. QUARTERLY FINANCIAL DATA (unaudited)**

(in thousands except per share data)

| Quarter Ended  | Net<br>Sales | Gross<br>Margin | Earnings                  |                                | Basic and<br>Diluted<br>Earnings |
|----------------|--------------|-----------------|---------------------------|--------------------------------|----------------------------------|
|                |              |                 | Before<br>Income<br>Taxes | Net<br>Earnings<br>/<br>(Loss) | / (Loss)<br>Per<br>Share         |
| September 2014 | \$60,172     | \$19,143        | \$1,741                   | \$923                          | \$ 0.13                          |
| December 2014  | 63,821       | 22,164          | 4,323                     | 2,447                          | 0.35                             |
| March 2015     | 56,116       | 18,694          | 3,508                     | 2,437                          | 0.35                             |
| June 2015      | 61,441       | 16,694          | 370                       | (563 )                         | (0.08 )                          |
|                | \$241,550    | \$76,695        | \$9,942                   | \$5,244                        | \$ 0.75                          |
| September 2015 | \$51,038     | \$15,852        | \$482                     | \$(178 )                       | \$(0.03 )                        |
| December 2015  | 53,671       | 15,999          | 992                       | 458                            | 0.07                             |
| March 2016     | 50,329       | 14,733          | 1,199                     | 597                            | 0.09                             |
| June 2016      | 54,647       | 404             | (23,048 )                 | (15,007 )                      | (2.14 )                          |
|                | \$209,685    | \$46,988        | \$(20,375 )               | \$(14,130 )                    | \$(2.01 )                        |

Fourth quarter sales in fiscal 2016 were \$6.8 million lower than in the fourth quarter of fiscal 2015. Unfavorable exchange rates represented \$2.6 million of the difference. In addition, precision hand tool and saw sales declined \$4.4 million in the fourth quarter of fiscal 2016 compared to fiscal 2015. Gross margins declined \$16.3 million with a non-cash pension charge of \$14.2 million representing approximately 90% of the decline. Lower sales of precision hand tool and saw sales accounted for the majority of the additional \$2.1 million decline.

**19. RELATED PARTY TRANSACTIONS**

In the fourth quarter of fiscal 2016, Mr. Guilherme Camargo was appointed Operations Manager of Armco do Brasil S.A. (Armco.) Armco is the largest supplier of steel to our subsidiary in Brazil. Mr. Camargo is the son of Salvador de Camargo, who is the president of our subsidiary in Brazil and a member of the board of directors. The Company plans to implement policies and procedures to ensure transactions between Starrett Brazil and Armco remain at “arms-length” in the future as they have been in the past. The Company made annual purchases from Armco of \$3.2 million, \$4.1 million and \$3.7 million in fiscal 2016, 2015 and 2014 respectively. The Company had accounts payable of \$0 and \$0.1 million as of June 30, 2016 and June 30, 2015 respectively.

**Item 9 - Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A - Controls and Procedures**

Pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934, we carried out an evaluation, with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined under Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this annual report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of such date in ensuring that information required to be filed in this annual report was recorded, processed, summarized and reported within the time period required by the rules and regulations of the Securities and Exchange Commission, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There have been no changes in internal control over financial reporting during the quarter that materially affected, or are reasonably likely materially affect, the Company's internal control over financial reporting

### **Management's Report on Internal Control Over Financial Reporting**

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Internal control over financial reporting includes those written policies and procedures that:

- Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and acquisitions and dispositions of the assets of the Company;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America;
  - Provide reasonable assurance that receipts and expenditures of the Company are being made only in accordance with authorization of management and directors of the Company; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect all misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting as of June 30, 2016. Management based this assessment on criteria established in the 2013 *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Management's assessment included an evaluation of the design of the Company's internal control over financial reporting and testing of the operational effectiveness of its internal control over financial reporting. Management reviewed the results of its assessment with the Audit Committee of the Board of Directors.

Based on our assessment, management concluded that as of June 30, 2016 our internal control over financial reporting was effective based on those criteria.

The Company's internal control over financial reporting as of June 30, 2016 has been audited by Grant Thornton LLP, an independent registered public accounting firm, as stated in their report included herein.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders

The L.S. Starrett Company

We have audited the internal control over financial reporting of The L.S. Starrett Company (a Massachusetts corporation) and subsidiaries (the “Company”) as of June 30, 2016, based on criteria established in the 2013 *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying “Management’s Report on Internal Control Over Financial Reporting.” Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, The L.S. Starrett Company and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of June 30, 2016, based on criteria established in the 2013 *Internal Control—Integrated Framework* issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of the Company as of and for the year ended June 30, 2016 and our report dated August 24, 2016 expressed an unqualified opinion on those financial statements.

/s/ Grant Thornton LLP

Boston, Massachusetts

August 24, 2016

**Item 9B - Other Information**

None.

**PART III****Item 10 – Directors, Executive Officers and Corporate Governance**

The information concerning the Directors of the Registrant will be contained immediately under the heading “Election of Directors” and prior to Section A of Part I in the Company’s definitive Proxy Statement for the Annual Meeting of Stockholders to be held on October 12, 2016 (the “2016 Proxy Statement”), which will be mailed to stockholders on or about September 9, 2016. The information in that portion of the 2016 Proxy Statement is hereby incorporated by reference.

**Executive Officers of the Registrant**

| Name                | Age | Held Present | Position                              |
|---------------------|-----|--------------|---------------------------------------|
|                     |     | Office Since |                                       |
| Douglas A. Starrett | 64  | 2001         | President and CEO and Director        |
| Francis J. O’Brien  | 69  | 2009         | Chief Financial Officer and Treasurer |
| Anthony M. Aspin    | 63  | 2000         | Vice President Sales                  |
| James B. Taylor     | 50  | 2015         | Vice President Operations             |

Douglas A. Starrett has been President of the Company since 1995 and became CEO in 2001.

Francis J. O’Brien was previously Chief Financial Officer at Delta Education, LLC, an elementary school education company, from 2005 to 2009. Prior to Delta Education, he was Chief Financial Officer at StockerYale Corporation, a publicly traded technology company, from 2001 to 2004 and Director of Finance and Business Development at Analogic Corporation, a publicly traded manufacturer of medical and security systems, from 1998 to 2000. Mr. O’Brien served as Corporate Vice President of Finance & Administration for Addison Wesley, a global education company, from 1982 to 1997 and as Senior Manager at Coopers & Lybrand, an international public accounting firm, from 1976 to 1982. Mr. O’Brien holds a BA from the University of Massachusetts and an MBA from Suffolk University and is a Certified Public Accountant.



Anthony M. Aspin was previously a divisional sales manager with the Company.

Mr. Taylor joined the Company on June 22, 2015. He was previously Division Vice President, Operations for Zygo Corporation, a unit of Ametek's Ultra Precision Technologies Division, from 2014 to 2015, Director of Optical components Manufacturing of Zygo Corporation from 2010 to 2014, and Vice President of JML Optical Industries, Inc. from 2004 to 2010. Mr. Taylor holds a Bachelor's degree, a Master's degree, and a Doctorate in Industrial Engineering from Purdue University.

The positions listed above represent their principal occupations and employment during the last five years.

The President and Treasurer hold office until the first meeting of the directors following the next annual meeting of stockholders and until their respective successors are chosen and qualified, and each other officer holds office until the first meeting of directors following the next annual meeting of stockholders, unless a shorter period shall have been specified by the terms of his election or appointment or, in each case, until he sooner dies, resigns, is removed or becomes disqualified.

There have been no events under any bankruptcy act, no criminal proceedings and no judgments or injunctions material to the evaluation of the ability and integrity of any executive officer during the past ten years.

### **Code of Ethics**

The Company has adopted a Policy on Business Conduct and Ethics (the "Ethics Policy") applicable to all directors, officers and employees of the Company. The Code is intended to promote honest and ethical conduct, full and accurate reporting, and compliance with laws as well as other matters. The Ethics Policy is available on the Company's website at [www.starrett.com](http://www.starrett.com). Stockholders may also obtain free of charge a printed copy of the Ethics Policy by writing to the Clerk of the Company at The L.S. Starrett Company, 121 Crescent Street, Athol, MA 01331. We intend to disclose any future amendments to, or waivers from, the Ethics Policy within four business days of the waiver or amendment through a website posting or by filing a Current Report on Form 8-K with the Securities and Exchange Commission.

**Item 11 - Executive Compensation**

The information concerning management remuneration will be contained under the heading “General Information Relating to the Board of Directors and Its Committees,” and in Sections C-H of Part I of the Company’s 2015 Proxy Statement, and is hereby incorporated by reference.

On July 15, 2010, the Company entered into a Change of Control Agreement with Francis J. O’Brien. The terms of Mr. O’Brien’s Agreement are described in section H in the Company’s 2016 Proxy Statement, which is hereby incorporated by reference.

**Item 12 - Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

(a) The following table gives information about the Company’s common stock that may be issued upon the exercise of options, warrants and rights under the Company’s 2012 Employees’ Stock Purchase Plan (“2012 Plan”) as of June 30, 2016. The 2012 Plan was approved by stockholders at the Company’s 2012 annual meeting and shares of Class A or Class B common stock may be issued under the 2012 Plan. Options are not issued under the Company’s Employees’ Stock Purchase Plan that was adopted in 1952.

| <b>Plan Category</b> | <b>Number of<br/>Securities<br/>to be issued<br/>Upon<br/>Exercise of<br/>Outstanding<br/>Options,<br/>Warrants<br/>and Rights<br/>(a)</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price of<br/>Outstanding<br/>Options,<br/>Warrants<br/>and Rights<br/>(b)</b> | <b>Number of<br/>Securities<br/>Remaining<br/>Available<br/>For Future<br/>Issuance<br/>Under<br/>Equity<br/>Compen-<br/>sation<br/>Plans (Ex-</b> |
|----------------------|--|--|--|
|----------------------|--|--|--|

|  |        |          | cluding<br>Securities<br>Reflected<br>in<br>Column<br>(a)<br>(c) |
|--|--------|----------|--|
| Equity compensation plans approved by security holders     | 63,915 | \$ 10.45 | 389,844  |
| Equity compensation plans not approved by security holders | —      | —        | —  |
| Total  | 63,915 | \$ 10.45 | 389,844  |

(b) Security ownership of certain beneficial owners:

The information concerning a more than 5% holder of any class of the Company's voting shares will be contained under the heading "Security Ownership of Certain Beneficial Owners" in Section I of Part I of the Company's 2016 Proxy Statement, and is hereby incorporated by reference.

(c) Security ownership of directors and officers:

The information concerning the beneficial ownership of each class of equity securities by all directors, and all directors and officers of the Company as a group, will be contained under the heading "Security Ownership of directors and officers" in Section I of Part I in the Company's 2016 Proxy Statement. These portions of the 2016 Proxy Statement are hereby incorporated by reference.

(d) The Company knows of no arrangements that may, at a subsequent date, result in a change in control of the Company.

**Item 13 - Certain Relationships and Related Transactions, and Director Independence**

The information required by this Item 13 will be contained in the Company's 2016 Proxy Statement, and is hereby incorporated by reference.

**Item 14 - Principal Accountant Fees and Services**

The information required by this Item 14 will be contained in the Audit Fee table in Section B of Part I in the Company's 2016 Proxy Statement. These portions of the Proxy Statement are hereby incorporated by reference.

**PART IV**

**Item 15 – Exhibits, Financial Statement Schedules**

(a) 1. Financial statements filed in Item 8 of this annual report:

Consolidated Balance Sheets at June 30, 2016 and June 30, 2015.

Consolidated Statements of Operations for each of the years in the three year period ended June 30, 2016.

Consolidated Statements of Comprehensive Income (Loss) for each of the years in the three year period ended June 30, 2016.

Consolidated Statements of Stockholders' Equity for each of the years in the three year period ended June 30, 2016.

Consolidated Statements of Cash Flows for each of the years in the three year period ended June 30, 2016.

Notes to Consolidated Financial Statements

2. The following consolidated financial statement schedule of the Company included in this annual report on Form 10-K is filed herewith pursuant to Item 15(c) and appears immediately before the Exhibit Index:

**SCHEDULE II – VALUATION AND QUALIFYING ACCOUNTS**

**Schedule II**

**Valuation and Qualifying Accounts****Allowance for Doubtful Accounts**

| <i>(in 000)</i>                  | <b>Balance</b>   |                   | <b>Charges</b>  |                   | <b>Balance</b> |
|----------------------------------|------------------|-------------------|-----------------|-------------------|----------------|
|                                  | <b>at</b>        |                   | <b>to</b>       |                   | <b>at</b>      |
|                                  | <b>Beginning</b> | <b>Provisions</b> | <b>Other</b>    | <b>Write-offs</b> | <b>End of</b>  |
|                                  | <b>of Period</b> |                   | <b>Accounts</b> |                   | <b>Period</b>  |
| Allowance for Doubtful Accounts: |                  |                   |                 |                   |                |
| Year Ended June 30, 2016         | \$ 612           | \$ 352            | \$ (2 )         | \$ (75 )          | \$ 887         |
| Year Ended June 30, 2015         | 704              | 179               | (163 )          | (108 )            | 612            |
| Year Ended June 30, 2014         | 697              | 27                | 27              | (47 )             | 704            |

**Valuation Allowance on Deferred Tax Asset**

| <i>(in 000)</i>          | <b>Balance</b>   |                   | <b>Charges</b>  |                   | <b>Balance</b> |
|--------------------------|------------------|-------------------|-----------------|-------------------|----------------|
|                          | <b>at</b>        |                   | <b>to</b>       |                   | <b>at</b>      |
|                          | <b>Beginning</b> | <b>Provisions</b> | <b>Other</b>    | <b>Write-offs</b> | <b>End of</b>  |
|                          | <b>of Period</b> |                   | <b>Accounts</b> |                   | <b>Period</b>  |
| Year Ended June 30, 2016 | \$ 4,501         | \$ 1,193          | \$ (344 )       | \$ (104 )         | \$ 5,246       |
| Year Ended June 30, 2015 | 3,334            | 1,242             | (24 )           | (51 )             | 4,501          |
| Year Ended June 30, 2014 | 4,539            | 302               | (355 )          | (1,152 )          | 3,334          |

All other financial statement schedules are omitted because they are inapplicable, not required under the instructions, or the information is reflected in the financial statements or notes thereto.

3. See Exhibit Index below. Compensatory plans or arrangements are identified by an “\*.”

(b) See Exhibit Index below.

(c) Not applicable.

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**THE L.S. STARRETT COMPANY AND SUBSIDIARIES - EXHIBIT INDEX**

Exhibit

3a. Restated Articles of Organization as amended, filed with Form 10-K for the year ended June 30, 2012, is hereby incorporated by reference.

3b. Amended and Restated Bylaws, filed with Form 10-Q for the quarter ended December 31, 2012, is hereby incorporated by reference.

4a. Rights Agreement dated as of November 2, 2010 between the Company and Mellon Investor Services LLC, as Rights Agent (together with exhibits, including the Form of Rights Certificate, and the Summary of Rights to Purchase Shares of Class A Common Stock), filed with Form 10-Q for the quarter ended September 25, 2010, is hereby incorporated by reference.

4b. Amendment No. 1 to Rights Agreement dated as of February 5, 2013 by and between the Company and Computershare Shareowner Services LLC, filed with Form 10-Q for the quarter ended December 31, 2012, is hereby incorporated by reference.

10a. Form of indemnification agreement with directors and executive officers, filed with Form 10-K for the year ended June 29, 2002, is hereby incorporated by reference.

10b\*. The L.S. Starrett Company Supplemental Executive Retirement Plan, as amended and restated on January 1, 2009 is hereby incorporated by reference.

10c\*. The L.S. Starrett Company 401(k) Stock Savings Plan (2001 Restatement), filed with Form 10-K for the year ended June 29, 2002 is hereby incorporated by reference.

10d\*. The L.S. Starrett Company Employee Stock Ownership Plan and Trust Agreement, as amended, filed with Form 10-K for the year ended June 30, 2012 is hereby incorporated by reference.

10e\*. Amendment dated April 1, 2003 to the Company's 401(k) Stock Savings Plan, filed with Form 10-K for the year ended June 28, 2003, is hereby incorporated by reference.



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10f\* Amendment dated October 20, 2003 to the Company's 401(k) Stock Savings Plan, filed with Form 10-Q for the quarter ended September 27, 2003, is hereby incorporated by reference.

10g Amendment dated as of June 24, 2006 to the Company's Amended and Restated Credit Agreement, filed with Form 10-K for the year ended June 24, 2006, is hereby incorporated by reference.

10h Loan and Security Agreement dated as of June 30, 2009 by and among the Company, certain subsidiaries of the Company, and TD Bank, N.A., as lender as amended through April 25, 2012, filed with Form 10-K for the year ended June 30, 2012, is hereby incorporated by reference.

10i\* 2007 Employees' Stock Purchase Plan filed with the Definitive Proxy Statement for the 2008 Annual Meeting of Stockholders is hereby incorporated by reference.

10j Change in Control Agreement, dated January 16, 2009, between the Company and Douglas A. Starrett, filed with Form 10-Q for the quarter ended December 27, 2008, is hereby incorporated by reference.

10k Form of Non-Compete Agreement, dated as of January 16, 2009, executed separately by the Company and each of Francis J. O'Brien, Douglas A Starrett and Stephen F. Walsh on July 15, 2010, January 16, 2009 and January 16, 2009, filed with Form 10-Q for the quarter ended December 27, 2008, is hereby incorporated by reference.

10l\* The L. S. Starrett Company 2013 Employee Stock Ownership Plan and Trust Agreement, filed with Form 10-Q for the quarter ended March 31, 2013, is hereby incorporated by reference.

- 10m\* First Amendment to The L. S. Starrett Company 2013 Employee Stock Ownership Plan and Trust Agreement, dated December 31, 2013 is hereby incorporated by reference.
- 10n\* The L.S. Starrett Company 2012 Employees' Stock Purchase Plan, filed with the Company's Registration Statement on Form S-8 (File No. 333-184934) filed on November 14, 2012, is hereby incorporated by reference.
- 10o\* The L.S. Starrett Company 2012 Long-Term Incentive Plan, filed with the Company's Registration Statement on Form S-8 (File No. 333-184934) filed on November 14, 2012, is hereby incorporated by reference.
- 10p Form of Non-Statutory Stock Option Agreement under The L.S. Starrett Company 2012 Long-Term Incentive Plan, filed with Form 10-Q for the quarter ended December 31, 2012, is hereby incorporated by reference.
- 10q Form of Director Non-Statutory Stock Option Agreement under The L.S. Starrett Company 2012 Long-Term Incentive Plan, filed with Form 10-Q for the quarter ended December 31, 2012, is hereby incorporated by reference.
- 10r Form of Restricted Stock Unit Agreement under The L.S. Starrett Company 2012 Long-Term Incentive Plan, filed with Form 10-Q for the quarter ended December 31, 2012, is hereby incorporated by reference.
- 10s Form of Director Restricted Stock Unit Agreement under The L.S. Starrett Company 2012 Long-Term Incentive Plan, filed with Form 10-Q for the quarter ended December 31, 2012, is hereby incorporated by reference.
- 10t\* Cash Bonus Plan for executives officers of the Company, filed with Form 10-K for the year ended June 30, 2013, is hereby incorporated by reference.
- 10u Amendment dated December 23, 2013 to the Company's amended Loan and Security Agreement, is hereby incorporated by reference.
- 10v Amendment dated January 26, 2015 to the Loan and Security Agreement dated as of June 30, 2009 by and among the Company, certain subsidiaries of the Company, and TD Bank, N.A., as lender, filed with Form 10-K for the year ended June 30, 2015, is hereby incorporated by reference.
- 21 Subsidiaries of the L.S. Starrett Company, filed herewith.
- 23 Consent of Independent Registered Public Accounting Firm, filed herewith.
- 31a Certification of Chief Executive Officer Pursuant to Rule 13a-14(a), filed herewith.
- 31b Certification of Chief Financial Officer Pursuant to Rule 13a-14(a), filed herewith.
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Rule 13a-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code), filed herewith.

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The following materials from The L. S. Starrett Company Annual Report on Form 10-K for the year ended June 30, 2016 are furnished herewith, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Comprehensive Income (Loss), (iv) the Consolidated Statements of Stockholders' Equity (v) the Consolidated Statements of Cash Flows, and (vi) Notes to the Consolidated Financial Statements, tagged as blocks of text.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**THE L.S. STARRETT COMPANY**

**(Registrant)**

By: /S/ Francis J. O'Brien  
Francis J. O'Brien

Treasurer and Chief Financial Officer

(Principal Accounting Officer)

Date: Aug. 24, 2016

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the date indicated:

/S/DOUGLAS A. STARRETT

Douglas A. Starrett, Aug. 24, 2016

President and CEO and Director (Principal Executive Officer)

/S/SALVADOR DE  
CAMARGO, JR.

Salvador de Camargo, Jr., Aug.  
24, 2016

President and Director

Starrett Industria e Comercio  
Ltda, Brazil

By: /S/ Francis J. O'Brien  
Francis J. O'Brien , Aug. 24, 2016

Treasurer and Chief Financial Officer (Principal Accounting Officer) Director

/S/TERRY A. PIPER

Terry A. Piper, Aug. 24, 2016

/S/RICHARD B. KENNEDY

Richard B. Kennedy, Aug. 24, 2016

/S/STEPHEN F. WALSH

Stephen F Walsh, Aug. 24, 2016

Director

/S/DAVID A. LEMOINE

David A. Lemoine, Aug. 24, 2016

Director

Senior Vice President Operations and Director

/S/RALPH G. LAWRENCE

Ralph G. Lawrence, Aug. 24, 2016

Director