

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934 [FEE REQUIRED]
For the fiscal year ended: May 31, 1998

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934 [NO FEE REQUIRED]
For the transition period from _____ to _____

Commission File Number: 0-23996

SCHMITT INDUSTRIES, INC.
(Exact name of registrant as specified in its charter)

Oregon

91-1151989

(State or other jurisdiction of incorporation or organization) (IRS Employer Identification)

2765 N.W. Nicolai Street
Portland, Oregon 97210
(Address of principal executive offices) (Zip Code)

(503) 227-7908
(Registrant's telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
----- None	----- None

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

Common Stock - no par value
(Title of each class)

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
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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 any amendment to this Form 10-K.

As of August 7, 1998, the aggregate market value of the registrant's Common Stock held by nonaffiliates of the registrant was \$24,992,657 based on the closing sales price of the registrant's Common Stock on the Nasdaq National Market. On that date, there were 7,099,139 shares of Common Stock outstanding.

Portions of the registrant's 1998 Annual Report to Shareholders are incorporated by reference into Parts II and IV hereof, and portions of the registrant's definitive Proxy Statement for its 1998 Annual Meeting of

Shareholders are incorporated by reference into Part III hereof.

PART I

ITEM 1. BUSINESS

INTRODUCTION

The Company designs, assembles and markets computer-controlled balancing equipment for use primarily by the machine tool industry. Through its wholly owned subsidiary, Schmitt Measurement Systems, Inc. ("SMS"), a Montana corporation, the Company also designs, manufactures and markets precision laser measurement systems.

The Company was incorporated under the laws of British Columbia, Canada in 1984. The name of the Company was changed to Schmitt Industries Inc. in 1987. In February 1996, the Company was "continued" from British Columbia to the state of Wyoming and then merged into its wholly owned subsidiary, Schmitt Industries, Inc., an Oregon corporation; Schmitt Industries, Inc. was the surviving entity.

The Company acquired its original balancing equipment technology pursuant to a series of agreements from 1987 through 1991. The patented technology has been substantially enhanced and advanced by the Company in the past decade.

In May 1995, the Company acquired TMA Technologies Inc. ("TMA"), a designer, assembler and marketer of innovative industrial measurement systems based on laser light scatter technologies. For all of the outstanding shares of TMA, the Company paid \$15,000, assumed approximately \$515,000 of TMA debt and agreed to make royalty payments to TMA's shareholders of 5% on sales of TMA products and future Company products that utilize TMA's technologies, hardware, software and existing patents, subject to a maximum royalty of \$6 million. In June 1995, TMA began operations in Portland and subsequently changed its name to Schmitt Measurement Systems, Inc. ("SMS")

In June 1996, the Company formed a wholly owned subsidiary, Schmitt Europe, Ltd., under the laws of Great Britain to market and sell the Company's products in Great Britain.

In December 1996, the Company completed the acquisition of the assets of the grinding wheel balancer division of Hofmann Maschinenbau GmbH of Germany. The Company operates this business as Schmitt Hofmann Systems GmbH, a wholly owned subsidiary of the Company ("SHS"). The Company purchased the assets from Hofmann Maschinenbau GmbH for \$496,000.

The Company's executive offices are located at 2765 N.W. Nicolai Street, Portland, Oregon 97210, and its telephone number is (503) 227-7908.

BALANCING PRODUCTS

The Company's principal product is the Schmitt Dynamic Balance System (the "SBS System"). It consists of a computer control unit, sensor, spindle mounting adapter, and balance head. It was designed to be an inexpensive, yet highly accurate, permanent installation on grinding machines. Today, the SBS System is beginning to be evaluated by manufacturers for additional applications including large electric motors, industrial fans, industrial brushing devices, turbines and similar devices.

The SBS System is fully automated and consequently the user does not have to pre-balance such devices as grinding wheels. This reduces the setup time of such operations and ensures a smoother and more efficient operation.

The SBS System operates on a principle of mass compensation for wheel imbalance. The balance head contains two movable eccentric weights, each of which is driven by electric motors through a precision gear train. These weights can be repositioned to offset any imbalance in a grinding wheel or other application. Imbalance or vibration is picked up by the sensor. The signal is fed to a controller that filters the signal by revolutions per minute. The

controller then drives the two balance head weights in the direction that reduces the amplitude of the vibration signal. When the weights are positioned so the lowest vibration level is reached, the balance cycle is complete.

Notable features of the SBS System include its ability to fit almost all machines, ease of installation, compact and modular construction, ability to balance a wheel while on a machine, elimination of wheel vibration, automatic monitor of balance, display in both English and metric systems, instrument grade calibration, short balance process, measurement of both displacement and/or velocity, and minimal user maintenance.

Benefits to the system user include improved quality of finished parts, ease of product adaptation, minimal downtime, complete and ready installation, elimination of need for static balancing, longer life for wheels, dressings, diamonds and spindle bearings, the ability to balance within 0.2 microns and its adaptability to all types of machines.

The precision grinding industry has a worldwide presence and is established in all industrialized countries. In each major industrialized country there are three major market segments: the machine tool builders, the rebuilders and grinding machine users.

The first major market segment consists of machine tool builders who actually design and manufacture a variety of cylindrical, surface, and specialty application grinding machines that are sold at home and also exported to foreign markets. SBS System products are distributed to a variety of world markets through OEM (original equipment manufacturer) accounts, where a special pricing (20%) discount is offered to the machine builder if the designer incorporates the SBS System into its machine.

Examples of some of well-known worldwide machine tool builders who have offered and/or installed the SBS System include ANCA (Australia), Bryant Grinders Corporation (U.S.), Blohm Incorporated (U.S.), Blohm GmbH (Germany), Capco Machinery (U.S.), Cincinnati Milacron (U.S.), Ecotech/SMTW (China/U.S.), Gold Crown Machinery (U.S.), Gleason Works (U.S.), Litton IAS/Landis Grinding (U.S.), Micron Machinery Limited (Japan/U.S.), Normac Incorporated (U.S.), NTC Toyama America (U.S./Japan), Okomoto (Japan), Okuma Machine (Japan), Royal Master Grinders (U.S.), Shigiya Machine (Japan), Sumitomo Heavy Industry (Japan), CETOS Hostivar (Czech Republic), TOS Holice (Czech Republic), Toyoda Machine (Japan) and Weldon Machine Tool (U.S.).

One successful marketing channel to tool builders is the sale of the SBS System to users who purchase new machines and thereby experience the benefits of the SBS System and then purchase additional units for application to their older machines.

The second major market segment consists of machine tool rebuilders who are found in all industrial nations and who develop their business with users by offering to completely update and refurbish older machine tools. These rebuilders typically tear the old machine apart and install new bearings, new electronics, and new advanced features, such as an SBS Automatic Wheel Balancer. The Company currently sells its product directly to all major machine rebuilders in the U.S. and to some countries in Western Europe.

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Grinding machine users in industrialized countries are the third major market segment. Users become aware of the SBS System through trade shows, trade magazine advertising, distributors, field representatives, referrals and new machine suppliers.

Precision grinding is increasing as a worldwide method of material removal and material processing. Therefore, the Company believes that there may be an increase in market growth and an increase in the need for automatic balancers. Precision grinding is necessary in all major manufacturing areas such as the automotive industry (camshafts, crankshafts, valves), bearings (roller and tapered types), ceramics (precision shaping), electric motors (shafts), pumps (shafts and turbines), aircraft (engine parts), and general manufacturing.

The Company's business is conducted with many customers located throughout the world. Examples of some of the more well known of these include Black & Decker, Briggs and Stratton, Caterpillar Inc., Daewoo International Corp., Eaton

Corporation, Ford Motor Company, General Electric Corp., General Motors, Ingersoll Rand, Sumitomo Heavy Industries, Texas Instruments, The Timken Company, Torrington, TRW Automotive Components and Westinghouse Electric Corp.

The acquisition of SHS has added additional balancer designs to the Company's worldwide product line. The SHS internal spindle balancers and ring balancers add to the total balancer package available from the Company. These proven designs, along with the original water balancer, allow Schmitt to broaden its machine applications. The Company is now developing additional electronic controllers that will operate all Schmitt, including SHS, balancers from a single electronic controller.

In Fiscal 1996, 1997 and 1998, net sales of the Company's balancing products totaled \$4,801,151, \$6,151,473, and \$7,532,112, respectively. Net sales of balancing products accounted for 68% of the Company's revenue in Fiscal 1996, 58% in Fiscal 1997 and 71% in Fiscal 1998. See Note 8 to Consolidated Financial Statements.

COMPETITION. Management believes that the SBS System is the only fully automatic balancing system marketed in the world. All other competitive balancing products require special setup and training or calibration to the specific machine. The Company believes that the SBS System is currently the only balancing product on the market that fits all machines with wheel sizes from 6 to 48 inches in diameter and spindle rpm of 500 through 7,500.

Competitive products include European manufacturers building water balancers and electromechanical balancers similar to the SBS System. Water balancers are currently priced at about 1.5 times the level of the SBS System because of expensive plumbing and water chambers machined into the wheel hub. The machines are disassembled and parts remachined or replaced within the spindle assembly, a process that takes from one to two days. The system is "tuned" or "calibrated" to the machine by a factory service technician. Although water systems are unable to balance at low rpm, they work at mid- and high-speeds when properly monitored by regularly cleaning filters and checking clearance of water jets. This technology is the oldest in the market and is employed in the SHS-installed systems. After the acquisition of SHS in December 1996, the Company considers European electromechanical balancers to be the its major competition due to their established base in Europe.

Electromechanical balancers similar to the SBS System are produced by several European companies, located primarily in Switzerland, Germany, Spain and Italy. These European balancers have deficiencies in electronics which render them less effective in solving essential balancing requirements. They cannot achieve the consistent low balance levels obtained by the SBS System and cannot operate effectively at 500 rpm (low speed) or at 7,500 rpm (high speed). In addition, these balancers have

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inferior brush and cable assemblies which cause down time and high maintenance. None of these companies can compete effectively with the Company in providing mounting adapters for all grinding machines.

The SBS System list price is \$7,800 worldwide. Water balancers produced by German companies other than SHS are priced at \$11,000 to \$15,000, and the electromechanical systems are priced at \$8,000 to \$10,000 worldwide. Market surveys by management indicate that customers perceive values of an automatic balancer to approximately \$8,000; therefore, Company pricing is geared to obtaining a dominant market position and meeting competitive supplier prices. The market strategy is to establish the SBS System as the dominant product with the best quality, reliability and performance and superior economic value.

SCHMITT MEASUREMENT SYSTEMS, INC.

HISTORICAL BACKGROUND. SMS manufactures and markets a line of laser-based, precision measurement systems. In addition, SMS operates a precision light scatter measurement laboratory which is utilized by third-party equipment manufacturers and others.

Light scatter technology involves using lasers, optics and detectors to throw a beam of light on a material sample and recording its reflection/transmission. Analysis of light scatter information can determine

material characteristics such as surface roughness and defects, without introducing contaminants and causing changes to the tested material.

SMS PRODUCTS. The principal products of SMS are laser-based measurement products and technology that can be applied to both military and industrial markets. Historically, TMA (now SMS) did not pursue industrial markets but instead concentrated on military markets. The Company believes that this strategy was a significant contributing factor in the failure of TMA to achieve profitable operations.

The Company believes that the patents, patent applications, trademarks and other proprietary technology acquired with TMA can be successfully refocused into industrial markets, including electronics, computer disk manufacturers and flat-panel display manufacturers.

The Company is developing a product review and marketing plan. Over the long term, the Company expects SMS products to add to sales and profitability of the Company. Net sales of SMS products totaled \$2,278,977 or 32% of the Company's total revenue in Fiscal 1996, \$4,390,499 or 42% of the Company's total revenue in Fiscal 1997, and \$3,093,972 or 29% of the Company's total revenue in Fiscal 1998. See Note 8 to Consolidated Financial Statements.

SMS operates three businesses: a light-scatter measurement laboratory, laser-based light-scatter measurement products and other laser alignment products. SMS provides a highly advanced, extremely precise measurement services laboratory to a wide variety of industrial and commercial businesses, using advanced laser, light scatter technology.

The laboratory uses three SMS CASI Scatterometers for measuring surface roughness. The true value of the laboratory is not only its extremely precise measurement capability but also that the item being tested is not altered, touched or destroyed. Thus, the laboratory is widely used by the semiconductor and computer hard disk industries, as well as manufacturers of critical optical components in aerospace and defense systems. Customers of the laboratory have included Aerojet, AT&T Bell Labs, Eastman Kodak, General Electric, IBM, NASA and dozens of other industrial companies, universities and government agencies.

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The three SMS CASI Scatterometers in the laboratory are angle-resolved BRDF measurement instruments providing customers with precise roughness measurements of optical surfaces, diffuse materials, semiconductor wafers, magnetic storage media, precision-machined surfaces, as well as surfaces affecting the cosmetic appearance of consumer products. A Scatterometer uses ultraviolet or infrared laser light as a nondestructive probe to measure surface quality, optical performance, smoothness, appearance, defects and contamination on a wide variety of materials.

The sample is mounted on stages capable of moving bidirectionally and/or in rotation. The incident angle can be set anywhere up to an 85DEG. angle from surface normal. The detector sweeps around the sample in the incident plane measuring scattered and specular light. During the scan, the computer controls gain, filter and aperture changes through user-defined parameters. The instrument background is measured separately and can be compared with the sample data.

The CASI Analysis Software simplifies analysis of scatter data. BRDF values are used to calculate total integrated scatter, PSD and RMS roughness. Annotated results print on the HP PaintJet printer as viewgraphs or publication-ready figures.

The laboratory generated approximately 2% of SMS's total revenue during Fiscal 1997 and 3% during Fiscal 1998. Total revenue for this business is expected to rise modestly in the future while representing a smaller percentage of SMS's business. Use of the laboratory, leading to orders for SMS's laser-based light scatter measurement products by its customers, represents the best marketing channel for SMS's current and future products. Existing products (such as the Scan and the Model 2002 alignment laser system) and products being developed in conjunction with the measurement services laboratory are being marketed to a variety of industrial customers.

The Scan System consists of a hand-held control unit, an interchangeable

measurement head and a separate charging unit. To perform a measurement, the operator places the measurement head on the objective area and presses the button. Each measurement takes less than five seconds. The results are displayed and stored in system memory. The Scan can store 700 measurements in 255 files and provides the capability to program pass/fail criteria. Software is available for control, analysis and file conversion. From a single measurement, a user can determine RMS surface roughness, reflectance and scatter light levels (BRDF) on flat or curved surfaces under any lighting conditions.

The Auto-Collimating Alignment Laser System - Model 2002 is an extremely accurate laser alignment system. The incorporation of a solid-state laser diode provides increased beam stability and eliminates warm-up time. A new unique TMA See-Thru target design completely eliminates beam displacement and power loss. The addition of an operator selectable auto-collimating feature provides one arc second accuracy over a large angular range. A microprocessor automates system configuration. A new bus interconnect reduces setup time and allows up to seven operator selectable targets, reducing time required to perform measurements. A complete Model 2002 system consists of an auto-collimating laser, power supply, digital display, See-Thru and end targets, carrying case and cable assemblies.

The Company introduced a new product, a Dual Texture Measurement machine called the DTM-2000, in the first half of Fiscal 1998. Using the Company's patented non-contact light scatter process of surface measurement, the automated DTM-2000 provides for measurements on both sides of computer hard disks at 1,200 disks per hour at a measurement range of 2 angstroms to 200 angstroms.

On April 23, 1998, the Company entered into a Technology Transfer Agreement with Centerline Engineering, Inc. and several individuals for the purchase of the rights to a non-contact gauging

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apparatus. The \$100,000 purchase included the technology, the prototype and instruction manuals, technical information, and related patent applications.

BUSINESS AND MARKETING STRATEGY

MARKETING. The Company designs, assembles and markets all of its products, except SMS products which are marketed through a strategic alliance with Veeco Instruments Inc. ("Veeco"). The Company's operations are divided into a number of different areas. The production organization, which is responsible for all assembly, purchasing and production engineering, is directed by the Vice President of Operations. The Product Marketing Division is responsible for the sale of SBS System products. This division is managed by the President/CEO and four Marketing Managers. Three of the Marketing Managers are responsible for domestic sales. The fourth Marketing Manager is responsible for sales in mainland China, Japan and Korea. The President/CEO is responsible for sales in both eastern and western Europe and also oversees the efforts of the four Marketing Managers. The technical services division is responsible for providing technical support to customers and is managed by the Vice President of Operations. In addition, there is a research and development group which is supervised directly by the President/CEO and the Vice President of Operations.

The Company markets and sells the SBS System in a variety of ways. First, the Company uses the conventional channels provided by independent manufacturer's representatives and distributors. There are currently 25 individuals and/or organizations in the United States acting in one of these capacities. Independent sales agents are paid a 10% commission; distributors are sold products at a 15% discount.

Second, trade shows represent a significant amount of marketing/sales effort. These events are held throughout the world and have proven to be excellent sources of business for the Company. A representative from the Company, usually one of the marketing managers and/or Wayne A. Case, attends these events along with local Company representatives. These individuals attend a display booth that features professional products, an SBS System demonstration stand, product literature, and technical literature. Representatives from all facets of the market to which the Company directs its sales efforts attend these trade shows.

Third, original equipment manufacturers often include the SBS System on the machine tools which they produce. Users thus purchase the SBS System

concurrently with the machine tools. The SBS Systems are also often installed by machine builders prior to displaying their own machine tools at various trade shows. These samples often become endorsements that prove to be beneficial to the Company's sales efforts.

In the United States, most products are shipped directly to customers from the Company's distribution center in Portland, Oregon. Where the Company has distributors, the product is shipped to the distributor, who in turn pays the Company directly and then delivers and installs the product for the end user. Western European distribution to customers is handled by shipping the product directly from the Company's Portland headquarters to the end users.

The acquisition of SMS (formerly TMA) has resulted in revision of marketing strategy of both the balancer business and the new measurement products. The Company is evaluating all products acquired through the acquisition of TMA and evaluating existing measurement product and balancing product distributors and agents to determine the most efficient mix.

On February 23, 1998, the Company entered into an Exclusive Distribution Agreement, effective January 1, 1998, with Sloan Technology, Inc. (dba Veeco Process Metrology), a subsidiary of Veeco

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(NASDAQ : VECO), pursuant to which Veeco was appointed the exclusive distributor for the promotion and sale of SMS products. Veeco is also to provide customers with after-sale services. The initial term of the agreement ends on December 31, 1999 and is automatically renewed for consecutive two-year periods unless either party notifies the other of its intention to terminate the agreement six months prior to the expiration of the then current term. This agreement replaces an earlier agreement with Veeco having similar terms and dated September 18, 1996.

In fiscal 1998, approximately 24% of the Company's total revenue was attributable to sales made to Veeco. No other customer accounted for more than 10% of the Company's total revenue in fiscal 1998.

The SBS System customer base consists of over 250 companies. The SMS customer base consists of approximately 200 companies, many of which are also purchasers of the Company's balancing products.

MANUFACTURING. The Company does not use any unique sources of supply or raw materials in its products for either SBS System balancing products or SMS measurement products. Essential electronic components used are available in large quantities from various suppliers. These electronic components are assembled into the SBS System and SMS electronic control units to meet the Company's quality and assembly standards. Company-owned software and firmware are coupled with the electronic components to provide the basis of the Company's various electronic control units. The Company believes several sources of supplies exist for all electronic components and assembly work that is used in its electronic control system. The Company's primary outside supplier of electronic assembly is Laughlin-Wilt Group, Inc. ("Laughlin-Wilt") of Beaverton, Oregon, a custom supplier of assembled electronic products for several Pacific Northwest companies. In the event of supply problems, the Company believes that two or three alternatives could be developed within 30 days to supplement or replace Laughlin-Wilt.

Mechanical parts for the Company's SBS System and SMS products are produced to the customers' drawings and specifications by local high quality CNC machine shops. Several such CNC machine shops exist in the local area, and the Company is not dependent on any one supplier of mechanical components. Principal suppliers of components for the Company's products include MacKay Manufacturing of Spokane, Washington; OEM Manufacturing of Corvallis, Oregon; Eagle Industries of Newberg, Oregon; and Forest City Gear of Roscoe, Illinois.

The Company uses in-house skilled assemblers to construct and test vendor-supplied components. Component inventory of finished vendor-supplied parts is held on the Company property to assure adequate flow of parts to meet customer order requirements. Inventory is monitored by a computer control system designed to assure timely re-ordering of components.

In-house personnel assemble various products and test all finished

components before placing them in the finished goods inventory. Finished goods inventory is maintained via computer to assure timely shipment and service to customers. All customer shipments are from the finished goods inventory.

In November 1996, the Company's Quality Control Program received full ISO-9001 certification.

PATENTS AND TRADEMARKS

SBS SYSTEM PRODUCTS. The Company manufactures its products under copyright protection in the U.S. for all electronic board designs which are also further protected with encapsulation of the finished product to protect the Company's technologies and software. U.S. Patent No. 4951526 was issued to the

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Company in 1990 and covers both the new ring balancer and the existing SBS Balance Heads that the Company markets to the grinding industries.

The trademark "SBS" is a registered trademark of the Company and is affixed to all products and literature created in the Company's balance product line.

The Company pays no licenses or royalties on its balancing technologies and has offered no concessions, labor agreements or royalty agreements on its balancing product lines.

SMS PRODUCTS. The trademark "SMS" is a registered trademark of the Company and is affixed to all products and literature created in the Company's measurement product line.

The following tables include information about patents and trademarks issued and patents pending with respect to SMS products.

SMS PATENTS ISSUED

5196906	1993	Scan: surface measurement
5416590	1995	GapMaster: gap and mismatch
5596403	1997	Pitch, yaw of a single laser beam system and method of measuring angular position
5625451	1997	Methods and apparatus for characterizing a surface
5661556	1997	System for measuring the total integrated scatter of a surface

SMS TRADEMARKS

Scan	1992	Surface measurement system
CASI	1993	Surface inspection system
Accunet	1994	Distance measurement NET
FMS	1994	Finished measurement systems
Surf-Map	1995	Surface inspection process
SMS	1995	Schmitt Measurement System

PRODUCT DEVELOPMENT

Prior to Fiscal 1996, research and development activities of the Company were focused on the enhancement of the existing product lines for balancers and on development work toward the new ring balance product. Since its May 1995 acquisition of TMA, the Company has expended significant efforts evaluating existing and potential new products for the light-scatter precision measurement market.

During Fiscal 1994 and 1995, the Company developed the Ring Balancer, a dynamic balancer shaped as a "ring" that allows the device to be fitted "around" a rotating shaft rather than on the end of a shaft where the current Company products are mounted. This mounting and configuration will allow the Company to apply its ring balancers to virtually any rotating device such as fans, turbines, large motors, centrifuges and other industrial machine tools.

During the last several years, the Company has developed several new major offshoot products of its balancing technologies to widen market opportunities. All costs associated with these developments have been borne directly by the Company's customers, with minimal development costs to the Company. Research and development costs for existing product line enhancements are treated as product improvements and expenses, including costs toward the new Ring Balancer.

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During Fiscal 1998, the Company continued to develop new balancing products and expended considerable time and effort in evaluating and developing new laser-based measurement products. During Fiscal 1998, the Company developed and began marketing the DTM-2000 Automatic Disk Measurement System.

During Fiscal 1996, 1997 and 1998, the Company's research and development expense totaled \$0, \$205,800 and \$379,798, respectively.

INTERNATIONAL SALES

The Company's sales in the last three fiscal years have been generated from the following geographic areas:

	NORTH AMERICA -----	EUROPE -----	ASIA -----
Fiscal 1998	\$ 8,006,428	\$ 2,488,344	\$ 131,312
Fiscal 1997	8,664,819	1,601,369	275,394
Fiscal 1996	6,298,170	442,470	339,488

BACKLOG

The Company does not generally track backlog. Normally, orders are shipped within several weeks after receipt unless the customer requests otherwise.

EMPLOYEES

As of July 15, 1998, the Company employed 50 individuals worldwide on a full-time basis. There were no regular part-time employees. None of the Company's employees is covered by a collective bargaining agreement.

ITEM 2. PROPERTIES

The Company's design and assembly facilities and executive offices are located in a 7,500-square foot building in Portland, Oregon owned by the Company; a 33,000-square foot facility, located across the street from the executive offices and also owned by the Company, houses SMS's operations. Schmitt Europe Ltd. occupies a 1,893-square foot facility in Coventry, England pursuant to a five-year lease beginning February 1, 1997 with a basic monthly rent of L1,708 (approximately \$2,790 as of July 15, 1998). SHS occupies a 5,194-square foot facility in Alsbach, Germany pursuant to a five-year lease beginning February 1, 1997 with a basic monthly rent of DM 5,442 (approximately \$3,022 as of July 15, 1998). The Company believes its facilities are adequate to meet its current needs.

ITEM 3. LEGAL PROCEEDINGS

There are no material legal proceedings currently pending against the Company.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of the security holders of the Company during the fourth quarter ended May 31, 1998.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Since May 5, 1997, the Company's Common Stock has been traded on the Nasdaq National Market; prior to that it was traded on the Nasdaq-Small Cap Market. The Common Stock is traded under the symbol "SMIT."

The following tables set forth the high and low sales prices of the Company's Common Stock as reported on the Nasdaq-Small Cap Market and on the Nasdaq National Market (since May 5, 1997) for the periods indicated.

YEAR ENDED MAY 31, 1997 -----	HIGH -----	LOW -----
First Quarter	\$ 13.75	\$ 8.88
Second Quarter	\$ 11.00	\$ 7.88
Third Quarter	\$ 11.00	\$ 7.88
Fourth Quarter	\$ 10.25	\$ 7.00

YEAR ENDED MAY 31, 1998 -----	HIGH -----	LOW -----
First Quarter	\$9.75	\$7.50
Second Quarter	\$12.00	\$8.00
Third Quarter	\$10.13	\$7.38
Fourth Quarter	\$8.13	\$5.69

As of July 15, 1998, there were 7,099,139 shares of Common Stock outstanding held by 129 holders of record. The number of holders does not include individual participants in security position listings; the Company believes that there are more than 2,500 individual holders of shares of Common Stock.

The Company has not paid any dividends on its Common Stock since 1994. The Company's current policy is to retain earnings to finance the Company's business. Future dividends will be dependent upon the Company's financial condition, results of operations, current and anticipated cash requirements, acquisition plans and plans for expansion and any other factors that the Company's Board of Directors deems relevant. The Company has no present intention of paying dividends on its Common Stock in the foreseeable future.

ITEM 6. SELECTED FINANCIAL DATA

The information required by this Item is included in the Company's Annual Report to Shareholders for the fiscal year ended May 31, 1998 ("Annual Report") under the heading "Selected Financial Data" and is incorporated herein by reference.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The information required by this Item is included in the Annual Report under the heading "Management's Discussion and Analysis" and is incorporated herein by reference.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements and other information required by this Item are included in the Annual Report and are incorporated herein by reference.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS

ON ACCOUNTING AND FINANCIAL DISCLOSURE

In July 1997, the Company replaced its independent accountant, Moss Adams LLP, with PricewaterhouseCoopers LLP. This decision was made by the Audit Committee of the Company's Board of Directors.

Moss Adams LLP's reports for the fiscal years ended May 31, 1996 and May 31, 1997 did not contain an adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles. During Fiscal 1996 and 1997 and until Moss Adams LLP's dismissal, there were no disagreements with Moss Adams LLP on any matter of accounting principles or practices, financial statement disclosure or auditing scope of procedure, which disagreements, if not resolved to the satisfaction of Moss Adams LLP, would have caused it to make reference to the subject matter of the disagreements in connection with its report.

PART III

Certain information required by Part III is included in the Company's definitive Proxy Statement for its 1998 Annual Meeting of Shareholders ("Proxy Statement") and is incorporated herein by reference. The Proxy Statement will be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934 not later than 120 days after the end of the fiscal year covered by this Report.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this item is included in the Proxy Statement under the heading "Proposal No.1: Election of Directors" and is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is included in the Proxy Statement under the heading "Executive Compensation" and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this item is included in the Proxy Statement under the heading "Principal Shareholders" and is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item is included in the definitive Proxy Statement under the heading "Certain Transactions" and is incorporated herein by reference.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) Documents filed as part of this report:

1. INDEPENDENT AUDITOR'S REPORT:

To the Board of Directors and Shareholders of
Schmitt Industries, Inc.

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of income, of cash flows and of changes in stockholders' equity present fairly, in all material respects, the financial position of Schmitt Industries, Inc. and its subsidiaries at May 31, 1998, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit

of these statements in accordance with generally accepted auditing standards which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for the opinion expressed above. The financial statements of Schmitt Industries, Inc. for the years ended May 31, 1996 and 1997 were audited by other independent accountants whose report dated July 10, 1997 expressed an unqualified opinion on those statements.

PricewaterhouseCoopers LLP
Portland, Oregon
July 17, 1998

2. INDEPENDENT AUDITOR'S REPORT:

To the Board of Directors and Stockholders of
Schmitt Industries, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Schmitt Industries, Inc. and Subsidiaries as of May 31, 1997 and 1996, and the related consolidated statements of income, changes in stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis,

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evidence supporting the amounts and disclosures in the consolidated 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 Schmitt Industries, Inc. and Subsidiaries as of May 31, 1997 and 1996, and the results of their operations and cash flows for the years then ended in conformity with generally accepted accounting principles.

Moss Adams LLP
Portland, Oregon
July 10, 1997

3. FINANCIAL STATEMENTS:

The following financial statements required by this Item are included in the Company's Annual Report to Shareholders for the fiscal year ended May 31, 1998 and are incorporated by reference herein:

A. Consolidated Balance Sheets as of May 31, 1998 and May 31, 1997	10
B. Consolidated Statements of Income for each of the years ended May 31, 1998, May 31, 1997 and May 31, 1996	11
C. Consolidated Statements of Cash Flows for each of the years ended May 31, 1998, May 31, 1997 and May 31, 1996	12
D. Consolidated Statements of Changes in Stockholders' Equity for each of the years ended May 31, 1998, May 31, 1997 and May 31, 1996	13
E. Notes to Financial Statements	14

4. FINANCIAL STATEMENT SCHEDULES:

All financial statement schedules are omitted either because they are not applicable, not required, or the required information is included in the financial statements or notes thereto.

(b) Reports on Form 8-K: None.

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.

SCHMITT INDUSTRIES, INC.

By: /s/ Wayne A. Case

Wayne A. Case
CHAIRMAN OF THE BOARD, PRESIDENT
AND CHIEF EXECUTIVE OFFICER

Date: August 28, 1998

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 indicated on August 28, 1998.

SIGNATURE - -----	TITLE -----
/s/ Wayne A. Case - ----- Wayne A. Case	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)
/s/ Annie Windsor - ----- Annie Windsor	Chief Financial Officer (Principal Financial and Accounting Officer)
/s/ David L. Dotlich - ----- David L. Dotlich	Director
/s/ David M. Hudson	Director

 David M. Hudson
 /s/ Trevor Nelson

 Trevor Nelson
 /s/ Dennis T. Pixton

 Dennis T. Pixton

Director

Director

INDEX TO EXHIBITS

EXHIBITS	DESCRIPTION

*3(i)	Second Restated Articles of Incorporation of Schmitt Industries, Inc. (the "Company")
*3(ii)	Second Restated Bylaws of the Company
*10.1	Schmitt Industries, Inc. Amended & Restated Stock Option Plan
10.2	Agreement dated April 21, 1995 between TMA Technologies, Inc. and the Company. Incorporated by reference to Exhibit 10.2 to the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 1996 . .
10.3	Exclusive Distribution Agreement dated February 23, 1998 between Sloan Technology Inc. and the Company. Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended February 28, 1998. (Confidential treatment has been granted for certain portions of this Agreement; these confidential portions have been filed separately with the Securities and Exchange Commission.)
10.4	Sales Contract dated November 19, 1996 between Herr Dirk Pfeil, receiver of Hofmann Maschinenbau GmbH, and Schmitt Hofmann Systems GmbH. Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended February 28, 1997
*10.5	Technology Transfer Agreement dated April 23, 1998 between Centerline Engineering, Inc. and the Company
*13.1	Annual Report to Shareholders of Schmitt Industries, Inc. for fiscal year ended May 31, 1998
*21.1	Subsidiaries of Schmitt Industries, Inc.
*23.1	Consent of PricewaterhouseCoopers LLP
*23.2	Consent of Moss Adams LLP
*27.1	Financial Data Schedule

* Filed herewith

SCHMITT INDUSTRIES, INC.

SECOND RESTATED ARTICLES OF INCORPORATION

ARTICLE I

NAME

The name of this Corporation is Schmitt Industries, Inc.

ARTICLE II

CAPITAL STOCK

2.1 AUTHORIZED CAPITAL. The total number of shares which this Corporation is authorized to issue is 22,000,000, consisting of 20,000,000 shares of Common Stock and 2,000,000 shares of Preferred Stock. The Common Stock is subject to the rights and preferences of the Preferred Stock as hereinafter set forth.

2.2 ISSUANCE OF PREFERRED STOCK IN SERIES. The Preferred Stock may be issued from time to time in one or more series in any manner permitted by law and the provisions of these Second Restated Articles of Incorporation, as determined from time to time by the Board of Directors and stated in the resolution or resolutions providing for the issuance thereof. The Board of Directors shall have the authority to fix, determine and amend, subject to the provisions hereof, the designations, preferences, limitations and relative rights of the shares of any series that is wholly unissued or is to be established. Unless otherwise specifically provided in the resolution establishing any series, the Board of Directors shall further have the authority, after the issuance of shares of a series whose number it has designated, to amend the resolution establishing such series to decrease the number of shares of that series, but not below the number of shares of such series then outstanding. In the event that there are no issued or outstanding shares of a series of Preferred Stock which this Corporation has been authorized to issue, unless otherwise specifically provided in the resolution establishing such series, the Board of Directors, without any further action on the part of the holders of the outstanding shares of any class or series of stock of this corporation, may amend these Second Restated Articles of Incorporation to delete all reference to such series.

2.3 DIVIDENDS. The holders of shares of Preferred Stock shall be entitled to receive dividends, out of the funds of this Corporation legally available therefor, at the rate and at the time or times, whether cumulative or noncumulative, as may be provided by the

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Board of Directors in designating a particular series of Preferred Stock. If such dividends on the Preferred Stock shall be cumulative, then if dividends shall not have been paid, the deficiency shall be fully paid or the dividends declared and set apart for payment at such rate, but without interest on cumulative dividends, before any dividends on the Common Stock shall be paid or declared and set apart for payment. The holders of Preferred Stock shall not be entitled to receive any dividends thereon other than the dividends referred to in this section.

2.4 REDEMPTION. The Preferred Stock may be redeemable at such price, in such amount, and at such time or times as may be provided by the Board of Directors in designating a particular series of Preferred Stock. In any event, such Preferred Stock may be repurchased by this Corporation to the extent legally permissible.

2.5 LIQUIDATION. In the event of any liquidation, dissolution or winding up of the affairs of this Corporation, whether voluntary or involuntary, then,

before any distribution shall be made to the holders of Common Stock, the holders of Preferred Stock at the time outstanding shall be entitled to be paid the preferential amount or amounts per share as may be provided by the Board of Directors in designating a particular series of Preferred Stock and dividends accrued thereon to the date of such payment. The holders of Preferred Stock shall not be entitled to receive any distributive amount upon the liquidation, dissolution or winding up of the affairs of this Corporation other than the distributive amounts referred to in this section, unless otherwise provided by the Board of Directors in designating a particular series of Preferred Stock.

2.6 CONVERSION. Shares of Preferred Stock may be convertible into Common Stock of this Corporation upon such terms and conditions, at such rate and subject to such adjustments as may be provided by the Board of Directors in designating a particular series of Preferred Stock.

2.7 VOTING RIGHTS. Holders of Preferred Stock shall have such voting rights as may be provided by the Board of Directors in designating a particular series of Preferred Stock.

ARTICLE III

NO PREEMPTIVE RIGHTS

Except as may otherwise be provided by the Board of Directors, no holder of any shares of this Corporation shall have any preemptive right to purchase, subscribe for or otherwise acquire any securities of this Corporation of any class or kind now or hereafter authorized.

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ARTICLE IV

NO CUMULATIVE VOTING

There shall be no cumulative voting of shares in this Corporation.

ARTICLE V

DIRECTORS

5.1 NUMBER. The Corporation shall have at least one director, the actual number to be determined as set forth in the Bylaws.

5.2 STAGGERED TERMS. The Board of Directors shall be divided into three classes if the number of directors is four or more, with said classes to be as equal in number as may be possible. Any director or directors in excess of the number divisible by three shall be first assigned to Class 1, and any additional director shall be assigned to Class 2, as the case may be. (For example, if there are five directors, the fourth director shall be in Class 1 and the fifth director in Class 2.) At the first election of directors to such classified Board of Directors, each Class 1 Director shall be elected to serve until the next ensuing annual meeting of shareholders, each Class 2 Director shall be elected to serve until the second annual meeting of shareholders and each Class 3 Director, shall be elected to serve until the third ensuing annual meeting of shareholders. At each annual meeting of shareholders following the meeting at which the Board of Directors is initially classified, the number of directors equal to the number of directors in a class whose term expires at the time of such meeting shall be elected to serve until the third ensuing annual meeting of shareholders. Notwithstanding any of the foregoing provisions of this Article V, directors shall serve until their successors are elected and qualified or until their earlier death, resignation or removal from office, or until there is a decrease in the number of directors; provided, however, that no decrease in the number of directors shall have the effect of shortening the term of any incumbent director.

5.3 REMOVAL. The directors of this Corporation may be removed only for cause, in the manner provided in the Bylaws, by the affirmative vote of the holders of not less than two-thirds of the shares entitled to elect the director

or directors whose removal is being sought.

5.4 VACANCIES. Vacancies on the Board of Directors, including vacancies caused by an increase in the number of Directors, shall be filled by a majority vote of the remaining directors only, unless there are no directors remaining, in which case the vacancies shall be filled by the shareholders, and except as set forth in the Bylaws.

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ARTICLE VI

LIMITATION ON DIRECTOR LIABILITY

To the fullest extent permitted by the Oregon Business Corporation Act, as it exists on the date hereof or may hereafter be amended, a director of this Corporation shall not be liable to the Corporation or its shareholders for monetary damages for his or her conduct as a director. Any amendment to or repeal of this Article shall not adversely affect any right or protection of a director of this Corporation with respect to any acts or omissions of such director occurring prior to such amendment or repeal.

ARTICLE VII

INDEMNIFICATION OF DIRECTORS

To the fullest extent permitted by the Oregon Business Corporation Act and the Bylaws of this Corporation, this Corporation is authorized to indemnify any of its officers and directors. The Board of Directors shall be entitled to determine the terms of indemnification, including advance of expenses, and to give effect thereto through the adoption of Bylaws, approval of agreements, or by any other manner approved by the Board of Directors. Any amendment to or repeal of this Article shall not adversely affect any right of an individual with respect to any right to indemnification arising prior to such amendment or repeal.

ARTICLE VIII

BYLAWS

The Board of Directors shall have the power to adopt, amend or repeal the Bylaws of this Corporation subject to approval by a majority of the Continuing Directors (as defined in Article XI hereof); provided, however, that the Board of Directors may not repeal or amend any bylaw that the shareholders expressly have provided may not be amended or repealed by the Board of Directors. The shareholders shall also have the power to adopt, amend or repeal the Bylaws of this Corporation by the affirmative vote of the holders of not less than two-thirds of the outstanding shares entitled to vote thereon and, to the extent, if any, provided by resolution adopted by the Board of Directors authorizing the issuance of a class or series of Preferred Stock, by the affirmative vote of the holders of not less than two-thirds

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of the outstanding shares of Common Stock and/or such class or series of Preferred Stock, voting as separate voting groups.

ARTICLE IX

SPECIAL MEETINGS OF SHAREHOLDERS

The President or the Board of Directors may call special meetings of the shareholders for any purpose. Further, a special meeting of the shareholders

shall be held if the holders of not less than 25% of all the votes entitled to be cast on any issue proposed to be considered at such special meeting have dated, signed and delivered to the Secretary of this Corporation one or more written demands for such meeting, describing the purpose or purposes for which it is to be held.

ARTICLE X

AMENDMENTS TO RESTATED ARTICLES OF INCORPORATION

This Corporation reserves, and the rights of the shareholders of this Corporation are granted subject to, the right to amend or repeal any of the provisions contained in these Second Restated Articles of Incorporation as follows:

10.1 SUPERMAJORITY VOTING. Except as provided in Section 10.2 of this Article, the Second Restated Articles of Incorporation may be amended or repealed only upon the affirmative vote of the holders of at least two-thirds of the outstanding shares entitled to vote thereon and, to the extent, if any, provided by resolution adopted by the Board of Directors authorizing the issuance of a class or series of Preferred Stock, by the affirmative vote of the holders of at least two-thirds of the outstanding shares of Common Stock and/or of such class or series of Preferred Stock, voting as separate voting groups.

10.2 MAJORITY VOTING. Notwithstanding the provisions of Section 10.1 of this Article, if an amendment or repeal of a Section or Article of the Second Restated Articles of Incorporation is approved by a majority of the Continuing Directors (as defined in Section 11.1 hereof), voting separately and as a subclass of directors, such amendment or repeal shall require the affirmative vote of the holders of at least a majority of the outstanding shares entitled to vote thereon and, to the extent, if any, provided by resolution adopted by the Board of Directors authorizing the issuance of a class or series of Preferred Stock, by the affirmative vote of the holders of at least a majority of the Common Stock and/or of such class or series of Preferred Stock, voting as separate voting groups.

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ARTICLE XI

SPECIAL VOTING REQUIREMENTS

In addition to any affirmative vote required by law, by these Second Restated Articles of Incorporation or otherwise, any "Business Combination" (as hereinafter defined) involving this Corporation shall be subject to approval in the manner set forth in this Article.

11.1 DEFINITIONS. For the purpose of this Article:

(a) "Business Combination" means (i) a merger, share exchange or consolidation of this Corporation or any of its Subsidiaries with any other corporation; (ii) the sale, lease, exchange, mortgage, pledge, transfer or other disposition or encumbrance, whether in one transaction or a series of transactions, by this Corporation or any of its Subsidiaries of all or a substantial part of this Corporation's assets otherwise than in the usual and regular course of business; or (iii) any agreement, contract or other arrangement providing for any of the foregoing transactions.

(b) "Continuing Director" means any member of the Board of Directors (i) who was a member of the Board of Directors on September 26, 1997, or (ii) who is elected to the Board of Directors after September 26, 1997, after being nominated by a majority of the Continuing Directors voting separately and as a subclass of directors on such nomination.

(c) "Subsidiary" means a domestic or foreign corporation, a majority of the outstanding voting shares of which are owned, directly or indirectly, by this Corporation.

11.2 VOTE REQUIRED FOR BUSINESS COMBINATIONS.

(a) Except as provided in subsection 11.2(b) hereof, the affirmative vote of the holders of not less than two-thirds of the outstanding shares entitled to vote thereon and, to the extent, if any, provided by resolution adopted by the Board of Directors authorizing the issuance of a class or series of Preferred Stock, the affirmative vote of the holders of not less than two-thirds of the outstanding shares of Common Stock and/or of such class or series of Preferred Stock, voting as separate voting groups, shall be required for the adoption or authorization of a Business Combination.

(b) Notwithstanding subsection 11.2(a) hereof, if a Business Combination shall have been approved by a majority of the Continuing Directors, voting separately and as a subclass of directors, such Business Combination, if required to be approved by this Corporation's shareholders by the Oregon Business Corporation Act or these Second Restated Articles of Incorporation, shall be approved only with the affirmative vote of the holders of not less than a majority of the outstanding shares entitled to vote thereon and, to the extent, if any, provided by resolution adopted by the Board of Directors authorizing the issuance of a class or series of Preferred Stock, the affirmative vote of the holders of not less than a majority of the outstanding shares of Common Stock and/or such class or series of Preferred Stock, voting as

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separate voting groups.

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SCHMITT INDUSTRIES, INC.

SECOND RESTATED BYLAWS

SECTION 1

SHAREHOLDERS AND SHAREHOLDERS' MEETINGS

1.1 ANNUAL MEETING. The annual meeting of the shareholders of this corporation (the "Corporation") for the election of directors and for the transaction of such other business as may properly come before the meeting shall be held once in each calendar year (not being more than 13 months after the holding of the last preceding annual meeting) at the principal office of the Corporation, or at some other place, all as determined by the Board of Directors.

1.2 SPECIAL MEETINGS. Special meetings of the shareholders for any purpose or purposes may be called at any time by the President or Board of Directors. Further, a special meeting of the shareholders shall be held if the holders of not less than 25% of all votes entitled to be cast on the issue proposed to be considered at such special meeting have dated, signed and delivered to the Secretary one or more written demands for such meeting, describing the purpose or purposes for which it is to be held. The meetings shall be held at such time and place as the Board of Directors prescribe, or, if not held upon the request of the Board of Directors, at such time and place may be established by the President or by the Secretary in the President's absence.

1.3 NOTICE OF MEETINGS. Written notice of the place, date and time of the annual shareholders' meeting and written notice of the place, date, time and purpose or purposes of special shareholders' meetings shall be delivered not less than 10 or more than 60 days before the date of meeting, either personally, by facsimile, or by mail, or in any other manner approved by law, by or at the direction of the President or the Secretary, to each shareholder of record entitled to notice of such meeting. Mailed notices shall be deemed to be delivered when deposited in the mail, first-class postage prepaid, correctly addressed to the shareholder's address shown in the Corporation's current record of shareholders. Notice given in any other manner shall be deemed effective when dispatched to the shareholder's address, telephone number or other number appearing on the records of the Corporation.

1.4 WAIVER OF NOTICE. Except where expressly prohibited by law or the Articles of Incorporation, notice of the place, date, time and purpose or purposes of any shareholders' meeting may be waived in a signed writing delivered to the Corporation by any shareholder at any time, either before or after the meeting. Attendance at the meeting in person or by proxy waives objection to lack of notice or defective notice of the meeting unless the shareholder at the beginning of the meeting objects to holding the meeting or transacting business at the meeting. A shareholder waives objection to consideration of a particular matter at a meeting that is not within the purpose or purposes described in the meeting notice, unless the shareholder objects to considering the matter when it is presented.

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1.5 SHAREHOLDERS' ACTION WITHOUT A MEETING. The shareholders may take any action without a meeting that they could properly take at a meeting, if one or more written consents setting forth the action so taken are signed by all of the shareholders entitled to vote with respect to the subject matter and are delivered to the Corporation for inclusion in the minutes or filing with the corporate records. Actions taken under this section are effective when all consents are in the possession of the Corporation, unless otherwise specified in the consent. A shareholder may withdraw consent only by delivering a written notice of withdrawal to the Corporation prior to the time that all consents are in the possession of the Corporation.

1.6 TELEPHONE MEETINGS. Shareholders may participate in a meeting of shareholders by means of a conference telephone or any similar communication equipment that enables all persons participating in the meeting to hear each other during the meeting. Participation by such means shall constitute presence in person at a meeting.

1.7 LIST OF SHAREHOLDERS. At least 10 days before any shareholders' meeting, the Secretary of the Corporation or the agent having charge of the stock transfer books of the Corporation shall have prepared an alphabetical list of the names of the shareholders on the record date who are entitled to notice of a shareholders' meeting, arranged by voting group, and within each voting group, by class or series of shares, and showing the address of and number of shares held by each shareholder.

1.8 QUORUM AND VOTING. The presence in person or by proxy of the holders of a majority of the votes entitled to be cast on a matter at a general or special meeting shall constitute a quorum of shareholders for that matter. If a quorum exists, action on a matter shall be approved by a voting group if the votes cast within a voting group favoring the action exceed the votes cast within the voting group opposing the action, unless a greater number of affirmative votes is required by the Articles of Incorporation or by law. If the Articles of Incorporation or Oregon law provide for voting by two or more voting groups on a matter, action on a matter is taken only when voted upon by each of those voting group counted separately. Action may be taken by one voting group on a matter even though no action is taken by another voting group.

1.9 ADJOURNED MEETINGS. If a shareholders' meeting is adjourned to a different place, date or time, whether for failure to achieve a quorum or otherwise, notice need not be given of the new place, date or time if the new place, date or time is announced at the meeting before adjournment. When a determination of shareholders entitled to vote at any meeting of shareholders has been made as provided in these Bylaws, that determination shall apply to any adjournment thereof, unless Oregon law requires fixing a new record date. If Oregon law requires that a new record date be set for the adjourned meeting, notice of the adjourned meeting must be given to shareholders as of the new record date. Any business may be transacted at an adjourned meeting that could have been transacted at the meeting as originally called.

1.10 PROXIES. A shareholder may appoint a proxy to vote or otherwise act for the shareholder by signing an appointment form, either personally or by an agent. No

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appointment shall be valid after 11 months from the date of its execution unless the appointment form expressly so provides. An appointment of a proxy is revocable unless the appointment is coupled with an interest. No revocation shall be effective until written notice thereof has actually been received by the Secretary of the Corporation or any other officer or agent authorized to tabulate votes.

1.11 BUSINESS FOR SHAREHOLDERS' MEETINGS.

1.11.1 BUSINESS AT ANNUAL MEETINGS.

(a) In addition to the election of directors, other proper business may be transacted at an annual meeting of shareholders, provided that such business is properly brought before such meeting. To be properly brought before an annual meeting business must be (i) brought by or at the direction of the Board or (ii) brought before the meeting by a shareholder by inclusion in the Corporation's proxy statement pursuant to the provisions of Rule 14a-8 under Section 14 of the Securities Exchange Act of 1934, as amended, or any successor provision, when and if such Rule is applicable thereto, or if such business is not so included in the Corporation's proxy statement, only pursuant to written notice thereof in accordance with subsection 1.12 hereof, and received by the Secretary not fewer than 60 nor more than 90 days prior to the date of such annual meeting (or, if less than 60 days' notice or prior public disclosure of the date of the annual meeting is given or made to the shareholders, not later than the close of business on the tenth business day following the day on which such notice of the date of the annual meeting was mailed or such public

disclosure was made, whichever first occurs).

(b) Any such shareholder notice shall set forth (i) the name and address of the shareholder proposing such business; (ii) a representation that the shareholder is entitled to vote at such meeting; (iii) a statement of the number of shares of the Corporation which are beneficially owned by the shareholder and the date upon which such shares were acquired; (iv) a representation that the shareholder intends to appear in person or by proxy at the meeting to propose such business; and (v) as to each matter the shareholder proposes to bring before the meeting, a brief description of the business desired to be brought before the meeting, the reasons for conducting such business at the meeting, the language of the proposal (if appropriate), and any material interest of the shareholder in such business.

(c) No business shall be conducted at any annual meeting of shareholders except in accordance with this subsection 1.11.1. If the facts warrant, the Board, or the chairman of an annual meeting of shareholders, may determine and declare that (i) a proposal does not constitute proper business to be transacted at the meeting or (ii) the business was not properly brought before the meeting in accordance with the provisions of this subsection 1.11.1 and, if, in either case, it is so determined, any such business shall not be transacted.

1.11.2 BUSINESS AT SPECIAL MEETINGS. At any special meeting of the shareholders, only business within the purpose or purposes described in the meeting notice required by Section 1.3 may be conducted.

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1.12 NOTICE TO CORPORATION. Any written notice required to be delivered by a shareholder to the Corporation pursuant to Section 1.2 or Section 1.11 hereof must be given, either by personal delivery or by registered or certified mail, postage prepaid, to the Secretary at the Corporation's principal office.

SECTION 2

BOARD OF DIRECTORS

2.1 NUMBER AND QUALIFICATION. The business affairs and property of the Corporation shall be managed under the direction of a Board of Directors, the number of members of which shall be no fewer than two nor more than nine, as established from time to time by the Board of Directors. The Board of Directors may increase or decrease this number or this range by resolution. A member of the Board of Directors does not need to be a shareholder of the Corporation.

2.2 ELECTION--TERMS OF OFFICE.

2.2.1 The directors shall be elected by the shareholders at each annual shareholders' meeting or at a special shareholders' meeting called for such purpose.

2.2.2 The Board of Directors shall be divided into three classes if the authorized number of directors is four or more, with said classes to be as equal in number as may be possible. Any director or directors in excess of the number divisible by three shall be first assigned to Class 1 and any additional director shall be assigned to Class 2, as the case may be. (For example, if there are five directors, the fourth director shall be in Class 1 and the fifth director in Class 2.) At the first election of directors to such classified Board of Directors, each Class 1 Director shall be elected to serve until the next ensuing annual meeting of shareholders, each Class 2 Director shall be elected to serve until the second ensuing annual meeting of shareholders and each Class 3 Director, shall be elected to serve until the third ensuing annual meeting of shareholders. At each annual meeting of shareholders following the meeting at which the Board of Directors is initially classified, the number of directors equal to the number of directors in the class whose term expires at the time of such meeting shall be elected to serve until the third ensuing annual meeting. Notwithstanding any of the foregoing provisions of this Section 2, directors shall serve until their successors are elected and qualified or until their earlier death, resignation or removal from office, or until there is a decrease in the number of directors; provided, however, that no decrease in the number of directors shall have the effect of

shortening the term of any incumbent director.

2.2.3 The term of office of a director shall commence effective immediately upon election, unless otherwise specified in a resolution approved by the shareholders in connection with the election of such director. Directors shall serve until their successors are elected and qualified or until their earlier death, resignation or removal from office, or until there is a decrease in the authorized number of directors; provided, however, that no decrease in the number of directors shall have the effect of shortening the term of any incumbent

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director.

2.3 NOMINATIONS.

2.3.1 Only persons who are nominated in accordance with the following procedures shall be eligible for election as directors. Nominations for the election of directors may be made (a) by or at the direction of the Board or (b) by any shareholder of record entitled to vote for the election of directors at such meeting; provided, however, that a shareholder may nominate persons for election as directors only if written notice (in accordance with Section 1.12 hereof) of such shareholder's intention to make such nominations is received by the Secretary not later than (i) with respect to an election to be held at an annual meeting of the shareholders, not fewer than 60 nor more than 90 days prior to the date of such annual meeting (or, if less than 60 days' notice or prior public disclosure of the date of the annual meeting is given or made to the shareholders, not later than the close of business on the tenth business day following the day on which such notice of the date of the annual meeting was mailed or such public disclosure was made, whichever first occurs) and (ii) with respect to an election to be held at a special meeting of the shareholders for the election of directors, the close of business on the tenth business day following the date on which notice of such meeting is first mailed to shareholders.

2.3.2 Any such shareholder's notice shall set forth (a) the name and address of the shareholder who intends to make a nomination; (b) a representation that the shareholder is entitled to vote at such meeting; (c) a statement of the number of shares of the Corporation which are beneficially owned by the shareholder and the dates upon which such shares were acquired; (d) a representation that the shareholder intends to appear in person or by proxy at the meeting to nominate the person or persons specified in the notice; (e) as to each person the shareholder proposes to nominate for election or reelection as a director, the name and address of such person and such other information regarding such nominee as would be required in a proxy statement filed pursuant to the proxy rules of the Securities and Exchange Commission had such nominee been nominated by the Board, and a description of any arrangements or understandings between the shareholder and such nominee and any other persons (including their names) pursuant to which the nomination is to be made; and (f) the consent of each such nominee to serve as a director if elected.

2.3.3 If the facts warrant, the Board, or the chairman of a shareholders' meeting at which directors are to be elected, shall determine and declare that a nomination was not made in accordance with the foregoing procedure and, if it is so determined, the defective nomination shall be disregarded. The right of shareholders to make nominations pursuant to the foregoing procedure is subject to the rights of the holders of any class or series of stock having a preference over the Common Stock as to dividends or upon liquidation. The procedures set forth in this Section 2.3 for nomination for the election of directors by shareholders are in addition to, and not in limitation of, any procedures now in effect or hereafter adopted by or at the direction of the Board or any committee thereof.

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2.4 REMOVAL.

2.4.1 Any director or the entire Board may be removed for cause by the holders of not less than two-thirds of the shares entitled to elect the director or directors whose removal is sought. Such action may only be taken at a special meeting of the shareholders called expressly for that purpose, provided that notice of the proposed removal, which shall include a statement of the charges alleged against the director, shall have been duly given to the shareholders together with or as a part of the notice of the meeting.

2.4.2 The vacancy created by the removal of a director under this Section 2.4. shall be filled only by a vote of the holders of two-thirds of the shares then entitled to elect the director removed. Such vote may be taken at the same meeting at which the removal of such director was accomplished, or at such later meeting, annual or special, as the shareholders may decide.

2.5 VACANCIES. Subject to the provisions of Section 2.4 hereof and unless the Second Restated Articles of Incorporation provide otherwise, vacancies in the Board of Directors, whether caused by resignation, death, retirement, disqualification, increase in the number of directors, removal or otherwise, may be filled for the remainder of the term by the Board of Directors only or, if the directors in office constitute less than a quorum of the Board of Directors, by an affirmative vote of a majority of the remaining directors, unless there are no directors remaining in which case the vacancies shall be filled by the shareholders. The term of a director elected to fill a vacancy expires at the next annual shareholders' meeting. A vacancy that will occur at a specific later date may be filled before the vacancy occurs, but the new director may not take office until the vacancy occurs.

2.6 QUORUM AND VOTING. At any meeting of the Board of Directors, the presence in person (including presence by electronic means such as a telephone conference call) of 50% of the number of directors presently in office shall constitute a quorum for the transaction of business. Notwithstanding the foregoing, in no case shall a quorum be less than one-third of the authorized number of directors. If a quorum is present at the time of a vote, the affirmative vote of a majority of the directors present at the time of the vote shall be the act of the Board of Directors and of the Corporation except as may be otherwise specifically provided by the Articles of Incorporation, by these Bylaws, or by law. A director who is present at a meeting of the Board of Directors when action is taken is deemed to have assented to the action taken unless: (a) the director objects at the beginning of the meeting, or promptly upon his or her arrival, to holding it or to transacting business at the meeting; (b) the director's dissent or abstention from the action taken is entered in the minutes of the meeting; or (c) the director delivers written notice of his or her dissent or abstention to the presiding officer of the meeting before its adjournment or to the Corporation within a reasonable time after adjournment of the meeting. The right of dissent or abstention is not available to a director who votes in favor of the action taken.

2.7 REGULAR MEETINGS. Regular meetings of the Board of Directors shall be held at such place, date and time as shall from time to time be fixed by resolution of the Board.

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2.8 SPECIAL MEETINGS. Special Meetings of the Board of Directors may be held at any place and at any time and may be called by the Chairman of the Board, if there is one, the President or any two or more directors.

2.9 NOTICE OF MEETING.

2.9.1 Unless the Articles of Incorporation provide otherwise, any regular meeting of the Board of Directors may be held without notice of the date, time, place, or purpose of the meeting. Any special meeting of the Board of Directors must be preceded by at least two days' notice of the date, time, and place of the meeting, but not of its purpose, unless the Articles of Incorporation or these Bylaws require otherwise. Each director shall have a mailing address, telephone number and facsimile number on record with the Corporation for purposes of receiving notice.

2.9.2 Notice may be given personally, by facsimile, by mail, or in any other manner allowed by law. Oral notice shall be sufficient only if a written record of such notice is included in the Corporation's minute book. Notice shall be deemed effective at the earliest of: (a) receipt; (b) delivery

to the proper address or telephone number of the director as shown in the Corporation's records: or (c) three days after its deposit in the United States mail, as evidenced by the postmark, if correctly addressed and mailed with first-class postage prepaid.

2.9.3 Notice of any meeting of the Board of Directors may be waived by any director at any time, by a signed writing, delivered to the Corporation for inclusion in the minutes, either before or after the meeting. Attendance or participation by a director at a meeting shall constitute a waiver of any required notice of meeting unless the director promptly objects to holding the meeting or to the transaction of any business on the grounds that the meeting was not lawfully convened and the director does not thereafter vote for or assent to action taken at the meeting.

2.10 DIRECTORS' ACTION WITHOUT A MEETING. The Board of Directors or a committee thereof may take any action without a meeting that it could properly take at a meeting if one or more written consents setting forth the action are signed by all of the directors, or all of the members of the committee, as the case may be, either before or after the action is taken, and if the consents are delivered to the Corporation for inclusion in the minutes or filing with the corporate records. Such action shall be effective upon the signing of a consent by the last director to sign, unless the consent specifies a later effective date.

2.11 COMMITTEES OF THE BOARD OF DIRECTORS. The Board of Directors, by resolutions adopted by a majority of the members of the Board of Directors in office, may create from among its members one or more committees and shall appoint the members thereof. Each such committee must have two or more members, who shall be directors and who shall serve at the pleasure of the Board of Directors. Each committee of the Board of Directors may exercise the authority of the Board of Directors to the extent provided in its enabling resolution and any pertinent subsequent resolutions adopted in like manner, provided that the authority of each such committee shall be subject to applicable law. Each committee of the Board of Directors

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shall keep regular minutes of its proceedings and shall report to the Board of Directors when requested to do so.

2.12 TELEPHONE MEETINGS. Members of the Board of Directors or of any committee appointed by the Board of Directors may participate in a meeting of the Board of Directors or committee by means of a conference telephone or similar communications equipment that enables all persons participating in the meeting to hear each other during the meeting. Participation by such means shall constitute presence in person at a meeting.

2.13 COMPENSATION OF DIRECTORS. The Board of Directors may fix the compensation of directors as such and may authorize the reimbursement of their expenses.

SECTION 3

OFFICERS

3.1 OFFICERS ENUMERATED--APPOINTMENT. The officers of the Corporation shall consist of such officers and assistant officers as may be designated by resolution of the Board of Directors. The officers shall include a President and a Secretary, and may include a Chairman of the Board, one or more Vice Presidents, a Treasurer, and any assistant officers or other officers having such designations as shall be determined by the Board of Directors. The officers shall hold office at the pleasure of the Board of Directors. Unless otherwise restricted by the Board of Directors, the President may appoint any assistant officer or other officers, the Secretary may appoint one or more Assistant Secretaries, and the Treasurer may appoint one or more Assistant Treasurers; provided that any such appointments shall be recorded in writing in the corporate records.

3.2 QUALIFICATIONS. None of the officers of the Corporation needs to be a director. Any two or more corporate offices may be held by the same person.

3.3 DUTIES OF THE OFFICERS. Unless otherwise prescribed by the Board of Directors, the duties of the officers shall be as follows:

3.3.1 CHAIRMAN OF THE BOARD. The Chairman of the Board, if one is elected, shall preside at meetings of the Board of Directors and of the shareholders, shall be responsible for carrying out the plans and directives of the Board of Directors, shall report to and consult with the Board of Directors and, if the Board so resolves, shall have such other powers and duties as the Board of Directors may from time to time prescribe.

3.3.2 PRESIDENT. The President shall exercise the usual executive powers pertaining to the office of President. In the absence of a Chairman of the Board, the President shall preside at meetings of the Board of Directors and of the shareholders, perform the other duties of the Chairman of the Board prescribed in this section, and perform such other duties as the Board of Directors may from time to time designate. In addition, if there is no Secretary in office, the President shall perform the duties of the Secretary.

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3.3.3 VICE PRESIDENT. Each Vice President shall perform such duties as the Board of Directors may from time to time designate. In addition, in the absence or disability of the President, the Vice President (or if there is more than one Vice President, then in the order designated by the Board of Directors) shall perform the duties of the President, and when so acting, shall have all the powers of and be subject to all restrictions upon the President.

3.3.4 SECRETARY. The Secretary shall be responsible for and shall keep, personally or with the assistance of others, records of the proceedings of the directors and shareholders; authenticate records of the Corporation; attest all certificates of stock in the name of the Corporation; keep the corporate seal, if any, and affix the same to certificates of stock and other proper documents; keep a record of the issuance of certificates of stock and the transfers of the same; and perform such other duties as the Board of Directors may from time to time designate.

3.3.5 TREASURER. The Treasurer shall have the care and custody of, and be responsible for, all funds and securities of the Corporation and shall cause to be kept regular books of account. The Treasurer shall cause to be deposited all funds and other valuable effects in the name of the Corporation in such depositories as may be designated by the Board of Directors. In general, the Treasurer shall perform all of the duties incident to the office of Treasurer, and such other duties as from time to time may be assigned by the Board of Directors.

3.3.6 ASSISTANT OFFICERS. Assistant officers may consist of one or more Vice Presidents, one or more Assistant Secretaries, one or more Assistant Treasurers and such other titles as may be designated from time to time. Each assistant officer shall perform those duties assigned to him or her from time to time by the Board of Directors, the President, or the officer who appointed him or her.

3.4 VACANCIES. Vacancies in any office arising from any cause may be filled by the Board of Directors at any regular or special meeting.

3.5 REMOVAL. Any officer or agent may be removed by action of the Board of Directors with or without cause, but any removal shall be without prejudice to the contract rights, if any, of the person removed. Election or appointment of an officer or agent shall not itself create any contract rights.

3.6 COMPENSATION. The compensation of all officers of the Corporation shall be fixed by the Board of Directors.

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SECTION 4

SHARES AND CERTIFICATES OF SHARES

4.1 SHARE CERTIFICATES. Share certificates shall be issued in numerical order, and each shareholder shall be entitled to a certificate signed by the Chairman of the Board, President or a Vice President, and signed by the Secretary or an Assistant Secretary. Share certificates may be sealed with the corporate seal, if any. Facsimiles of the signatures and seal may be used as permitted by law. Every share certificate shall state:

- (a) the name of the Corporation;
- (b) that the Corporation is organized under the laws of the State of Oregon;
- (c) the name of the person to whom the share certificate is issued;
- (d) the number, class and series (if any) of shares that the certificate represents; and
- (e) if the Corporation is authorized to issue shares of more than one class or series, that upon written request and without charge, the Corporation will furnish any shareholder with a full statement of the designations, preferences, limitations and relative rights of the shares of each class or series, and the authority of the Board of Directors to determine variations for future series.

4.2 CONSIDERATION FOR SHARES. Shares of the Corporation may be issued for such consideration as shall be determined by the Board of Directors to be adequate. The consideration for the issuance of shares may be paid in whole or in part in cash, or in any tangible or intangible property or benefit to the Corporation, including but not limited to promissory notes, service performed, contracts for services to be performed, or other securities of the Corporation. Establishment by the Board of Directors of the amount of consideration received or to be received for shares of the Corporation shall be deemed to be a determination that the consideration so established is adequate.

4.3 TRANSFERS. Shares may be transferred by delivery of the certificate, accompanied either by an assignment in writing on the back of the certificate, or by a written power of attorney to sell, assign and transfer the same, signed by the record holder of the certificate. Except as otherwise specifically provided in these Bylaws, no shares of stock shall be transferred on the books of the Corporation until the outstanding certificate thereof has been surrendered to the Corporation.

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4.4 LOSS OR DESTRUCTION OF CERTIFICATES. In the event of the loss or destruction of any certificate, a new certificate may be issued in lieu thereof upon satisfactory proof of such loss or destruction, and upon the giving of security against loss to the Corporation by bond, indemnity or otherwise, to the extent deemed necessary by the Board of Directors, the Secretary, or the Treasurer.

4.5 FIXING RECORD DATE. The Board of Directors may fix in advance a date as the record date for determining shareholders entitled: (a) to notice of or to vote at any shareholders' meeting or any adjournment thereof; (b) to receive payment of any share dividend; or (c) to receive payment of any distribution. The Board of Directors may in addition fix record dates with respect to any allotment or rights of conversion or exchange of any securities by their terms, or for any other proper purpose, as determined by the Board of Directors and by law. The record date shall be not more than 70 days and, in case of a meeting of shareholders, not less than 10 days (or such longer period as may be required by Oregon law) prior to the date on which the particular action requiring determination of shareholders is to be taken. If no record date is fixed for determining the shareholders entitled to notice of or to vote at a meeting of shareholders, the record date shall be the date before the day on which notice of the meeting is mailed. If no record date is fixed for the determination of shareholders entitled to a distribution (other than one involving a purchase, redemption, or other acquisition of the Corporation's own shares), the record

date shall be the date on which the Board adopted the resolution declaring the distribution. If no record date is fixed for determining shareholders entitled to a share dividend, the record date shall be the date on which the Board of Directors authorized the dividend.

SECTION 5

BOOKS, RECORDS AND RECORDS

5.1 RECORDS OF CORPORATE MEETINGS, ACCOUNTING RECORDS AND SHARE REGISTERS.

5.1.1 The Corporation shall keep, as permanent records, minutes of all meetings of the Board of Directors and shareholders, and all actions taken without a meeting, and all actions taken by a committee exercising the authority of the Board of Directors. The Corporation or its agents shall maintain, in a form that permits preparation of a list, a list of the names and addresses of its shareholders, in alphabetical order by class of shares, showing the number, class, and series, if any, of shares held by each.

5.1.2 The Corporation shall also maintain appropriate accounting records, and at its principal place of business shall keep copies of: (a) its Articles of Incorporation or restated Articles of Incorporation and all amendments in effect; (b) its Bylaws or restated Bylaws and all amendments in effect; (c) minutes of all shareholders' and directors meetings and records of all actions taken without meetings for the past three years; (d) appropriate accounting records; (e) all written communications to shareholders generally in the past three years; (f) a list of the names and business addresses of its current officers and directors; and (g) its most recent annual report to the Secretary of State.

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5.2 COPIES OF CORPORATE RECORDS. Any person dealing with the Corporation may rely upon a copy of any of the records of the proceedings, resolutions, or votes of the Board of Directors or shareholders, when certified by the President, Vice President, Secretary or Assistant Secretary.

5.3 EXAMINATION OF RECORDS.

5.3.1 A shareholder shall have the right to inspect and copy, during regular business hours at the principal office of the Corporation, in person or by his or her attorney or agent, the corporate records referred to in subsection 5.1.2 hereof if the shareholder gives the Corporation written notice of the demand at least five business days before the date on which the shareholder wishes to make such inspection.

5.3.2 In addition, if a shareholder's demand is made in good faith and for a proper purpose, a shareholder may inspect and copy, during regular business hours at a reasonable location specified by the Corporation, excerpts from minutes of any meeting of the Board of Directors, records of any action of a committee of the Board of Directors, minutes of any meeting of the shareholders, and records of actions taken by the shareholders or the Board of Directors without a meeting, to the extent not subject to inspection under subsection 5.3.1, accounting records of the Corporation, or the record of shareholders; provided that the shareholder shall have made a demand describing with reasonable particularity the shareholder's purpose and the records the shareholder desires to inspect, and provided further that the records are directly connected to the shareholder's purpose.

5.3.3 This section shall not affect any right of shareholders to inspect records of the Corporation that may be otherwise granted to the shareholders by law.

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SECTION 6

FISCAL YEAR

The fiscal year-end of the Corporation shall be May 31.

SECTION 7

CORPORATE SEAL

The corporate seal of the Corporation, if any, shall be in the form shown here.

SECTION 8

MISCELLANEOUS PROCEDURAL PROVISIONS

The Board of Directors may adopt rules of procedure to govern any meetings of shareholders or directors to the extent not inconsistent with law, the Articles of Incorporation, or these Bylaws, as they are in effect from time to time. In the absence of any rules of procedure adopted by the Board of Directors, the chairman of the meeting shall make all decisions regarding the procedures for any meeting.

SECTION 9

AMENDMENT OF BYLAWS

The Board of Directors is expressly authorized to adopt, amend and repeal the Bylaws of the Corporation, subject to approval by a majority of the Continuing Directors (as defined in the Articles of Incorporation); provided, however, the Board of Directors may not repeal or amend any bylaws that the shareholders have expressly provided may not be amended or repealed by the Board of Directors. The shareholders of the Corporation also have the power to adopt, amend or repeal the Bylaws of the Corporation by the affirmative vote of the holders of not less than two-thirds of the outstanding shares and, to the extent, if any, provided by resolution adopted by the Board of Directors authorizing the issuance of a class or series of Preferred Stock, by the affirmative vote of the holders of not less than two-thirds of the outstanding shares of Common Stock and/or of such class or series of Preferred Stock, voting as separate voting groups.

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SECTION 10

INDEMNIFICATION OF DIRECTORS AND OTHERS

10.1 GRANT OF INDEMNIFICATION. Subject to Section 10.2, each person who was or is made a party or is threatened to be made a party to or is involved (including, without limitation, as a witness) in any threatened, pending, or completed action, suit or proceeding, whether formal or informal, civil, criminal, administrative or investigative (hereinafter "proceeding"), by reason of the fact that he or she is or was a director of the Corporation or who, while a director of the Corporation, is or was serving at the request of the Corporation as a director, officer, employee or agent of this or another corporation or of a partnership, joint venture, trust, other enterprise, or employee benefit plan, whether the basis of such proceeding is alleged action in an official capacity as a director or in any other capacity while serving as a director, officer, employee or agent, shall be indemnified and held harmless by the Corporation to the fullest extent permitted by applicable law, as then in effect, against all expense, liability and loss (including attorneys' fees, costs, judgments, fines, ERISA excise taxes or penalties and amounts to be paid in settlement) reasonably incurred or suffered by such person in connection therewith, and such indemnification shall continue as to a person who has ceased to be a director and shall inure to the benefit of his or her heirs, executors and administrators.

10.2 LIMITATIONS ON INDEMNIFICATION. Notwithstanding Section 10.1, no indemnification shall be provided hereunder to any such person to the extent that such indemnification would be prohibited by the Oregon Business Corporation Act or other applicable law as then in effect, nor, except as provided in Section 10.4 with respect to proceedings seeking to enforce rights to indemnification, shall the Corporation indemnify any such person seeking indemnification in connection with a proceeding (or part thereof) initiated by

such person except where such proceeding (or part thereof) was authorized by the Board of Directors of the Corporation.

10.3 ADVANCEMENT OF EXPENSES. The right to indemnification conferred in this Section 10 shall include the right to be paid by the Corporation the expenses incurred in defending any such proceeding in advance of its final disposition, except where the Board of Directors shall have adopted a resolution expressly disapproving such advancement of expenses.

10.4 RIGHT TO ENFORCE INDEMNIFICATION. If a claim under Section 10.1 is not paid in full by the Corporation within 60 days after a written claim has been received by the Corporation, or if a claim for expenses incurred in defending a proceeding in advance of its final disposition authorized under Section 10.3 is not paid within 60 days after a written claim has been received by the Corporation, the claimant may at any time thereafter bring suit against the Corporation to recover the unpaid amount of the claim and, to the extent successful in whole or in part, the claimant shall be entitled to be paid also the expense of prosecuting such claim. The claimant shall be presumed to be entitled to indemnification hereunder upon submission of a written claim (and, in an action brought to enforce a claim for expenses

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incurred in defending any proceeding in advance of its final disposition, where the required undertaking has been tendered to the Corporation), and thereafter the Corporation shall have the burden of proof to overcome the presumption that the claimant is so entitled. It shall be a defense to any such action (other than action with respect to expenses authorized under Section 10.3) that the claimant has not met the standards of conduct which make it permissible hereunder or under the Oregon Business Corporation Act for the Corporation to indemnify the claimant for the amount claimed, but the burden of proving such defense shall be on the Corporation.

10.5 ALTERNATIVE PROCEDURES. Pursuant to ORS 60.414 or any successor provision of the Oregon Business Corporation Act, the procedures for indemnification and advancement of expenses set forth in this section are in lieu of the procedures required by ORS 60.404 or any successor provision of the Oregon Business Corporation Act.

10.6 NONEXCLUSIVITY. The right to indemnification and the advancement of expense conferred in this Section 10 shall not be exclusive of any other right which any person may have or hereafter acquire under any statute, provision of the Articles of Incorporation or the Bylaws of the Corporation, general or specific action of the Board, contract or otherwise.

10.7 INDEMNIFICATION OF OFFICERS, EMPLOYEES AND AGENTS. The Corporation may, by action of its Board of Directors from time to time, provide indemnification and pay expenses in advance of the final disposition of a proceeding to officers, employees and agents of the Corporation on the same terms with the same scope and effect as the provisions of this section with respect to the indemnification and advancement of expenses of directors of the Corporation or pursuant to rights granted pursuant to, or provided by, the Oregon Business Corporation Act or such other terms as the Board may deem proper.

10.8 INSURANCE AND OTHER SECURITY. The Corporation may maintain insurance, at its expense, to protect itself and any individual who is or was a director, officer, employee or agent of the Corporation or another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against or incurred by the individual in that capacity or arising from his or her status as an officer, director, agent or employee, whether or not the Corporation would have the power to indemnify such person against the same liability under the Oregon Business Corporation Act. The Corporation may enter into contracts with any director or officer of the Corporation in furtherance of the provisions of this Section 10 and may create a trust fund, grant a security interest or use other means (including, without limitation, a letter of credit) to ensure the payment of such amounts as may be necessary to effect indemnification as provided in this Section 10.

10.9 AMENDMENT OR MODIFICATION. This Section 10 may be altered or amended at any time as provided in these Bylaws, but no such amendment shall have the

effect of diminishing the rights of any person who is or was an officer or director as to any acts or omissions taken or omitted to be taken prior to the effective date of such amendment.

10.10 EFFECT OF SECTION. The rights conferred by this section shall be deemed to be contract rights between the Corporation and each person who is or was a director or officer.

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The Corporation expressly intends each such person to rely on the rights conferred hereby in performing his or her respective duties on behalf of the Corporation.

SECTION 11

REPRESENTATION OF SHARES OF OTHER CORPORATIONS

Unless otherwise restricted by the Board of Directors, the President and any Vice President of the Corporation are each authorized to vote, represent and exercise on behalf of the Corporation all rights incident to any and all shares of other corporations standing in the name of the Corporation. This authority may be exercised by such officers either in person or by a duly executed proxy or power of attorney.

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SCHMITT INDUSTRIES, INC.
AMENDED AND RESTATED
STOCK OPTION PLAN

1. PURPOSES. The purposes of this Schmitt Industries, Inc. Amended and Restated Stock Option Plan ("Plan") are to:

- 1.1 Closely associate the interests of the management of Schmitt Industries, Inc. ("Company") and its subsidiaries with the shareholders of the Company by reinforcing the relationship between the participants' rewards and shareholder gains;
- 1.2 Provide management with an equity ownership in the Company commensurate with the Company's and its subsidiaries' performance as reflected in increased value of the Company's common shares;
- 1.3 Maintain competitive compensation levels;
- 1.4 Provide a means whereby the Company can continue to attract, motivate, and retain key employees who can contribute materially to the Company's and its subsidiaries' growth and success; and
- 1.5 Provide a means whereby the Company and its subsidiaries can continue to attract, motivate and retain the services of selected non-employee agents, consultants, advisors, persons involved in the sale or distribution of the Company's and its subsidiaries' products and independent contractors of the Company and its subsidiaries.

2. ADMINISTRATION. This Plan shall be administered by the Board of Directors of the Company ("Board") or, in the event the Board shall appoint and/or authorize a committee to administer this Plan, by a committee of the Board consisting of at least two (2) non-employee directors ("Committee"). The administrator of this Plan, whether the Board or Committee, shall hereinafter be referred to as the "Plan Administrator." The Plan Administrator shall administer the Plan in accordance with the following:

2.1 INCAPACITY OF PLAN ADMINISTRATOR. No member of the Board or the Committee shall vote with respect to the granting of an option created under this Plan ("Option(s)") to himself or herself. Any Option granted to a director for his or her services as such shall not be effective until approved by the full Board.

2.2 REGISTRATION UNDER THE SECURITIES ACT. If the Company registers any of its equity securities pursuant to Section 12(b) or 12(g) of the Securities Exchange Act of 1934, as amended ("Exchange Act") and any officers or directors are eligible to receive Options, the following provisions shall apply to the administration of this Plan with respect to grants made to directors, officers or other Optionees (as hereinafter defined) affected by Section 16(b) of the Exchange Act. The Plan Administrator shall be constituted at all times so as to meet the requirements of Section 16(b) of the Exchange Act, as amended from time to time. The members of any committee serving as Plan Administrator shall be appointed by the Board for such term as the Board may determine. The Board may from time to time remove members from, or add members to, the committee. Vacancies on the committee, however caused, may be filled by the Board. Currently, the Plan Administrator is a committee. If, at any time, an insufficient number of disinterested non-employee directors is available to serve on such committee, interested non-employee directors may serve on the committee; however, during such time, no Options shall be granted to any person if the granting of such Option would not meet the requirements of Section 16(b) of the Exchange Act. For purposes of this Section 2, a disinterested director shall be a member of the Board who meets the definition of "disinterested person" as set forth in the rules and regulations promulgated under Section 16(b) of the Exchange Act, as amended from time to time (the "16(b) Rules"). Currently, a disinterested director for purposes of this Section 2 is

a member of the Board who for one (1) year prior to service as an administrator of this Plan has not been (and during service as a Plan Administrator, will not be) granted or awarded equity securities, including options for equity securities pursuant to this Plan or any other plan of the Company or its affiliates, except for certain exclusions described in Rule 16b-3. For purposes of this Section 2, a non-employee director shall be a member of the Board who meets the definition of "non-employee director" as set forth in the 16(b) Rules. Currently, a non-employee director is a member of the Board who (i) is not currently an officer of the Company or a parent or subsidiary of the Company, or otherwise currently employed by the Company or a parent or subsidiary of the Company; (ii) does not receive compensation, either directly or indirectly, from the Company or a parent or subsidiary of the Company, for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to Item 404(a) of Regulation S-K promulgated under the Exchange Act ("S-K"); (iii) does not possess an interest in any other transaction for which disclosure would be required pursuant to Item 404(b) of S-K; and (iv) is not engaged in a business relationship for which disclosure would be required pursuant to Item 404(b) of S-K.

2.3 PROCEDURES. The Board may designate one of the members of the Plan Administrator as chairman. The Plan Administrator may hold meetings at such times and places as it shall determine. The acts of a majority of the members of the Plan Administrator present at meetings at which a quorum exists, or acts reduced to or approved in writing by all Plan Administrator members, shall be

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valid acts of the Plan Administrator.

2.4 RESPONSIBILITIES. Except for the terms and conditions explicitly set forth in this Plan, the Plan Administrator shall have the authority, in its discretion, to determine all matters relating to the Options, including selection of the individuals to be granted Options, the number of shares to be subject to each Option, the exercise price for such Option ("Exercise Price"), and all other terms and conditions of the Options. The interpretation and construction by the Plan Administrator of any terms or provisions of this Plan or any Option, or of any rule or regulation promulgated in connection with this Plan, shall be conclusive and binding on all interested parties, so long as such interpretation and construction with respect to incentive stock options correspond to the requirements of Section 422 of the Internal Revenue Code of 1986, as amended ("Code"), and the regulations issued thereunder, and any amendment or successor sections or regulations.

2.5 SECTION 16(b) COMPLIANCE AND BIFURCATION OF PLAN. If the Company registers any of its equity securities pursuant to Sections 12(b) and 12(g) of the Exchange Act, it is the intention of the Company that this Plan then comply in all respects with Rule 16b-3 under the Exchange Act and, if any Plan provision is later found not to be in compliance with such Section, the provision shall be deemed null and void. In all events, the Plan shall be construed in favor of its meeting the requirements of Rule 16b-3. Notwithstanding anything in the Plan to the contrary, the Board, in its absolute discretion, may bifurcate the Plan so as to restrict, limit or condition the use of any provision of the Plan to participants who are officers and directors subject to Section 16(b) of the Exchange Act without so restricting, limiting or conditioning the Plan with respect to other participants.

3. STOCK SUBJECT TO THIS PLAN. The stock subject to this Plan shall be the Company's common stock ("Common Stock"). The Company shall have authorized and have in reserve for issuance at the time of exercise of any Option a sufficient number of shares of Common Stock to meet the Company's obligation. The maximum number of shares of Common Stock which may be issued under the Plan shall be eight hundred thousand (800,000). If any Option expires or is surrendered, exchanged for another Option, cancelled or terminated for any reason without having been exercised in full, the unpurchased shares subject to such Option shall again be available for purposes of this Plan, including for

replacement Options which may be granted in exchange for such expired, exchanged, surrendered, cancelled or terminated Options.

4. ELIGIBILITY. An incentive stock option in accordance with Section 422 of the Code ("Incentive Option") may be granted only to an individual who, at the time the option is granted, is an employee of the Company or a related corporation, as defined below, and who the Plan Administrator may from time to time select for participation in this Plan. Members of the Board shall not be eligible for grants of Incentive Options unless they are also employees of the Company or any of its related corporations. At the discretion of the Plan Administrator, employees, officers, directors of the Company or any of its related corporations (including non-employee directors), selected non-employee agents, consultants, advisors, persons involved in the

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sale or distribution of the Company's or related corporations' products and independent contractors of the Company or any of its related corporations also may receive stock options which are not qualified under Section 422 of the Code ("Nonqualified Option") (Qualified and Nonqualified Options are included collectively within the term "Options" as used in this Plan). Any party to whom an Option is granted shall be referred to as an "Optionee."

As used in this Plan, the term "related corporation," when referring to a subsidiary corporation, shall mean any corporation (other than the Company) in an unbroken chain of corporations beginning with the Company if, at the time of the granting of the Option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock of one of the other corporations in such chain. When referring to a parent corporation, the term "related corporation" shall mean any corporation (other than the Company) in an unbroken chain of corporations ending with the Company if, at the time of granting of the Option, each of the corporations other than the Company owns stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock of one of the other corporations in such chain.

5. TERMS AND CONDITIONS OF OPTIONS. Options granted under this Plan shall be evidenced by written agreements which shall contain such terms, conditions, limitations and restrictions as the Plan Administrator shall deem advisable and which are not inconsistent with this Plan. Notwithstanding the foregoing, Option agreements shall include or incorporate by reference the following terms and conditions:

5.1 NUMBER OF SHARES. Each Option agreement shall state the number of shares of stock subject to the Option.

5.2 OPTION PRICE. The Option agreement shall state the Exercise Price per share, and the Plan Administrator shall act in good faith to establish the Exercise Price as follows:

5.2.1 INCENTIVE OPTIONS. Subject to subsection 5.2.3, the Exercise Price of Incentive Options shall be not less than the fair market value per share of the Common Stock at the time the Incentive Option is granted.

5.2.2 INCENTIVE OPTIONS TO GREATER THAN 10% SHAREHOLDERS. With respect to Incentive Options granted to shareholders then holding greater than ten percent (10%) of the then-issued and outstanding shares of voting stock of the Company, the Exercise Price shall be as required by Section 6.

5.2.3 FAIR MARKET VALUE. With respect to Incentive Options, the fair market value per share of the Common Stock shall be determined by the Plan Administrator in good faith at the time the Incentive Option is granted.

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5.2.4 SUBSTITUTED OPTIONS. Options granted in substitution for outstanding Options in the Company in connection with the

merger, consolidation, continuation acquisition of property or stock of the Company or a subsidiary of the Company or another corporation or any subsidiary of another corporation may be granted with an exercise price equal to the exercise price for the substituted option of the Company or other corporation, subject to any adjustment consistent with the terms of the transaction pursuant to which the substitution is to occur.

5.2.5 NONQUALIFIED OPTIONS. The Exercise Price of Nonqualified Options shall be as is determined by the Plan Administrator in good faith at the time of their issuance.

5.3 TERM, MATURITY AND VESTING. Subject to the restrictions contained in Sections 5.8 and 6, the term of each Incentive Option shall be ten (10) years from the date it is granted unless a shorter period of time is established by the Plan Administrator, but in no event shall the term of any Incentive Option exceed ten (10) years. The term of each Nonqualified Option shall also be ten (10) years from the date it is granted unless a shorter period of time is established by the Plan Administrator. The Plan Administrator shall specify which Options granted hereunder are Incentive Options and which are Nonqualified Options.

No Option shall be exercisable until it has vested. The vesting schedule for each Option shall be specified by the Plan Administrator at the time of grant; PROVIDED, that if no vesting schedule is specified at the time of grant, the Option shall vest according to the following schedule:

NUMBER OF YEARS FOLLOWING DATE OF GRANT -----	PERCENTAGE OF TOTAL OPTION VESTED -----
One	25%
Two	50%
Three	75%
Four	100%

The Plan Administrator may specify a vesting schedule for all or any portion of an Option based on the achievement of performance objectives established in advance of the commencement by the Optionee of services related to the achievement of the performance objectives. Performance objectives shall be expressed in terms of one or more of the following: return on equity, return on assets, share price, market share, sales, earnings per share, costs, net earnings, net worth, inventories, cash and cash equivalents, gross margin or the Company's performance relative to its internal business plan. Performance objectives may be in respect of the performance of the Company as a whole (whether on a consolidated or unconsolidated basis), a related corporation, or a subdivision, operating unit, product or product line of either of the foregoing. Performance objectives may be absolute or relative and may be expressed in terms of a

progression or a range. An option which is exercisable (in whole or in part) upon the achievement of one or more performance objectives may be exercised only following written notice to the Optionee and the Company by the Plan Administrator that the performance objective has been achieved.

5.4 EXERCISE. Subject to the limitations on exercise described in subsection 5.3 above and any additional holding period required by applicable law, each Option may be exercised in whole or in part; provided, however, that only whole shares will be issued pursuant to the exercise of any Option. During an Optionee's lifetime, any Options granted under this Plan are personal to him or her and are

exercisable solely by such Optionee. Options shall be exercised by delivery to the Company of a written notice of the number of shares with respect to which the Option is to be exercised, together with payment of the Exercise Price in accordance with Section 5.5.

5.5 PAYMENT OF EXERCISE PRICE. Payment of the Exercise Price shall be made in full at the time the written notice of exercise of an Option is delivered to the Company, and shall be in cash, bank certified or cashier's check or personal check (unless at the time of exercise the Plan Administrator in a particular case determines not to accept a personal check) for the Common Stock being purchased. The Plan Administrator can determine in its discretion (i) at the time an Incentive Option is granted, or (ii) at any time before exercise of Nonqualified Options that additional forms of payment will be permitted, including installment payments on such terms and over such period as the Plan Administrator may determine. To the extent permitted by the Plan Administrator and applicable laws and regulations (including, but not limited to, federal tax and securities laws and regulations and state corporate law), an option may be exercised by:

5.5.1 DELIVERY OF COMMON STOCK. Delivery of shares of Common Stock held by an Optionee having a fair market value equal to the Exercise Price, such fair market value to be determined in good faith by the Plan Administrator;

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5.5.2 DELIVERY OF PROMISSORY NOTE. Delivery of a full-recourse promissory note executed by the Optionee; provided that (i) such note if delivered in connection with an Incentive Option shall, and such note if delivered in connection with a Nonqualified Option may, bear interest at a rate specified by the Plan Administrator, but in no case less than the rate required to avoid imputation of interest (taking into account any exceptions to the imputed interest rules) for federal income tax purposes; (ii) the Plan Administrator shall specify the term and other provisions of such note at the time an Incentive Option is granted or at any time prior to exercise of a Nonqualified Option; (iii) the Plan Administrator may require that the Optionee pledge the Optionee's shares to the Company for the purpose of securing the payment of such note, and may require that the certificate representing such shares be held in escrow to perfect the Company's security interest; (iv) the note provides that ninety (90) days following the Optionee's termination of employment with the Company or a related Corporation, the entire outstanding balance under the note shall become due and payable, if not previously due and payable; and (v) the Plan Administrator in its sole discretion may at any time after granting an Option restrict or rescind the right to pay using a promissory note upon written notification to any Optionee;

5.5.3 DELIVERY OF SALE PROCEEDS. Delivery of a properly executed written exercise notice, together with irrevocable instructions to a broker, all in accordance with the regulations of the Federal Reserve Board, to promptly deliver to the Company the amount of sale or loan proceeds to pay the exercise price and any federal, state or local withholding tax obligations that may arise in connection with the exercise; provided, that the Plan Administrator may at any time determine that this subsection 5.5.3, to the extent the instructions to the broker call for an immediate sale of the shares, shall not be available to any Optionee who is subject to Section 16(b) of the Exchange Act if such transaction would result in a violation of Section 16(b), or if such Optionee is not an employee at the time of exercise; or

5.5.4 DELIVERY OF WITHHOLDING NOTICE. Delivery of a properly executed written exercise notice together with instructions to the Company to withhold upon exercise from the shares that would otherwise be issued that number of shares having a fair market value equal to the Exercise Price.

5.6 WITHHOLDING TAX REQUIREMENT. The Company or any related entity shall have the right to retain and withhold from any payment of cash or Common Stock under this Plan the amount of taxes required by any government to be withheld or otherwise deducted and paid with respect to such payment. At its discretion, the Company may require an Optionee receiving shares of Common Stock to reimburse the Company for any such taxes required to be withheld by the Company, and may withhold any distribution in whole or in part until the

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Company is so reimbursed. In lieu of such withholding or reimbursement, the Company shall have the right to withhold from any other cash amounts due or to become due from the Company to the Optionee an amount equal to such taxes or to retain and withhold a number of shares having a market value not less than the amount of such taxes required to be withheld by the Company to reimburse the Company for any such taxes and cancel (in whole or in part) any such shares so withheld. If required by Section 16(b) of the Exchange Act, the election to pay withholding taxes by delivery of shares held by any person who at the time of exercise is subject to Section 16(b) of the Exchange Act, shall be made during the quarterly 10-day window period required under Section 16(b) of the Exchange Act for exercises of stock appreciation rights.

5.7 TRANSFERABILITY OF OPTION. Options and the rights and privileges conferred by this Plan shall not be transferred, assigned or pledged in any manner (whether by operation of law or otherwise) other than (i) by will or by the applicable laws of descent and distribution, or (ii) by gift to members of the Optionee's family, including grandparents, parents, spouses, siblings, children, grandchildren and great-grandchildren, or trusts for the benefit of such family members or to charitable organizations, and shall not be subject to execution, attachment or similar process. Any attempt to transfer, assign, pledge or otherwise dispose of any Option or of any right or privilege conferred by this Plan, contrary to the Code or to the provisions of this Plan, or the sale or levy or any attachment or similar process upon the rights and privileges conferred by this Plan shall be null and void. Notwithstanding the foregoing, an Optionee may, during the Optionee's lifetime, designate a person who may exercise the Option after the Optionee's death by giving written notice of such designation to the Plan Administrator. Such designation may be changed from time to time by the Optionee giving written notice to the Plan Administrator revoking any earlier designation and making a new designation. In the event that no such designation is made, the executor or personal representative of the Optionee's estate shall have any rights then remaining to the Optionee or his estate under this Plan.

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5.8 DURATION OF OPTION. Vested Options shall terminate, to the extent not previously exercised, upon the occurrence of the first of the following events: (i) the expiration of the Option, as designated by the Plan Administrator in accordance with section 5.3; (ii) the date of an Optionee's termination of employment with the Company or any related corporation for cause (as determined in the sole discretion of the Plan Administrator); (iii) the expiration of ninety (90) days from the date of an Optionee's termination of employment with the Company or any related corporation for any reason whatsoever other than cause, death or Disability (as defined below) unless, the exercise period is extended by the Plan Administrator until a date not later than the expiration date of the Option; or (iv) the expiration of one year from (A) the date of death of the Optionee or (B) cessation of an Optionee's employment by reason of Disability (as defined below) unless, the exercise period is extended by the Plan Administrator until a date not later than the expiration date of the Option. If an Optionee's employment is terminated by death, any Option held by the Optionee shall be exercisable only by the person or persons to whom such Optionee's rights under such Option shall pass by the Optionee's will or by the laws of descent and distribution of the

state or county of the Optionee's domicile at the time of death. For purposes of the Plan, unless otherwise defined in the Agreement, "Disability" shall mean any physical, mental or other health condition which substantially impairs the Optionee's ability to perform his or her assigned duties for one hundred twenty (120) days or more in any two hundred forty (240) day period or that can be expected to result in death. The Plan Administrator shall determine whether an Optionee has incurred a Disability on the basis of medical evidence acceptable to the Plan Administrator. Upon making a determination of Disability, the Plan Administrator shall, for purposes of the Plan, determine the date of an Optionee's termination of employment.

Unless accelerated in accordance with Section 7, unvested Options shall terminate immediately upon termination of employment of the Optionee by the Company for any reason whatsoever, including death or Disability. For purposes of this Plan, transfer of employment between or among the Company and/or any related corporation shall not be deemed to constitute a termination of employment with the Company or any related corporation. For purposes of this subsection with respect to Incentive Stock Options, employment shall be deemed to continue while the Optionee is on military leave, sick leave or other bona fide leave of absence (as determined by the Plan Administrator). The foregoing not withstanding, employment shall not be deemed to continue beyond the first ninety (90) days of such leave, unless the Optionee's re-employment rights are guaranteed by statute or by contract.

5.9 STATUS OF SHAREHOLDER. Neither the Optionee nor any party to which the Optionee's rights and privileges under the Option may pass shall be, or shall have any of the rights or privileges of, a shareholder of the Company with respect to any of the shares issuable upon the exercise of any Option unless and until such Option has been exercised.

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5.10 RIGHT TO TERMINATE EMPLOYMENT. Nothing in this Plan or in any Option shall confer upon any Optionee any right to continue in the employ of the Company or of a related entity, or to interfere in any way with the right of the Company or of any related corporation to terminate, at will, his or her employment or other relationship with the Company at any time.

5.11 MODIFICATION AND AMENDMENT OF OPTION. Subject to the requirements of Code Section 422 with respect to Incentive Options and to the terms, conditions and limitations of this Plan, the Plan Administrator may modify or amend outstanding Options. The modification or amendment of an outstanding Option shall not, without the consent of the Optionee, impair or diminish any of his or her rights or any of the obligations of the Company under such Option. Except as otherwise provided in this Plan, no outstanding Option shall be terminated without the consent of the Optionee. Unless the Optionee agrees otherwise, any changes or adjustments made to outstanding Incentive Options shall be made in such a manner so as not to constitute a "modification" as defined in Code Section 424(h) and so as not to cause any Incentive Option to fail to continue to qualify as an "incentive stock option" as defined in Code Section 422(b).

5.12 LIMITATION ON VALUE FOR INCENTIVE OPTIONS. As to all Incentive Options, to the extent that the aggregate fair market value of the Common Stock with respect to which Incentive Options are exercisable for the first time by the Optionee during any calendar year (under this Plan and all other incentive stock option plans of the Company, a related corporation or a predecessor corporation) exceeds \$100,000, those Options (or the portion of an Option) beyond the \$100,000 threshold shall be treated as Nonqualified Options. If the Internal Revenue Service publicly rules, issues a private ruling to the Company, any Optionee, or any legatee, personal representative or distributee of an Optionee or issues regulations changing or eliminating such annual limit, the dollar limitation in the preceding sentence shall be adjusted correspondingly.

6. GREATER THAN 10% SHAREHOLDERS. In the case of Incentive Options granted to employees who own at the time of their grant ten percent (10%) or

more of the then-issued and outstanding voting stock of the Company, the following rules shall apply:

6.1 EXERCISE PRICE AND TERM OF INCENTIVE OPTIONS. If Incentive Options are granted to employees who own more than ten percent (10%) of the total combined voting power of all classes of stock of the Company or any related corporation, the term of such individual's Incentive Options shall not exceed five (5) years and the Exercise Price shall be not less than one hundred ten percent (110%) of the fair market value of the Common Stock at the time the Incentive Option is granted. This provision shall control notwithstanding any contrary terms contained in an Option agreement or any other document.

6.2 ATTRIBUTION RULE. For purposes of subsection 6.1, in determining stock

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ownership, an employee shall be deemed to own such shares as are owned by those persons or entities defined in Code Section 424. For purposes of this Section 6, stock owned by an employee shall include all stock actually issued and outstanding immediately before the grant of the Incentive Option to the employee.

7. ADJUSTMENTS UPON CHANGES IN CAPITALIZATION. The aggregate number and class of shares for which Options may be granted under this Plan, the number and class of shares covered by each outstanding Option and the Exercise Price per share thereof (but not the total price), and each such Option, shall all be proportionately adjusted for any increase or decrease in the number of issued shares of Common Stock of the Company resulting from a split-up or consolidation of shares or any like capital adjustment, or the payment of any stock dividend.

7.1 EFFECT OF LIQUIDATION, REORGANIZATION OR CHANGE IN CONTROL.

7.1.1 CASH, STOCK OR OTHER PROPERTY FOR STOCK. Except as provided in subsection 7.1.2, upon a merger (other than a merger of the Company in which the holders of Common Stock immediately prior to the merger have the same proportionate ownership of Common Stock in the surviving corporation immediately after the merger), consolidation, acquisition of property or stock, separation, reorganization (other than a mere reincorporation or the creation of a holding company) or liquidation of the Company, as a result of which the shareholders of the Company receive cash, stock or other property in exchange for or in connection with their shares of Common Stock, any Option granted under this Plan shall terminate, but the Optionee shall have the right immediately prior to any such merger, consolidation, acquisition of property or stock, separation, reorganization or liquidation to exercise such Option in whole or in part, to the extent the vesting requirements set forth in the Option agreement have been satisfied, unless stated otherwise in the Optionee's individual Option agreement.

7.1.2 CONVERSION OF OPTIONS ON STOCK-FOR-STOCK EXCHANGE. If the shareholders of the Company receive capital stock of another corporation ("Exchange Stock") in exchange for their shares of Common Stock in any transaction involving a merger (other than a merger of the Company in which the holders of Common Stock immediately prior to the merger have the same proportionate ownership of Common Stock in the surviving corporation immediately after the merger), consolidation, acquisition of property or stock, separation or reorganization (other than a mere reincorporation or the creation of a holding company), all Options granted under this Plan shall be converted into options to purchase shares of Exchange Stock unless the Company and the Corporation issuing the Exchange Stock, in their sole discretion, determine that any or all such Options shall not be converted into options to purchase shares of Exchange Stock, but instead shall terminate in accordance with the provisions of subsection 7.1.1. The amount and price of converted options shall be

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determined by adjusting the amount and price of the Options in the same proportion as used for determining the number of shares of Exchange Stock the holders of the Common Stock receive in such merger, consolidation, acquisition of property or stock, separation or reorganization. Unless accelerated by the Board, the exercise limitations set forth in the Option agreement and the Plan shall continue to apply for the Exchange Stock.

7.1.3 CHANGE IN CONTROL. In the event of a "Change in Control," as defined below, of the Company, unless otherwise determined by the Board prior to the occurrence of such Change in Control, any Options or portions of such Options outstanding as of the date such Change in Control is determined to have occurred that are not yet fully vested on such date shall become immediately exercisable in full.

7.1.4 DEFINITION OF "CHANGE IN CONTROL". For purposes of this Plan, a "Change in Control" shall mean (a) the first approval by the Board or by the stockholders of the Company of an Extraordinary Event, (b) a Purchase or (c) a Board Change. For purposes of the Plan, such terms shall have the following meanings:

7.1.4.1 An "Extraordinary Event" shall mean any of the following actions: (i) any consolidation or merger of the Company in which the Company is not the continuing or surviving corporation or pursuant to which shares of Common Stock would be converted into cash, securities or other property, other than a merger of the Company in which the holders of Common Stock immediately prior to the merger have the same proportionate ownership of common stock of the surviving corporation immediately after the merger; (ii) any sale, lease, exchange or other transfer (in one transaction or a series of related transactions) of all, or substantially all, the assets of the Company; or, (iii) the adoption of any plan or proposal for liquidation or dissolution of the Company.

7.1.4.2 A "Purchase" shall mean the acquisition by any person (as such term is defined in Section 13(d) of the Exchange Act) of any shares of Common Stock or securities convertible into Common Stock without the prior approval of a majority of the Continuing Directors (as defined below) of the Company, if after making such acquisition such person is the beneficial owner (as such term is defined in Rule 13d-3 under the Exchange Act) directly or indirectly of Securities of the Company representing twenty percent (20%) or more of the combined voting power of the Company's then outstanding securities (calculated as provided in paragraph (d) of such Rule 13d-3).

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7.1.4.3 A "Board Change" shall have occurred if individuals who constitute the Board of the Company at the time of adoption of this Plan (the "Continuing Directors") cease for any reason to constitute at least a majority of the Board, provided that any person becoming a Director subsequent to the date of adoption of this Plan whose nomination for election was approved by a vote of at least a majority of the Continuing Directors (other than a nomination of an individual whose initial assumption of office is in connection with an actual threatened election contest relating to the election of the Directors of the Company, as such terms are used in Rule 14a-11 of Regulation 14A under the Exchange Act) shall be deemed to be a Continuing Director.

7.2 FRACTIONAL SHARES. In the event of any adjustment in the number of shares covered by any Option, any fractional shares resulting from such adjustment shall be disregarded and each such Option shall cover only the number of full shares resulting from such adjustment.

7.3 DETERMINATION OF BOARD TO BE FINAL. All Section 7 adjustments shall be made by the Board, and its determination as to what adjustments shall be made, and the extent of such adjustments, shall be final, binding and conclusive. Unless an Optionee agrees otherwise, any change or adjustment to an Incentive Option shall be made in such a manner so as not to constitute a "modification" as defined in Code Section 424(h) and so as not to cause his or her Incentive Option to fail to continue to qualify as an incentive stock option as defined in Code Section 422(b).

8. SECURITIES REGULATION. Shares shall not be issued with respect to an Option unless the exercise of such Option and the issuance and delivery of such shares pursuant to the exercise of such Option shall comply with all relevant provisions of law, including, without limitation, any applicable state securities laws, the Securities Act of 1933, as amended, the Exchange Act, the rules and regulations promulgated thereunder, and the requirements of any stock exchange upon which the shares may then be listed, and shall be further subject to the approval of counsel for the Company with respect to such compliance, including the availability of an exemption from registration for the issuance and sale of any shares under this Plan. Inability of the Company to obtain from any regulatory body having jurisdiction, the authority deemed by the Company's counsel to be necessary for the lawful issuance and sale of any shares under this Plan or the unavailability of an exemption from registration for the issuance and sale of any shares under this Plan shall relieve the Company of any liability in respect of the non-issuance or sale of such shares as to which such requisite authority shall not have been obtained.

As a condition to the exercise of any Option, the Company may require the Optionee to represent and warrant at the time of any such exercise that the shares are being purchased only for investment and without any present intention to sell or distribute such shares if, in the opinion of counsel for the Company, such a representation is required by any relevant provision of the aforementioned laws. At the option of the Company, a stop-transfer order against any shares of stock may be placed on the official stock books and records of the Company, and a legend

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indicating that the stock may not be pledged, sold or otherwise transferred unless an opinion of counsel is provided (concurred in by counsel for the Company) stating that such transfer is not in violation of any applicable law or regulation, may be stamped on stock certificates in order to assure exemption from registration. The Plan Administrator may also require such other action or agreement by the Optionees as may from time to time be necessary to comply with the federal and state securities laws. THIS PROVISION SHALL NOT OBLIGATE THE COMPANY TO UNDERTAKE REGISTRATION OF THE OPTIONS OR STOCK HEREUNDER. Should any of the Company's capital stock of the same class as the stock subject to Options be listed on a national securities exchange, all stock issued under this Plan if not previously listed on such exchange shall be authorized by that exchange for listing on such exchange prior to the issuance of such stock.

9. AMENDMENT AND TERMINATION. This Plan may be amended from time to time as follows:

9.1 BOARD ACTION. The Board may at any time suspend, amend or terminate this Plan; provided, that except as set forth in Section 7, the approval of the Company's shareholders is necessary within twelve (12) months before or after the adoption by the Board of any amendment which will:

9.1.1 increase the number of shares which are to be reserved for the issuance of Options;

9.1.2 permit the granting of stock options to a class of persons other than those presently permitted to receive Options;
or

9.1.3 require shareholder approval under applicable law, including Section 16(b) of the Exchange Act.

Any amendment made to this Plan which would constitute a

"modification" to Incentive Options outstanding on the date of such amendment, shall not be applicable to such outstanding Incentive Options, but shall have prospective effect only, unless the Optionee agrees otherwise.

9.2 AUTOMATIC TERMINATION. Unless sooner terminated by the Board, this Plan shall terminate ten (10) years from the earlier of (i) the date on which this Plan is adopted by the Board or (ii) the date on which this Plan is approved by the shareholders of the Company. No Option may be granted after such termination or during any suspension of this Plan. The amendment or termination of this Plan shall not, without the consent of the option holder, alter or impair any rights or obligations under any option previously granted under this Plan.

10. EFFECTIVENESS OF THIS PLAN. This Plan shall become effective upon adoption by the Board so long as it is approved by the Company's shareholders any time within twelve (12) months before or after the adoption of this Plan.

TECHNOLOGY TRANSFER AGREEMENT

THIS AGREEMENT is made between Schmitt Industries, Inc., an Oregon corporation having a principal place of business at 2765 N.W. Nicolai, Portland, Oregon 97210 (hereinafter "Schmitt") and Centerline Engineering, Inc., an Illinois corporation having a principal place of business at 1146 Beatty Mound Road, Jerseyville, Illinois 62052 and the following individuals: Michael Harms having a principal place of residence at R. R. #2, Box 6, Dow, Illinois 62035, Michael Smith having a principal place of residence at 1109 Reddish Drive, Jerseyville, Illinois 62052, and Nelson Miller having a principal place of residence at R. R. #4, Box 136, Jerseyville, Illinois 62052, (hereinafter "Centerline").

WHEREAS, Centerline has developed certain Technology relating to a non-contact gauging apparatus and method and has filed with the U.S. Patent and Trademark Office a Patent Application directed to the Technology; and

WHEREAS, Schmitt is desirous of acquiring from Centerline all rights in and to said Technology.

NOW, THEREFORE, Centerline and Schmitt, in consideration of the premises and mutual covenants stated herein and other good and valuable consideration, the sufficiency of which is hereby acknowledged, do hereby agree as follows:

I. DEFINITIONS

When used in this Agreement, the following terms shall have the meaning indicated:

- A. Technology: Any invention, improvement, discovery, product, apparatus, method, formula or process, or patent or patent application with respect thereto, know-how or trade secret relating to the gauging of cylindrical rolls which has been developed by Centerline.
- B. Device: Any apparatus employing the Technology, the manufacture, use or sale of which by a third party would constitute an infringement of any claim in an issued patent (or pending application), which claim covers an invention invented solely by Centerline and relating to the Technology.
- C. Prototype: The measurement machine built by Centerline and employing the Technology which was disclosed to Schmitt on April 17, 1998.
- D. Patent Application: U.S. Patent Application Serial No. 08/844,727 filed April 18, 1997 entitled "Non-contact Gauging Apparatus And Method."
- E. Net Sales Price: The gross amount billed for any Devices sold, excluding Schmitt's actual cost of transporting the Devices to its customers, the actual cost

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of installation (if any), income or business taxes paid to any governmental entity whether domestic or foreign, the actual cost of insurance paid in connection with the delivery of devices to customers, and the actual cost, not exceeding 24% of gross sales price, of any commissions or rebates given to unrelated non-user customers, distributors, or sales representatives.

II. WARRANTY

- A. Centerline warrants that to the best of Centerline's knowledge that the Technology is secret and has not been published or otherwise publicly disclosed, or revealed to anyone not having an obligation of confidentiality to keep the Technology confidential.
- B. Centerline warrants that it has the right and power to enter into this Agreement and to grant, sell, assign and transfer all rights in the

Technology to Schmitt.

- C. Centerline warrants that it has not heretofore entered into any contract in conflict with this Agreement and has not sold, granted, assigned or transferred to any third party any right, license or privilege relating to the Technology.
- D. Centerline warrants that it has not filed or caused to be filed any applications for letters patent in the U.S. or anywhere else in the world relating to the Technology except U.S. Provisional Patent Application Serial No. 60/015,670, filed April 19, 1996 and U.S. Patent Application Serial No. 08/844,727, filed April 18, 1997.
- E. Centerline warrants that it knows of no patents, trade secrets or proprietary rights of others which would be infringed or violated by the making, using, selling, testing, promoting or distributing of the Prototype by Schmitt.

III. TRANSFER OF THE TECHNOLOGY

- A. Centerline agrees to assign to Schmitt, and hereby does assign to Schmitt, the entire right, title and interest in and to the Technology, including, without limitation, the right to file for and prosecute patent applications in the name of Schmitt relating to the Technology wherever such right may be legally exercised.
- B. Centerline agrees to supply to Schmitt, at no additional charge, the technical information and material in Centerline's possession required to adequately disclose the Technology, including the operation and method of manufacture of

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the Prototype. This technical information shall include, but is not limited to, all presently existing prototypes, drawings, schematics, software code, blueprints, and test reports, relating to the performance, function, operation, design, and manufacture of the Prototype.

IV. ROYALTIES, PAYMENTS AND RECORD KEEPING

- A. Schmitt agrees to pay to Centerline One Hundred Thousand Dollars (\$100,000), said fee to be paid as follows:
 - 1. A payment of Twenty-Five Thousand Dollars (\$25,000) shall be due and payable by Schmitt to Centerline upon the execution of this Agreement by both parties.
 - 2. A payment of Twenty-Five Thousand Dollars (\$25,000) shall be due and payable by Schmitt to Centerline on or before May 11, 1998 provided that Centerline has delivered the Prototype to Schmitt or before May 11, 1998, and provided that by May 6, 1998, Centerline has:
 - a. Obtained a new assignment of the invention disclosed and claimed in the Patent Application from all inventors to Centerline and forwarded said assignment(s) to the U.S. Patent and Trademark Office for recordation;
 - b. Assigned the Patent Application to Schmitt and forwarded said assignment to the U.S. Patent and Trademark Office for recordation;
 - c. Filed with the U.S. Patent and Trademark Office an amendment under Rule 312 to correct typographical errors in the Patent Application;
 - d. Filed at Schmitt's expense with the U.S. Patent and Trademark Office a Petition to Correct Inventorship to correct the inventorship in the Patent Application; and
 - e. Paid the Issue Fee for the Patent Application.

3. A payment of Twenty-Five Thousand Dollars (\$25,000) shall be due and payable by Schmitt to Centerline on or before July 17, 1998, provided that by June 30, 1998:

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- a. Centerline personnel (including Michael Harms and Michael Smith) have cooperated with Schmitt in connection with the preparation and filing of a continuation-in-part application ("the CIP Patent Application") claiming priority to the Patent Application to be prepared by Schmitt; and
 - b. Centerline has physically transferred to Schmitt all information and equipment relating to the Technology being assigned by this Agreement.
4. A payment of Twenty-Five Thousand Dollars (\$25,000) shall be due and payable by Schmitt to Centerline on or before October 16, 1998.

B. Schmitt agrees to pay to Centerline a royalty of the greater of:

1. One Thousand Dollars (\$1,000) per Device; or
2. Five percent (5%) of the Net Sales Price obtained from the sale of each Device shipped by Schmitt.

However, Centerline hereby waives the first Fifty Thousand Dollars (\$50,000) of earned royalty after the date of this Agreement.

- C. The royalties provided for under this Agreement shall be paid quarterly, and Schmitt agrees to pay Centerline on or before the last day of the months of January, April, July and October the total amount of royalties due and payable under this Agreement during the calendar quarter immediately preceding said dates.
- D. Schmitt agrees to keep an accurate account of the operations coming under the scope of this Agreement and shall render a statement in writing to Centerline with each royalty payment indicating how many Devices have been sold and shipped during the period for which royalties are being paid.

V. PATENTS

- A. Centerline agrees, without further consideration, to sign all lawful papers and to perform all other lawful acts which Schmitt may request, including the prompt execution of all original, divisional, substitute, reissue, and other United States and foreign patent applications on said Technology, including the Patent Application and the CIP Patent Application, and all lawful documents requested by Schmitt to further the prosecution of any of such patent applications.

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- B. Centerline agrees to cooperate at Schmitt's expense to the best of its ability in the execution of all lawful documents and the production of evidence in any nullification, reissue, extension, or infringement proceedings involving any patents covering the Technology.
- C. Centerline agrees that Schmitt may, at its sole discretion and at its expense, file and prosecute foreign patent applications relating to the Technology.

VI. IMPROVEMENTS

If, during the next ten (10) years, Centerline makes any improvements relating to the Technology, Centerline shall promptly communicate such improvement to Schmitt and give Schmitt full information regarding the improvement. Such information may be transmitted orally, in writing,

and through demonstrations as the occasion requires and shall be sufficient for technical personnel of the parties to understand and apply and evaluate the subject matter. In order to facilitate such improvements, Schmitt will provide to Jerseyville Precision Inc., at 1148 Beatty Mound Road, Jerseyville, Illinois on behalf of Centerline, the most current model of the Device at no cost to Centerline or Jerseyville Precision, Inc. for improvement and demonstration. In exchange, Centerline agrees to convey and assign any such improvements to Schmitt at no additional price to Schmitt.

VII. NONCOMPETE

- A. Centerline agrees that Michael Harms, Michael Smith, and Nelson Miller, during the term of this Agreement and thereafter for a period of two (2) years, will not directly or indirectly use any of the Technology or perform activities relating to gauging of cylindrical rolls in any business, profession, or other endeavor which is either directly or indirectly in competition with the business of Schmitt.
- B. Centerline agrees that during the term of this Agreement and thereafter Centerline Engineering Inc. will not directly or indirectly use any of the Technology or perform activities relating to gauging of cylindrical rolls in any business, profession, or other endeavor which is either directly or indirectly in competition with the business of Schmitt.
- C. If any court finds the provisions in part VII. of this Agreement to be unreasonable, the parties agree that the court may so modify this Agreement to the extent necessary to make the provisions reasonable.

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VIII. TERM AND TERMINATION

- A. This Agreement shall become effective from the date of its execution and shall, unless terminated earlier by one of the parties hereto in accordance with its terms, expire upon the expiration of the last patent having a claim covering the Device or method of using the Device, or in two (2) years from the date of its execution if no patent issues.
- B. In the event that either party defaults or breaches any of the provisions of this Agreement, the non-defaulting party reserves the right to terminate this Agreement upon sixty (60) calendar days written notice to the defaulting party; unless, however, the defaulting party within the sixty (60) calendar day period referred to, cures the default or breach.

IX. GENERAL PROVISIONS

- A. **ARBITRATION:** Any controversy or claim arising out of or relating to this Agreement or the breach thereof shall be settled by arbitration in St. Louis, Missouri in accordance with the Commercial Arbitration Rules of the American Arbitration Association, and judgment upon the award rendered by the arbitrator(s) may be entered in any Court having jurisdiction thereof.
- B. **ATTORNEY'S FEES:** In the event of a dispute between the parties arising under this Agreement, the party prevailing in such dispute shall be entitled to collect such party's costs from the other party including, without limitation, court and investigation costs and reasonable attorney's fees and disbursements.
- C. **ASSIGNMENT:** This Agreement shall be binding by both parties to their successors and assignees and personal representatives, including specifically Michael Harms, Michael Smith, and Nelson Miller.
- D. **INTERPRETATION AND CONSTRUCTION:** This Agreement is written and will be administered under the laws and applicable regulations of commerce of the State of Oregon.
- E. **SEVERABILITY:** In the event any one or more of the provisions contained in this Agreement shall for any reason be held to be

invalid, illegal or unenforceable in any respect, such invalidity, illegality or unenforceability shall not affect the validity of any other provision hereof and this Agreement shall be construed as if such invalid, illegal or unenforceable provision were not contained herein provided the Agreement as so modified preserves the basic intent.

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- F. WAIVER: The failure of any party at any time to require performance by any other party of any of the provisions herein shall not operate as a waiver of the right of said party to request strict performance of the same or like provisions, or any other provisions hereof, at a later date.
- G. ENTIRE AGREEMENT: This Agreement represents the entire agreement between the parties on the subject matter hereof and supersedes all prior discussions, agreements, and understandings of every kind and nature between them. No modification of this Agreement will be effective unless in writing and signed by both parties.

IN WITNESS WHEREOF, the parties hereto intending to be legally bound have caused the presents to be signed, in duplicate, effective as of the date of the last signature hereto.

SCHMITT INDUSTRIES, INC.

CENTERLINE ENGINEERING INC.

/s/ Wayne A. Case

/s/ Nelson Miller

By: Wayne A. Case
Its: President

By: Nelson Miller
Its: Chairman and CEO

Date: May 8, 1998

Date: April 23, 1998

INDIVIDUALLY
The following undersigned individuals agree to assist Centerline in fulfilling all of its duties and obligations outlined in this Agreement.

/s/ Michael Harms

Michael Harms

/s/ Michael Smith

Michael Smith

/s/ Nelson Miller

Nelson Miller

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About Schmitt Industries

Schmitt Industries designs, manufactures and markets two distinct types of precision measurement systems. Schmitt's automatic balancing systems for rotating machinery are used by many of the world's leading automotive, aerospace and bearing manufacturers. The second Schmitt product line, non-contact measurement laser systems, are targeted to high-tech manufacturers worldwide and ensure that silicon wafers and computer hard disks meet exacting standards for surface microroughness.

The company's mission is to provide the best possible products and quality for its customers, to provide challenging and rewarding employee opportunities and to provide the greatest possible return to shareholders. Schmitt recorded fiscal 1998 revenues of \$10,626,084. The company currently employs 50 people in three international locations: Alsbach, Germany; Coventry, England; and at its corporate headquarters in Portland, Oregon. Company shares are traded on the NASDAQ National Market under the symbol, SMIT.

Financial Highlights

In thousands of dollars except per share information

	1998	1997	1996	1995	1994
Revenues	\$ 10,626	\$ 10,542	\$ 7,080	\$ 4,415	
	\$ 2,575				
Operating Income	1,339	2,296	1,509	697	313
Net Income After Taxes	1,250	1,725	1,217	249	182
Net Income Per Share, Diluted	\$.17	\$.23	\$.16	\$.04	\$.03
Stockholders' Equity	8,688	7,429	4,887	3,464	3,215

- a) Graph of Schmitt's Revenues, 1994-98
- b) Graph of Schmitt's Operating Income, 1994-98
- c) Graph of Schmitt's Net Income per share, 1994-98

- a) Photo of Wayne A. Case

To our shareholders:

...our balance sheet remains strong, even healthier than a year ago. Schmitt Industries is debt free and assets approach \$10 million. For the first six months of fiscal 1998, all signs pointed to another banner year of record sales and net profits at Schmitt Industries. Then, with little warning, the Asian financial crisis hit, precipitating a sales slump in our non-contact measurement product line that serves the high-technology industry. As a result, fiscal 1998 ended with slightly increased sales over a year ago, but profits fell short of expectations.

The good news, however, is that we further strengthened our hold on the U.S. market for balancer systems for the machine-tool industry. And we are making significant strides in the European balancer market through Schmitt Hofmann Systems (SHS) and Schmitt Europe Limited (SEL). Sales were up 130% in the United Kingdom and 91% in Germany. The solid performance in our balancer product line helped offset the decline in our Asian markets.

We've also taken another key step toward further solidifying our presence in the machine tool industry. We are introducing a strategic new product, the

SB-4500 electronic control system, which allows multi-tasking among multiple balancers. More importantly, this controller provides a convenient integrated platform for introducing additional machine-control products. We plan to expand our product offerings to users of grinding machines and other machine tools, while continuing to support our existing and growing balancer markets.

As a relatively small company, we have the capability to react rapidly to market changes and redeploy our research and development strategies when necessary.

As the situation in Asia plays out, we are concentrating more on the worldwide machine-tool market, where demand remains high. To that end, we are applying non-contact measurement laser technology to a new series of dimensional gauging and microroughness measurement products, which will ship in the fourth quarter of this year.

While we are shifting focus away from Asian markets, we must emphasize that this is only for the short-term. Our non-contact measurement tools, utilizing advanced laser technology, continue to make inroads in the hard-disk and silicon wafer markets. During fiscal 1998, we introduced the DTM-2000, a high-speed production-line testing system that has no equal in the industry. When the Asian markets rebound, we will be well-positioned to reap the benefits. I am pleased to report that our balance sheet remains strong, even healthier than a year ago. Schmitt Industries is debt free and assets approach \$10 million. This solid bottom line provides the impetus as we confidently move forward to: aggressively research new products, study additional acquisition opportunities, and seek strategic partnerships both in the U.S. and abroad.

Wayne A. Case
President and Chairman of the Board

The need to evolve.

Schmitt's automatic balancing systems for grinding machinery are preferred by many of the world's leading manufacturers. In fact, the company has garnered a greater than 50% market share for its products in the U.S. alone. However, to further solidify its presence in the industry, Schmitt recognized the need to evolve its balancer product line into ultra-high-speed markets. At the same time, the company wanted to broaden its machine-control product offerings beyond balancers.

How small is a micron

A human hair is about 50 microns. Grass grows at about 5 microns a minute. One micron is to a drop of water, as a teaspoon of water is to an Olympic swimming pool.

a) Photo of Schmitt's automatic balancing system components.

Beyond traditional balancers.

Schmitt's new SB-4500 electronic control system offers significant enhancements, including higher speed balancing, multi-functionality, improved balancer control and faster balancing cycles. Since the industry is moving toward ever increasing speed requirements and tighter tolerance control, the SB-4500 ably supports these increased market needs. The new platform allows integrated control of multiple balancers, and supports additional product functions. With this control system, Schmitt plans to expand its industrial machine-tool product lines and markets.

The SB-4500 provides a common interface for several different balancer products, and it allows for multi-language capabilities, plus worldwide compatible voltage and safety specifications. The product will eventually replace Schmitt's existing controls for balancers manufactured in the U.S., as well as additional controls manufactured in Germany.

Schmitt's latest technology advancement measures and controls vibrations to .04 millionths of an inch, a ten-fold improvement over the company's current balancer capability. Industry experts rate this performance as the best in the business.

In its goal to tap new markets, Schmitt is broadening its product line beyond balancers. The company is developing advanced non-contact dimensional profile and surface measurement gauging for the roll-grinder industry, which will be introduced by the fourth quarter of 1998.

The Schmitt Industries Story

Back in 1987, the founders of Schmitt Industries conducted comprehensive market research into industrial manufacturing. In the process, they learned that there was no simple, reliable solution for in-process balancing of grinding machines. Precision grinding is a necessary step for nearly every industrial manufacturing endeavor.

Over the years, our balancer line has grown to include power transmission technology, computer controls and sensors, external balancers and adapters, internal balancers, ring balancers and hydro-kompensers. But we've never lost focus of our overriding company philosophy: we bring to market products customers want.

We currently control over 50% of the U.S. balancer market, and we are continuing to make strong gains within the European marketplace. In 1995, we acquired a former competitor in Germany, and that strategic business move has accelerated our market penetration in Europe, while adding key products to our balancer line.

Schmitt balancer systems are production-proven in thousands of major manufacturing installations from coast-to-coast and around the world, including many of the largest manufacturing firms. Schmitt balancer products conform to strict ISO-9001 quality and measurement standards.

The latest addition to the Schmitt balancer family is the SB-4500 electronic control system. This new product enables multi-tasking among multiple balancers, and serves as an integrated platform for additional machine control products in the machine tool industry. The SB-4500 increases balancer speed and performance, and enables vibration measurements down to one-thousandth of a micron.

After conducting careful market research, Schmitt acquired TMA Technologies in May 1995, and along with it the company's fledgling laser technology. Schmitt refined this technology, assembled a separate company division called Schmitt Measurement Systems (SMS), and developed a new line of non-contact surface measurement products.

All smooth surfaces exhibit some degree of microroughness, even if only at the atomic level. Using proprietary light-scatter technology, Schmitt Measurement Systems provides rapid, accurate, repeatable and non-destructive surface measurements. SMS products are proving invaluable to manufacturers of hard disks, hard disk drives, and silicon wafers.

In 1997, SMS developed the DTM-2000, an automated production-line system that enables 100% testing of hard disks and delivers ten times the throughput of conventional systems. The SMS product line also features light-scatter measurement products, utilized by NASA and the Department of Defense for precision measuring of space optics, cameras, and telescope lenses. Schmitt Industries, by virtue of its debt-free balance sheet and \$10 million in assets, continues to devote significant resources to the research and development of new products.

And our company vision remains steadfast: "To provide the finest quality products for our customers, to provide challenging and rewarding employment opportunities, and to provide the greatest possible return to our shareholders."

The balancer puzzle.

Grinding machines--one of the world's most common machine tools--are designed for many different operations. However, all grinding machines have one feature in common: a rotating grinding wheel, which requires constant balancing. Major manufacturers, including the automotive industry, bearing companies and makers of hydraulic systems all incorporate grinding machines within their operations. The challenge is to design and fit applicable balancers on a wide variety of machines.

- a) Photo of Schmitt's External Balancer, Internal Balancer and Hydrokompensers.

Three key answers.

Schmitt Industries designs, manufactures and markets a line of balancers that covers the diverse needs of the market--both domestic and international. The balancer line is made up of three principal types of products--external balancers, internal balancers and hydrokompensers.

Schmitt has become the leader in its industry by responding to market needs. The company pre-engineers balancer applications, installs complete systems, offers comprehensive customer service, and maintains ample inventory of all products.

In the U.S., external balancers are far and away the optimum solution for most grinding machines. Schmitt external balancers are easy to mount, highly reliable and require little operator training, making them exceedingly popular. Internal balancers are typically specified by European manufacturers of grinding machines, and hydrokompensers fit unique applications when external and internal balancers are not appropriate. Hydrokompensers are particularly suited for ultra-high speed functions--balancing grinding wheels that rotate at more than 15,000 RPM.

Together Schmitt Balance Systems (SBS) and Schmitt Hofmann Systems (SHS) offer a breadth of products that satisfies nearly any manufacturing requirement. Schmitt also customizes balancers to fit applications. As the needs of the machine-tool industry grow more sophisticated, Schmitt will maintain its focus on the market, and continue to develop products that meet the increasing process control requirements of our customers.

Mitsubishi Siltec, a major supplier of silicon wafers to computer chip makers, needed an efficient, non-destructive method for testing the microroughness of its products. All silicon wafers exhibit a microscopic level of surface roughness, stemming from chemical deposition, grinding, polishing, etching, or any number of other production techniques. Silicon wafer manufacturing processes must be very precise and controlled, and these processes heavily rely on the surface roughness of the wafer. Quantifying microroughness is critical.

- a) Photo of silicon wafer texture measurement system.

Smoothing over market needs.

In 1995, Schmitt acquired TMA Technologies, a U.S. company that researched and developed laser technology. Schmitt engineers are harnessing this revolutionary technology within a series of products that conduct non-contact surface

measurements. And an entirely new company division has been created--Schmitt Measurement Systems (SMS).

The flagship product of SMS--the TMS-2000W--provided an ideal solution for Mitsubishi Siltec. The TMS-2000W enables fast, repeatable non-destructive measurements down to a few hundredths of an angstrom, a level unattainable by any other testing method. This system also provides a way for Mitsubishi Siltec to quantify and control its manufacturing process. The TMS-2000W and the complementary TMS-3000W are marketed worldwide by means of a strategic partnership with Veeco Process Metrology.

While the TMS-2000W represents an excellent solution for the silicon manufacturing environment, Schmitt engineers also developed the Microscan--a mobile light-scatter surface-measurement tool. The Microscan is used by the National Aeronautic and Space Administration (NASA) to measure microroughness and reflectance on mirrors and space optics.

SMS product developers are aided by the world's most powerful light-scatter laboratory, including eight lasers that operate at 20 different wavelengths. Consequently, Schmitt contracts with customers to provide them with comprehensive light-scatter analysis for industrial, military and space optics applications.

The 100% problem.

In magnetic disk manufacturing, surface features are so small they cannot be seen visually. Traditional test methods that utilize optical and microscope technology do not provide the necessary resolution and speed to measure 100% of production.

HMT, one of the world's premier suppliers of magnetic disks for hard drives, was experiencing quality errors and omissions, due to a random testing policy. The company needed to implement 100% testing, and do it afford-ably. Schmitt answered with a technological breakthrough.

How small is an angstrom

The point of a needle is about 1 million angstroms in diameter. Fingernails grow at about 50 angstroms per second. One angstrom is to a grain of sand, as a child's wading pool is to the Atlantic Ocean.

a) Photo of Schmitt's non-contact texture measurement system used in the production of disks.

100% success.

Senior management at Schmitt Industries met with HMT representatives to discuss the development of a 100% production-test system for magnetic disks for hard drives. Schmitt Measurement Systems (SMS) engineers began research and development in earnest, and less than six months later, the company unveiled the DTM-2000. This new system utilizes light-scatter measurement technology to automatically process hard disks and render microroughness measurements at rapid speed--one every three seconds.

HMT conducted extensive preliminary testing on the DTM-2000 with highly satisfactory results. The automated system provides throughput of 1,200 hard disks per hour at measurement levels as low as one-tenth of an angstrom. In addition, the DTM-2000 is the first metrology system that offers disk drive manufacturers the ability to make critical non-contact measurements on both sides of disks, simultaneously. This technology leap makes 100% inspection economically feasible.

HMT purchased seven new DTM-2000 systems, each with a market value of \$165,000. Schmitt is currently working with Veeco, its worldwide marketing partner, to introduce the DTM-2000 to additional prospects in the disk drive industry. According to the 1997 annual survey in Data Storage magazine, 400 million hard disks are manufactured annually, and the industry is expected to grow by 15%

per year. This should result in strong future demand for SMS non-contact measurement products.

Consolidated Balance Sheets
May 31, 1998 and 1997

	1998	1997
Assets		
Current assets		
Cash	\$1,127,076	\$ 504,662
Trading securities	--	168,000
Accounts receivable	1,197,951	2,725,512
Inventories	4,166,755	2,479,820
Prepaid expenses	120,466	30,668
Deferred tax asset	34,623	136,000
Income tax receivable	190,806	--
Total current assets	6,837,677	6,044,662
Property and Equipment		
Land	299,000	299,000
Buildings and improvements	1,190,920	1,025,868
Furniture, fixtures, and equipment	906,058	760,596
Vehicles	139,261	146,299
	2,535,239	2,231,763
Less accumulated depreciation and amortization	691,258	530,587
	1,843,981	1,701,176
Other Assets		
Long-term deferred tax asset	837,560	679,000

Other assets	100,000	90,415
	937,560	769,415
Total Assets	\$9,619,218	\$8,515,253
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	\$ 681,524	\$ 530,667
Accrued royalties	55,335	131,983
Accrued commissions	131,154	111,996
Other accrued liabilities	63,076	62,832
Income taxes payable	--	68,563
Current portion of long-term debt	--	29,061
Total current liabilities	931,089	935,102
Long-Term Debt, net of current portion	--	150,922
Commitments and Contingencies (Note 7)		
Stockholders' Equity		
Common stock, no par value, 20,000,000 shares authorized, 7,099,139 and 7,081,889 shares issued and outstanding at May 31, 1998 and 1997, respectively	5,072,634	4,952,411
Cumulative foreign exchange translation adjustment	(147,708)	(36,270)
Retained earnings	3,763,203	2,513,088
Total stockholders' equity	8,688,129	7,429,229
Total Liabilities and Stockholders' Equity	\$9,619,218	\$8,515,253

Consolidated Statements of Income
For the years ended May 31, 1998, 1997 and 1996

	1998	1997	1996
Net Sales	\$10,626,084	\$10,541,972	\$7,080,128
Cost of Sales	4,632,485	3,875,790	2,547,054
Gross profit	5,993,599	6,666,182	4,533,074
General, Administrative, and Sales Expense	4,275,059	4,164,271	3,023,916
Research and Development Expense	379,798	205,800	--
Operating expenses	4,654,857	4,370,071	3,023,916
Operating income	1,338,742	2,296,111	1,509,158
Other Income and Expense			
Interest expense	(42,231)	(16,273)	(45,130)
Interest income	44,581	25,007	27,853
Unrealized gain (loss) on trading securities	--	22,400	(61,222)
Miscellaneous income	259,924	25,430	16,132
Other income and expense	262,274	56,564	(62,367)
Income Before Provision for Income Taxes	1,601,016	2,352,675	1,446,791
Provision for Income Taxes	350,901	627,947	229,538
Net income	\$ 1,250,115	\$ 1,724,728	\$1,217,253
Net income per common share, basic	\$.18	\$.25	\$.18
Weighted average number of common shares, basic	7,091,269	7,031,449	6,887,975
Net income per common share, diluted	\$.17	\$.23	\$.16
Weighted average number of common shares, diluted	7,456,172	7,561,744	7,416,713

Consolidated Statements
of Cash Flows

	1998	1997	1996
For the years ended May 31, 1998, 1997 and 1996			
Cash Flows Relating to Operating Activities			
Net income	\$1,250,115	\$1,724,728	\$1,217,253
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation	347,228	264,440	196,021
Amortization	--	72,393	189,103
Unrealized (gain) loss on trading securities	--	(22,400)	61,222
Deferred taxes	(57,183)	198,426	(30,822)
(Increase) decrease in:			
Trading securities	168,000	--	150,000
Accounts receivable	1,527,561	(1,313,707)	(444,024)
Inventories	(1,686,935)	(235,556)	(613,626)
Prepaid expenses	(89,798)	(14,762)	(4,004)
Notes receivable	--	--	10,000
Income taxes receivable	(190,806)	--	50,000
Other assets	(9,585)	(90,415)	(121,907)
Increase (decrease) in:			
Accounts payable	150,857	185,839	(96,215)

Accrued liabilities, royalties, and commissions	(57,246)	62,198	126,784
Income taxes payable	(44,809)	(226,186)	294,749
Net cash provided by operating activities	1,307,399	604,998	984,534
Cash Flows Relating to Investing Activities			
Purchase of property and equipment	(514,283)	(461,168)	(406,675)
Proceeds from disposal of equipment	24,250	10,651	--
Acquisition of assets of Hofmann Maschinenbau GmbH		(496,000)	
Net cash used in investing activities	(490,033)	(946,517)	(406,675)
Cash Flows Relating to Financing Activities			
Repayment of long-term debt	(179,983)	(34,895)	(69,131)
Long-term repayments mortgage	--	--	(233,920)
Exercise of stock options	96,469	409,106	92,188
Net cash (used in) provided by financing activities	(83,514)	374,211	(210,863)
Effect of foreign exchange translation on cash	(111,438)	(36,270)	--
Increase (Decrease) in Cash	\$ 622,414	\$ (3,578)	\$ 366,996
Cash, beginning of year	504,662	508,240	141,244
Cash, end of year	\$1,127,076	\$504,662	\$508,240
Supplemental Disclosure of Cash Flow Information			
Cash paid during the period for interest	\$ 42,231	\$ 15,272	\$ 45,130
Cash paid during the period for income taxes	\$ 405,800	\$ 450,871	\$ 11,600
Supplemental Schedule of Noncash Investing and Financing Activities			
Discount associated with long-term debt	\$ --	\$ --	\$ (78,085)
Reduction of goodwill	\$ (155,438)	\$ (215,973)	\$ (424,011)
Income tax benefit of stock options exercised	\$ (23,754)	\$ (444,793)	\$ (113,800)

Consolidated Statements of Changes in Stockholders' Equity

For the years ended May 31, 1998, 1997 and 1996

	Shares	Amount	Cumulative Foreign Exchange Translation Adjustment	Retained Earnings (Accumulated Deficit)	Total
Balance, May 31, 1995	6,886,889	\$3,892,524	\$ --	\$ (428,893)	\$3,463,631
Stock options exercised	31,250	92,188	--	--	92,188
Income tax benefit from exercise of stock options	--	113,800	--	--	113,800
Net income	--	--	--	1,217,253	1,217,253
Balance, May 31, 1996	6,918,139	4,098,512	--	788,360	4,886,872
Cumulative foreign exchange translation adjustment	--	--	(36,270)	--	(36,270)
Stock options exercised	163,750	409,106	--	--	409,106
Income tax benefit from exercise of stock options	--	444,793	--	--	444,793
Net income	--	--	--	1,724,728	1,724,728
Balance, May 31, 1997	7,081,889	4,952,411	(36,270)	2,513,088	7,429,229
Cumulative foreign exchange translation adjustment	--	--	(111,438)	--	(111,438)
Stock options exercised	17,250	96,469	--	--	96,469
Income tax benefit from exercise of stock options	--	23,754	--	--	23,754
Net income	--	--	--	1,250,115	1,250,115
Balance, May 31, 1998	7,099,139	\$5,072,634	\$ (147,708)	\$3,763,203	\$8,688,129

NOTE 1 Organization and Nature of Operations

Schmitt Industries, Inc. (the Company) is engaged in the design, assembly, marketing, and distribution of electronic and mechanical components for machine tool products and laser measurement systems worldwide.

On June 13, 1996, the Company established Schmitt Europe, Ltd. (SEL). In addition, on December 2, 1996, the Company established Schmitt Hofmann Systems GmbH (SHS) which acquired certain assets of the grinding wheel balance division of Hofmann Maschinenbau GmbH.

NOTE 2 Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements as of May 31, 1998 and 1997, and the consolidated statements of income for the years ended May 31, 1998, 1997 and 1996 include those of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in the preparation of the consolidated financial statements.

Revenue Recognition

Revenue from product sales is recognized upon shipment. Sales are reported net of applicable cash discounts and allowances for returns.

Inventory

Inventory is valued at the lower of cost or market. Cost is determined on the average cost basis. As of May 31, 1998 and 1997, inventories consisted of raw materials (\$2,502,310 and \$1,165,554, respectively), work-in-process (\$60,075 and \$258,912, respectively), and finished goods (\$1,604,370 and \$1,055,354, respectively).

Property and Equipment

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over estimated useful lives of three to seven years for furniture, fixtures, and equipment; three years for vehicles; and twenty-five years for buildings and improvements.

Technology Rights

From time to time the Company acquires certain rights to technology developed by unaffiliated parties. Costs to acquire technology rights are capitalized and amortized on a straight-line basis over the estimated useful life. Any related royalty costs are expensed as related revenues are earned. Capitalized acquired technology is included in other assets net of accumulated amortization.

Concentration of Credit Risk

Financial instruments which potentially expose the Company to concentration of credit risk are trade accounts receivable. Credit terms generally include a discount of 1-1/2% if the invoice is paid within ten days, with the net amount payable in 30 days. No allowance for doubtful accounts is considered necessary.

For the year ended May 31, 1998, approximately 24% of consolidated sales were made to one customer. During the year ended May 31, 1998, the Company renewed a strategic partnership with an entity to distribute systems manufactured by Schmitt Measurement Systems, Inc., for a period of two years. For the year ended May 31, 1997 and 1996, approximately 22% and 15% of consolidated sales were made to one customer, respectively.

Income Taxes

The Company follows the method of accounting for income taxes proscribed by the Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes," (FAS 109) whereby deferred tax assets and liabilities are recognized for the future tax consequences of differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases.

Research and Development Costs

Research and development costs are charged to expense when incurred.

Trading Securities

Trading securities consist of common stock and are stated at fair value, which is estimated based on quoted market prices. Unrealized gains or losses are included in other income and expense. Total realized gain on trading securities during fiscal 1998 was approximately \$186,000 and is included in other income.

No trading securities were held at May 31, 1998.

Use of Estimates

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Consolidated Statement of Cash Flows

The Company considers short-term investments which are highly liquid, readily convertible into cash, and have original maturities of less than three months to be cash equivalents for purposes of the cash flows statement.

Stock-Based Compensation

Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," (FAS 123) encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," (APB 25). Accordingly, compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock.

Foreign Currency Translation

Financial statements for the Company's subsidiaries outside the United States are translated into U.S. dollars at year-end exchange rates for assets and liabilities and weighted average exchange rates for income and expenses. The resulting translation adjustments are recorded as a separate component of stockholders' equity titled "Cumulative Foreign Exchange Translation Adjustment."

Fair Value of Financial Instruments

The carrying amounts of financial instruments approximate their fair values at May 31, 1998. The fair market value of long-term debt approximates carrying amounts based on discounted cash flow analyses.

Reclassifications

Certain reclassifications have been made to the 1997 and 1996 consolidated financial statements to conform with current year presentations.

Earnings Per Share

The Company adopted Statement of Financial Accounting Standards No. 128, "Earnings Per Share," (FAS 128), during 1998. All prior earnings per share data have been restated to conform to the provisions of this statement. Basic earnings per share is computed using the weighted average number of shares outstanding. Diluted earnings per share is computed using the weighted average number of shares outstanding, adjusted for the incremental shares attributed to outstanding options to purchase common stock. Using the treasury shares method as required by FAS 128, incremental shares of 364,903, 530,295 and 528,738 in 1998, 1997 and 1996, respectively, were used in the calculation of diluted earnings per share.

New Accounting Pronouncements

Between June 1997 and June 1998, the FASB issued three pronouncements, Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income," (FAS 130), Statement of Financial Accounting Standards No. 131,

"Disclosures about Segments of an Enterprise and Related Information," (FAS 131), and Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," (FAS 133), which will be effective in future reporting periods. Management has evaluated the provisions of these pronouncements and expects that their adoption will have

no effect on results of operations or the financial position of the Company.

NOTE 3 Company Acquisitions

On May 23, 1995, in a business combination accounted for as a purchase, the Company acquired TMA Technologies, Inc., which designs, manufactures, and markets optical quality assurance instruments. Subsequent to this acquisition, the Company changed the name of TMA Technologies, Inc., to Schmitt Measurement Systems, Inc. (SMS), and moved the operations to Portland, Oregon.

In transactions related to the acquisition, the Company established a royalty pool and has vested each shareholder and debt holder an interest in the royalty pool equal to the amount actually invested by shareholders or loaned by debt holders including interest payable through March 31, 1995. The royalty pool is funded at 5% of net sales (defined as gross sales less returns, allowances, and sales commissions) of Schmitt Measurement Systems, Inc.'s, products and future derivative products developed by Schmitt Industries, Inc., which utilize these technologies. As part of the royalty pool agreement, each of the former shareholders and debt holders released TMA Technologies, Inc., for any claims with regard to the acquisition except their rights to future royalties. Long-term debt of \$179,983 was fully paid to certain TMA Technologies, Inc. debt holders in fiscal year 1998.

On December 2, 1996, the Company purchased the inventories (\$462,933) and equipment (\$33,067) of the grinding wheel balancer division of Hofmann Maschinenbau GmbH for \$496,000 and subsequently established Schmitt Hofmann Systems GmbH. (See Note 1)

The results of both SHS and SMS are included in the accompanying consolidated financial statements since the date of acquisition.

NOTE 4 Line of Credit

The Company has an unsecured short-term line of credit agreement with Wells Fargo Bank, to a limit of \$1,500,000. The line is guaranteed by the Company's wholly-owned subsidiary, Schmitt Measurement Systems, Inc. Interest is payable at the bank's prime rate, or LIBOR +2.50%. The line of credit is renewable annually. No balance was outstanding as of May 31, 1998 or May 31, 1997.

NOTE 5 Income Taxes

The provision for income taxes was as follows:

	1998	Year ended May 31, 1997	1996
Current	\$243,264	\$826,368	198,716
Deferred	383,887	77,824	312,235
Decrease in valuation allowance	(276,250)	(276,245)	(281,413)
Total provision for income taxes	\$350,901	\$627,947	\$229,538

Deferred tax assets (liabilities) are comprised of the following components:

	Year ended May 31, 1998	Year ended May 31, 1997
Depreciation	\$ (29,861)	\$ (48,000)
Net operating loss carryforwards	1,038,559	1,314,809
Inventory basis differences	34,623	16,760
Other asset capitalization	13,840	142,181
Other deferred assets	49,254	64,250

Gross deferred tax assets	1,136,276	1,538,000
Deferred tax asset valuation allowance	(234,231)	(675,000)
Net deferred tax asset	\$ 872,184	\$ 815,000

Through the acquisition of Schmitt Measurement Systems, Inc., the Company acquired approximately \$5.5 million of U.S. federal net operating loss carryforwards. As of May 31, 1998, approximately \$3 million of these net operating losses remain (which expire in the years 2007 through 2009). The deferred tax asset valuation allowance in fiscal years 1996 through 1998 is attributed to these net operating losses. A portion of the reduction in valuation allowance related to the net operating loss carryforward represented tax asset benefit that reduced intangible assets acquired with TMA (see Note 3).

The provision for income taxes differs from the amount of income taxes determined by applying the U.S. statutory federal tax rate to pre-tax income due to the following:

	Year ended May 31,		
	1998	1997	1996
Statutory federal tax rate	34.0%	34.0%	34.0%
State taxes, net of federal benefit	3.2	4.4	2.2
Change in deferred tax valuation allowance	(27.5)	(20.9)	(48.8)
Reduction of goodwill associated with the acquisition of Schmitt Measurement Systems, Inc.	10.3	9.2	29.3
Other permanent differences	1.9	--	(0.9)
Effective tax rate	21.9%	26.7%	15.8%

NOTE 6 Employee Benefit Plans

The Company adopted the Schmitt Industries, Inc. 401(k) Profit Sharing Plan & Trust effective June 1, 1996. Employees must meet certain age and service requirements to be eligible. Participants may contribute up to 15% of their eligible compensation which is partially matched by the Company. The Company may further make either a profit sharing contribution or a discretionary contribution. Contributions made to this Plan during the year ended May 31, 1998 and May 31, 1997 were \$135,335 and \$116,248, respectively.

The Company adopted a Simplified Employee Pension Plan (SEP) during the year ended May 31, 1993. All permanent employees were eligible to participate once they met the age and length of employment requirements. Contributions were \$41,840 during the year ended May 31, 1996. The Plan was terminated effective May 31, 1996.

NOTE 7 Contingency

The Company is party to a legal action initiated by a competitor alleging wrongful misrepresentation of the competitor's product. The claim is considered, by management and the Company's legal counsel, to be without merit. The extent of potential liability, if any, cannot be estimated at this time.

NOTE 8 Segments of Business

The Company operates principally in two segments of business: the manufacturing of mechanical components for the machine tool industry, and the manufacturing of laser measurement systems for the computer disk and wafer industries. The segment, which manufactures mechanical components for the machine tool industry, reported gross sales of \$8,286,243 for the year ended May 31, 1998. This includes inter-company sales of \$754,131. This segment

reported gross sales of \$6,488,348 for the year ended May 31, 1997, including inter-company sales of \$336,875. The segment which manufactures laser measurement systems for the computer disk and wafer industries reported gross sales of \$3,108,769 for the year ended May 31, 1998, which includes inter-company sales of \$14,797. For fiscal year ended May 31, 1997, the measurement products segment reported gross sales of \$4,390,499. There were no inter-company sales. The mechanical components segment and laser measurement segment had sales of \$4,801,151 and \$2,278,977, respectively, for the year ended May 31, 1996, which had no inter-company sales. Geographically, U.S. sales were \$7,873,148 and \$8,728,082 for fiscal years ended May 31, 1998 and 1997, respectively. Foreign sales were \$3,521,864 and \$2,150,765 for the same years, respectively. This includes inter-company sales of \$768,928 for the year ended May 31, 1998 and \$336,875 for the year ended May 31, 1997. For the years ended May 31, 1998 and 1997, respectively, export sales by the U.S. segment totaled \$344,100 and \$612,704.

Income from operations for the years ended May 31, 1998, 1997 and 1996 for the mechanical components segment was \$363,656, \$176,927 and \$648,777, respectively. Income from operations for the years ended May 31, 1998, 1997 and 1996 of the laser measurement segment was \$975,086, \$2,119,184, and \$830,381, respectively. Consolidated income from operations includes an adjustment of \$90,000 for the elimination of inter-company rent for the year ended May 31, 1998 and \$30,000 for the years ended May 31, 1997 and 1996. Income from operations for the U.S. segment was \$1,423,502 and \$2,393,558, respectively, for the years ended May 31, 1998 and 1997 and for the foreign segment, losses of \$84,760 and \$97,447, respectively, for the same years. Identifiable assets at May 31, 1998, 1997 and 1996, were \$6,235,232, \$5,246,517, and \$4,162,209 for the mechanical components segment and \$3,383,986, \$3,268,736, and \$1,823,731 for the laser measurement segment. Identifiable assets at May 31, 1998 and 1997, were \$8,890,325 and \$7,034,431 for the U.S. segment and \$728,893 and \$1,480,822 for the foreign segment. Depreciation expense incurred during the years ended May 31, 1998, 1997 and 1996, by the mechanical components segment was \$206,335, \$156,374 and \$115,778, respectively. The laser measurement segment incurred depreciation expense of \$140,893, \$108,066 and \$80,243, for the years ended May 31, 1998, 1997 and 1996, respectively. Amortization expense incurred during the years ended May 31, 1998, 1997 and 1996, by the mechanical components segment was \$-0-, \$72,393 and \$91,756, respectively. The laser measurement segment did not incur amortization expense for years 1998 and 1997, but incurred amortization expense of \$97,347 for the year ended May 31, 1996. The U.S. segment incurred depreciation expense of \$276,102 and \$226,735 during the years ended May 31, 1998 and 1997, respectively. The foreign segment incurred depreciation expense of \$71,126 and \$37,705, respectively, for these same years. The U.S. segment incurred amortization expense of \$72,393 in fiscal

year ended May 31, 1997. The foreign segment has not incurred amortization expense. Capital expenditures for the years ended May 31, 1998, 1997 and 1996, were \$238,016, \$297,998 and \$317,861 by the mechanical components segment and \$276,267, \$163,170 and \$88,814 by the laser measurement segment, respectively. Capital expenditures for the years ended May 31, 1998 and 1997, were \$466,801 and \$291,128 by the U.S. segment and \$47,482 and \$170,040 by the foreign segment, respectively.

Income from operations represents sales less costs and operating expenses. In computing income from operations, all overhead expenses have been allocated to both industry segments, as they are an integral part of profit recognition for each segment. Identifiable assets by segment of business are those assets used in the Company's operations in each segment. There are no unallocated Company assets.

NOTE 9 Stock Options

Prior to 1995, the Company granted stock options to officers and employees of the Company. Stock options for up to 10% of the outstanding shares eligible for grant provided that the stock options for any one individual did not exceed 5% of the issued and outstanding shares of common stock. The purchase price of the optioned shares was equal to not less than the average closing price of the Company's common stock for the ten trading days immediately preceding the grant date of the stock options. The maximum term of each stock option did not exceed five years and all options were vested and exercisable upon grant. The options expire in the year 1999.

A 1995 Stock Option Plan was adopted by the Board of Directors on December 19, 1995, for the benefit of employees other than officers. An option granted under the Plan may be either an incentive stock option (ISO), or a nonstatutory stock option (NSO). ISOs may be granted only to employees of the Company and are subject to certain limitations, in addition to restrictions applicable to all stock options under the Plan. Options not meeting these limitations will be treated as NSOs. The purchase price of ISOs is fair market value on the date of grant; purchase price of NSOs may vary from fair market value. Vesting is generally on a cumulative basis over four years at 25% per year. This plan, which originally provided for 300,000 shares available for option, was amended during the year ended May 31, 1997, with the maximum number of available shares increased to 500,000. The options expire in years 2006 through 2008.

The following summarizes the options outstanding as of May 31, 1998:

For the 485,750 options granted prior to 1995, the exercise price range was \$0 to \$2.00, the weighted average price was \$1.72 and the remaining average contractual life was 0.6 years. For the 386,750 shares granted under the 1995 Stock Option Plan, the exercise price range was \$2.01 to \$6.00, the weighted average price was \$5.22 and the remaining average contractual life was 8.2 years.

The Company has adopted the disclosure only provisions of SFAS No. 123. Accordingly, no compensation cost has been recognized for the stock option plans. Options were assumed to be exercised upon vesting for purposes of this valuation. Adjustments are made for options forfeited prior to vesting. For the years ended May 31, 1998, 1997 and 1996, total value of options granted was computed to be \$877,963, \$395,740 and \$801,878, respectively, which would be amortized on a straight-line basis over the vesting period of the options. Had compensation cost for the Company's stock option plans been determined based on the fair value at the grant date for the awards in 1998, 1997 and 1996, consistent with the provisions of SFAS No. 123, the Company's pro forma net income for the years ended May 31, 1998, 1997 and 1996, would be \$889,944 and \$1,436,760 and \$602,835, respectively. Pro forma basic earnings per share for

the years ended May 31, 1998, 1997 and 1996 would be \$.13, \$.20 and \$.09, respectively. Pro forma diluted earnings per share for the years ended May 31, 1998, 1997 and 1996 would be \$.12, \$.19 and \$.18, respectively.

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option and pricing model. The weighted average assumptions used for fiscal 1998, 1997 and 1996 were a risk-free interest rate of 5.6%, 7.5% and 7.5%, respectively, an expected dividend yield of 0%, 0% and 0%, respectively, an expected life of 8, 10, and 10 years, respectively, and a volatility of 52%, 51% and 51%, respectively.

The effects of applying SFAS No. 123 in the pro forma disclosure are not indicative of future amounts.

	Options prior to 1995		1995 Stock Option Plan		Combined Plans
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Combined Shares
Options outstanding, May 31, 1995	614,500	\$1.72	--	\$ --	614,500
Options granted in 1996	--	\$ --	295,000	\$5.83	295,000
Options exercised in 1996	(18,750)	\$1.96	(12,500)	\$4.38	(31,250)
Options outstanding, May 31, 1996	595,750	\$1.72	282,500	\$5.83	878,250
Options granted in 1997	--	--	67,500	\$5.83	67,500
Options exercised in 1997	(110,000)	\$1.72	(53,750)	\$4.38	(163,750)
Options forfeited in 1997	--	--	(14,000)	--	(14,000)
Options outstanding, May 31, 1997	485,750	\$1.72	282,250	\$5.83	768,000
Options granted in 1998	--	--	174,000	\$6.63	174,000
Options exercised in 1998	--	--	(17,250)	\$5.59	(17,250)
Options forfeited in 1998	--	--	(52,250)	\$8.33	(52,250)
Options outstanding, May 31, 1998	485,750	\$1.72	386,750	\$5.22	872,500
Options vested at May 31, 1998	485,750		113,000		598,750

Management's Discussion and Analysis

The following information contains certain forward-looking statements that anticipate future trends or events. These statements are based on certain

assumptions that may prove to be erroneous and are subject to certain risks including but not limited to the uncertainties of the Company's industry and the risk factors listed from time to time in the Company's SEC reports, including but not limited to the Current Report on Form 8-K dated June 5, 1996. Accordingly, actual results may differ, possibly materially, from the predictions contained herein.

During fiscal 1998 the measurement markets the Company serves declined, particularly in the Asian region during the third and fourth quarters. The Company has responded to this decline in demand for its products by launching new products for both the laser measurement markets and the mechanical balancer markets. As a result of these changes by management, the Company's sales in fiscal 1998 increased slightly from fiscal 1997. The Company expects current levels of product sales and profitability to continue in the near future. However, there can be no assurance that the Company will continue to be profitable with increased sales levels in future time periods.

Sales outside the United States accounted for approximately 20% of the Company's revenues in each of the fiscal 1996, 1997 and 1998. Some foreign customers will purchase in their own country's currencies, thereby imposing on the Company a currency risk. All U.S. sales (74% of total sales in fiscal 1998) were in U.S. dollars and less than 10% of total sales in fiscal 1998 were in currencies other than U.S. dollars; as a result, currency fluctuations have historically had little impact on revenue realization. However, significant variations in the value of the U.S. dollar, relative to currencies of countries in which the Company has significant competitors, can impact future sales. The Company does not engage in currency hedging. In addition, the longer payment cycles of international sales can have a negative impact on liquidity. The Company believes that international sales will continue to grow in future periods.

A substantial portion of the Company's revenues is derived from sales to end users through selling agents and directly to builders of machine tools. For fiscal 1997 and 1998, sales to a single customer did not exceed 10% of total balancer revenues. In fiscal 1997 the Company entered into a strategic partnership with Veeco Instruments Inc. (NASDAQ:VECO) to act as the exclusive sales and marketing agent for SMS's laser light scatter products. As a result of this agreement, 24% of consolidated fiscal 1998 sales were through Veeco as compared with 22% in fiscal 1997. The Company is dependent on the sales activities of its selling agents, and there can be no assurance that these agents will continue to be successful in their efforts to market the Company's products. The Company enjoys substantial repeat business from a broad base of customers, but there can be no assurance that these customers will continue to buy the Company's products in the future.

Increased revenues during fiscal 1996, 1997 and 1998 principally have been the result of increased volume of product shipments. Product improvements and available features have resulted in modestly increased average product prices.

The Company operates in a highly competitive industry characterized by increasingly rapid technological changes. The Company's competitive advantage and future success are therefore dependent on its ability to develop new products, to qualify these new products with its customers, to successfully introduce these products to the marketplace on a timely basis, to commence production to meet customer demands and to develop new markets in the industries for its products and services. The successful introduction of new technology and products is increasingly complex. If the Company is unable, for whatever reason, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, its results of operations could be adversely impacted.

a) Graph of Schmitt's Shareholders' Equity, 1994-98.

Results of Operations

Sales in fiscal 1998 increased to \$10,626,084 from \$10,541,972 in fiscal 1997 and \$7,080,128 in fiscal 1996. Schmitt Measurement System (SMS) sales accounted for \$3,093,972 of fiscal 1998 sales compared with fiscal 1997 sales of \$4,390,499. Net income for fiscal 1998 totaled \$1,250,115 vs. fiscal 1997 totals of \$1,724,728. This decline was directly attributable to reduced sales

of SMS measurement products.

Historically the Company has enjoyed a high gross profit margin in excess of 60% on its SBS Dynamic Balancing products and its SMS measurement products. Fiscal year 1998 gross profits totaled 56%. Cost of sales as a percentage of sales for fiscal 1996, 1997 and 1998 was 35.9%, 36.7% and 43.6%, respectively. The introduction of the TMS-2000 during the third quarter of fiscal 1996 had a positive impact on sales and net earnings for fiscal 1996 and 1997. The fiscal 1998 decline in sales of TMS-2000 and TMS-2000W series products resulted in a negative impact on sales and net earnings. Management expects these trends in sales and profits of the TMS series products to continue throughout the 1998 calendar year. Management anticipates that cost of sales as a percentage of sales will be similar in future time periods to the Company's historical performance. No assurances can be made that the Company will be profitable or will generate increased sales in future time periods.

General selling and administrative expenses as a percentage of net sales were 40% in fiscal 1998, 40% in fiscal 1997, and 43% in fiscal 1996. During each of these fiscal years, the Company increased spending in marketing and selling programs to support the development of international markets, particularly in the European and Asia-Pacific regions, and to increase the awareness of new products. Administrative expenses have increased during each of the last three fiscal years to support the Company's growth, improve information technology capability and protect the Company's intellectual property rights.

The Company has had minor variable cost increases in periods of increased sales; therefore, fixed costs have been spread over an increasing sales revenue as unit sales of SBS and SMS products increased. Even with two operating segments, management believes the Company's costs will not increase at the same rate that sales are anticipated to increase in fiscal 1999 and beyond, although there can be no such assurance.

Net income for fiscal 1998 decreased to \$1,250,511, a 28% decrease from fiscal 1997 and 3% increase over fiscal 1996. Net income per basic share decreased to \$0.18 in fiscal 1998 from \$0.25 in fiscal 1997 and remained the same as fiscal 1996.

The Company's future operating results depend, to a considerable extent, on its ability to maintain a competitive advantage in both the products and services it provides. For this reason, the Company believes it is critical to continue to make future investments in research and development to ensure the flow of innovative, productive, high-quality products and support services. Accordingly, the Company expects research and development expenses to continue to increase in the immediate future.

a) Graph of Schmitt's Total Assets, 1994-98.

Liquidity and Capital Resources

The Company's financial condition remained very strong, with a ratio of current assets to current liabilities of 7.3:1 at May 31, 1998, compared with 6.5:1 at May 31, 1997. As of May 31, 1998, the Company had \$1,127,076 in cash, and trading securities, compared with \$672,662 at May 31, 1997.

Accounts receivable have decreased as revenue growth has slowed. At May 31, 1998, accounts receivable totaled \$1,197,951 compared with \$2,725,512 at May 31, 1997. At May 31, 1998, none of the Company's accounts receivable were

considered a doubtful collection. The Company generally experiences a payment cycle of 30-80 days on invoices. Management believes its credit policies and collection policies are effective and appropriate for the marketplace that it serves and the Company has had no bad debt write-offs since its inception in 1986. There can be no assurance that the Company's collection procedures will continue to be successful.

Working capital increased from \$5,109,560 at May 31, 1997 to \$5,906,588 at May 31, 1998. During fiscal 1997 the Company spent \$496,000 to acquire certain assets of a former European competitor, Hofmann Maschinenbau GmbH (SHS). Additionally the Company spent \$461,168 on the purchase of worldwide corporate assets of property and equipment in fiscal 1997. During fiscal 1998 the Company spent \$514,283 to acquire certain worldwide corporate assets of

property and equipment to assist in production and product development. Although the Company has no current material commitments for capital expenditures, product development to extend SBS products to new markets and to bring SMS products to advanced commercial status is expected to result in increased capital expenditures for equipment in fiscal 1999.

The Company maintains levels of inventory sufficient to satisfy normal customer demands, plus an increasing short-term delivery requirement for a majority of its products. Additionally, inventories are periodically adjusted according to management's forecast for future business activity. Management believes its ability to provide prompt deliveries gives it a competitive advantage for certain sales. It is expected that current inventory levels will be maintained or increased as new products are introduced. The average finished goods inventory turnover ratio for fiscal 1996, 1997 and 1998 was 1.7, 2.1 and 1.4, respectively.

The acquisition of SMS resulted in a tax loss carryforward in excess \$5 million, which is available to offset earnings from SMS through the year 2010. As of May 31, 1998 the Company's gross deferred tax asset balance was \$3,233,155.

a) Graph of Schmitt's Return on Equity (in percent), 1994-98.

The Company has completed an evaluation of Year 2000 computer information processing problems and Year 2000 program requirements for internal operations and Company products and does not expect to experience Year 2000 problems in those areas. A survey analysis of external vendors is in process and is anticipated to be complete by December 31, 1998. The Company's Year 2000 compliance evaluation will then be complete. The Company does not believe it has significant exposure to Year 2000 problems with significant vendors, customers and financial institutions and does not expect that Year 2000 will have a material cost or impact on Company operations. However, there can be no assurance that the systems of other companies on which the Company relies will not have an adverse effect on the Company's systems.

Management believes that its cash flows from operations, available credit resources and its improving cash position will provide adequate funds on both a short-term and long-term basis to cover currently foreseeable debt payments, lease commitments and payments under existing and anticipated supplier agreements. Management believes that such cash flow (without the raising of external funds) is sufficient to finance current operations, projected capital expenditures, anticipated long-term sales agreements and other expansion-related contingencies during fiscal 1998.

b) Graph of Schmitt's Working Capital, 1994-98.

Summarized Quarterly Financial Data
In thousands, except per share information (unaudited)

1998 Quarter Ended	August 31	November 30	February 28	May 31
Sales	\$2,666,941	\$3,220,475	\$2,372,320	\$2,366,348
Gross Profit	1,504,589	1,833,637	1,059,200	1,596,173
Net Income	354,551	695,449	101,794	98,321
Net Income Per Share, Basic	0.05	0.10	0.01	0.01
Net Income Per Share, Diluted	0.05	0.09	0.01	0.01
Market Price of Common Stock				
Low	7.50	8.00	7.38	5.69
High	9.75	12.00	10.13	8.13

1997 Quarter Ended	August 31*	November 30*	February 28*	May 31*
Sales	\$1,793,698	\$2,738,314	\$2,918,912	\$3,091,048
Gross Profit	1,069,558	1,725,676	1,827,858	2,043,090
Net Income	140,276	607,344	458,655	518,453

Net Income Per Share, Basic	0.02	0.09	0.07	0.07
Net Income Per Share, Diluted	0.02	0.08	0.06	0.07
Market Price of Common Stock				
Low	8.88	7.88	7.88	7.00
High	13.75	11.00	11.00	10.75

*Quarterly data have been restated to account for inter-company transactions.

Common Stock Information and Dividend Policy

As of July 15, 1998, there were 7,099,139 shares of Common Stock outstanding held by approximately 129 holders of record. The number of holders does not include individual participants in security position listings. Management estimates that there are over 2,500 shareholders who own the Company's stock.

The Company has not paid any dividends on its Common Stock since 1994. The Company's present policy is to retain earnings to finance the Company's business. Any future dividends will be dependent upon the Company's financial condition, results of operations, current anticipated cash requirements, acquisition plans and plans for expansion, and any other factors that the Company's Board of Directors deems relevant. The Company has no present intention of paying dividends on its Common Stock in the foreseeable future.

The sum of quarterly earnings per share does not equal annual earnings per share as a result of the computation of quarterly versus annual average shares outstanding.

Selected Financial Data

In thousands, except per share information

Year Ended	5/31/98	5/31/97	5/31/96	5/31/95	5/31/94
Sales	\$10,626	\$10,542	\$7,080	\$4,415	\$2,575
Net Income	\$ 1,250	\$ 1,725	\$1,217	\$ 249	\$ 182
Net Income Per Share, Basic	\$ 0.18	\$ 0.25	\$ 0.18	\$ 0.04	\$ 0.03
Weighted Average Number of Shares (000)	7,091	7,031	6,888	6,887	5,978
Net Income Per Share, Diluted	\$ 0.17	\$ 0.23	\$ 0.16	\$ 0.04	\$ 0.03

Weighted Average Number of Shares (000)	7,456	7,562	7,417	7,116	6,203
Stockholders' Equity	\$ 8,688	\$ 7,429	\$4,887	\$3,464	\$3,215
Total Assets	\$ 9,619	\$ 8,515	\$5,986	\$4,619	\$4,232

Report of Independent Accountants
To the Board of Directors and Shareholders of
Schmitt Industries, Inc.

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of income, of cash flows and of changes in stockholders' equity present fairly, in all material respects, the financial position of Schmitt Industries, Inc. and its subsidiaries at May 31, 1998, and the results of their operations and their cash flows for the year then ended in conformity with generally accepted accounting principles. These

financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with generally accepted auditing standards which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for the opinion expressed above. The financial statements of Schmitt Industries, Inc. for the years ended May 31, 1996 and 1997 were audited by other independent accountants whose report dated July 10, 1997 expressed an unqualified opinion on those statements.

PricewaterhouseCoopers LLP
Portland, Oregon
July 17, 1998

Schmitt Worldwide Customers
Adam Opel AG
Akashic Memories Corporation
Allied Signal Aerospace Company
Allison Engine Company
American Axel
American Koyo Bearing Mfg. Corp.
American NTN Bearing Company
Asahi Komag
Atlas Copco Airpower N.V.
Audi AG
Barden Corporation
Black & Decker Corporation
Blohm Maschinenbau GmbH
BMW Motoren GmbH
Boeing Company
Briggs & Stratton

Bryant Grinder Corporation
Caterpillar Belgium S.A.
Caterpillar Incorporated
Chrysler Corporation
Cincinnati Milacron
Cummins Engine Company
Daewoo International Corporation
Daimler Benz
Dana Corporation
Deere & Company
Diesel Technology Corporation
Dresser-Rand
Eaton Corporation
Emerson Power Transmission
Erwin Junker

FAG Bearing Ltd.
Federal Mogul Corporation
Fiat
Ford France S.A.
Ford Motor Company
Fuji Electric
General Electric Corporation
General Motors Corporation
Goldcrown Machinery
Greenfield Industries
Gyhring Automation
Harley-Davidson Motor Company
HMT Technology Corporation
Honda Motor Company, Honda
Of America
IBM Deutschland

INA Bearing Corporation
Jones & Shipman, Inc.
Komag, Inc.
Koube Steel
Koyo Machinery USA
Landis, Landis Lund
Lockheed Martin
Mercedes Benz AG
Milwaukee Electric Tool
Mitsubishi Chemical
Mitsubishi Material Silicon
Mitsubishi Motor Company Ltd.
NASA
Navistar International Transportation
New Venture Gear
Nissan Motors Ltd.
Normac, Inc.
Norton Company
Okamoto Corporation
Okunia Machinery, Inc.
Opel Austria GmbH

Parker Hannifin Corporation
Pratt & Whitney
Raytheon

Reliance Electric Company
Rexnord Corporation
Reynolds Metals
Robert Bosch Corporation
Robert Bosch GmbH
Saturn Corporation
Seagate Substrates
SEH America, Inc.
Siemens Automotive Systems
SKF Bearing Industries
SKF GmbH
Sumitomo Heavy Industries
Texas Instruments
The Timken Company
The Torrington Company
Timken France
Toyoda Machinery USA, Toyoda
Machinery, Ltd.
TRW Automotive Components
United Grinding Technologies
University Of Connecticut Grinding
Research Center
Volkswagen AG
Volvo
Weldon Machine Tool
Western Digital
Weyburn-Bartel

Corporate Offices
Schmitt Industries, Inc.
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Fax: (503) 223-1258
Web: www.schmitt-ind.com

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Sir William Lyons Road
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Phone: 44-1203-697192
Fax: 44-1203-412697

Schmitt Hofmann Systems GmbH
Schwingungsmesstechnik
Birkenweg 8 (Gewerbegebiet)
D - 64665 Alsbach, Germany

Phone: 49-6257-9351-21
Fax: 49-6257-9351-23
Transfer Agent & Registrar
Interwest Transfer Company
Salt Lake City, Utah U.S.A.
Banking Reference
Wells Fargo Bank
Portland, Oregon U.S.A.
Certified Public Accountants
PricewaterhouseCoopers, LLP

Portland, Oregon U.S.A.
Stock Listing
NASDAQ National Market
Symbol: SMIT

Officers

Wayne A. Case
President & Chief Executive Officer
David W. Case
Vice President of Operations
Annie N. Windsor
Chief Financial Officer
Linda M. Case
Corporate Secretary

Directors

Wayne A. Case
President & Chief Executive Officer
Schmitt Industries
Maynard Brown
Partner, Brown McCue, Attorneys
David L. Dotlich, Ph.D.
Faculty, University of Michigan
Business School, Business Consultant
David M. Hudson
President, Coldstream Holdings, Inc.
Trevor Nelson
Financial Consultant
The Stewart Thomas Group
Dennis T. Pixton
President, Chief Operating Officer
Michaels of Oregon Co.
John A. Rupp
Business Executive - Self Employed

Form 10-K Available

A copy of the Company's Form 10-K as filed with the Securities and Exchange Commission is available to shareholders free of charge upon request addressed to the Secretary at the Company's Corporate Offices.

Annual Meeting

The annual meeting of shareholders will be held Friday, October 9, 1998 at 3:00 p.m. at the Corporate Offices.

Forward-looking Statements

This summary annual report, other than the historical financial information, contains statements regarding future sales and earnings growth and projects or processes currently under development which are forward-looking statements that involve risks and uncertainties that could cause actual results to differ materially from those set forth in the forward-looking statements, including delays in technology or product developments, shipment or cancellation of orders, timing of future orders, customer reorganizations, fluctuations in demand and the other risks detailed from time-to-time in the Company's reports which are filed with the Securities and Exchange Commission.

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Portland, Oregon 97210
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Fax: (503) 223-1258
Web: www.schmitt-ind.com

SUBSIDIARIES OF SCHMITT INDUSTRIES, INC.
AS OF MAY 31, 1998

Subsidiary	State of Incorporation or Country in Which Organized
Schmitt Measurement Systems, Inc.	Montana
Schmitt Hoffman Systems GmbH	Germany
Schmitt Europe, Ltd.	United Kingdom

CONSENT OF INDEPENDENT ACCOUNTANTS

We hereby consent to the incorporation by reference in the Registration Statement on Form S-8 (No. 333-3910) of Schmitt Industries, Inc. of our report dated July 17, 1998 appearing on page 13 of this Form 10-K.

PricewaterhouseCoopers LLP

Portland, Oregon
August 27, 1998

CONSENT OF INDEPENDENT AUDITORS

We consent to the inclusion in this Annual Report on Form 10-K, and to the inclusion in the Form S-8 Registration Statement No. 333-3910, of our report dated July 10, 1997, on our audits of the consolidated financial statements of Schmitt Industries, Inc., and its subsidiaries.

Moss Adams LLP

Portland, Oregon
August 28, 1998

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THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM SCHMITT INDUSTRIES, INC. INDEPENDENT AUDITOR'S REPORT AND CONSOLIDATED FINANCIAL STATEMENTS MAY 31, 1998, 1997, 1996 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

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