

Omega Flex, Inc.  
Form 10-Q  
November 06, 2018

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended **September 30, 2018**

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

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

Commission File Number **000-51372**

**Omega Flex, Inc.**

(Exact name of registrant as specified in its charter)

**Pennsylvania**

**23-1948942**

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(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

**451 Creamery Way, Exton, PA**

**19341**

(Address of principal executive offices) (Zip Code)

**(610) 524-7272**

Registrant's telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of The Exchange Act).

Yes  No

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS  
DURING THE PRECEDING FIVE YEARS.**

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Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 12 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by the courts.

The number of shares of the registrant's common stock outstanding as of September 30, 2018 was 10,091,822.

**OMEGA FLEX, INC.**

**QUARTERLY REPORT ON FORM 10-Q**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2018**

**INDEX**

|   | <b>Page<br/>No.</b> |
|---|---------------------|
| <b><u>PART I - FINANCIAL INFORMATION</u></b>  |                     |
| <u>Item 1 – Financial Statements</u>  |                     |
| <u>Condensed consolidated balance sheets at September 30, 2018 (unaudited) and December 31, 2017</u>  | 3                   |
| <u>Condensed consolidated statements of income for the three-months and nine-months ended September 30, 2018 and 2017 (unaudited)</u>               | 4                   |
| <u>Condensed consolidated statements of comprehensive income for the three-months and nine-months ended September 30, 2018 and 2017 (unaudited)</u> | 5                   |
| <u>Condensed consolidated statement of shareholders’ equity for the nine-months ended September 30, 2018 (unaudited)</u>                            | 6                   |
| <u>Condensed consolidated statements of cash flows for the nine-months ended September 30, 2018 and 2017 (unaudited)</u>                            | 7                   |
| <u>Notes to the condensed consolidated financial statements (unaudited)</u>   | 8                   |
| <u>Item 2- Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>  | 23                  |
| <u>Item 3 – Quantitative and Qualitative Information About Market Risks</u>   | 36                  |
| <u>Item 4 – Controls and Procedures</u>   | 36                  |
| <b><u>PART II - OTHER INFORMATION</u></b>   |                     |
| <u>Item 1 – Legal Proceedings</u>   | 37                  |
| <u>Item 1A – Risk Factors</u>   | 38                  |

|   |    |
|---|----|
| <u>Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds</u> | 38 |
| <u>Item 3 – Defaults Upon Senior Securities</u>                             | 38 |
| <u>Item 4 – Mine Safety Disclosures</u>                                     | 38 |
| <u>Item 5 – Other Information</u>   | 38 |
| <u>Item 6 - Exhibits</u>  | 39 |
| <b><u>SIGNATURE</u></b>   | 40 |

**PART I - FINANCIAL INFORMATION****Item 1 - Financial Statements****OMEGA FLEX, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

|  | September<br>30,<br>2018<br>(unaudited) | December<br>31,<br>2017<br>(unaudited) |
|--|---|--|
|  | (Dollars in thousands)                  |  |
| <b>ASSETS</b>  |   |  |
| Current Assets:  |   |  |
| Cash and Cash Equivalents  | \$6,445                                 | \$ 37,938                              |
| Accounts Receivable - less allowances of \$1,061 and \$920, respectively | 17,480                                  | 15,636                                 |
| Investments  | 34,897                                  | -                                      |
| Inventories-Net  | 7,620                                   | 8,007                                  |
| Other Current Assets   | 2,411                                   | 1,895                                  |
| <b>Total Current Assets</b>  | <b>68,853</b>                           | <b>63,476</b>                          |
| Property and Equipment-Net   | 7,681                                   | 6,998                                  |
| Goodwill-Net   | 3,526                                   | 3,526                                  |
| Deferred Taxes   | 12                                      | 12                                     |
| Other Long Term Assets   | 1,343                                   | 3,079                                  |
| <b>Total Assets</b>  | <b>\$81,415</b>                         | <b>\$ 77,091</b>                       |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                              |   |  |
| Current Liabilities:   |   |  |
| Accounts Payable   | \$2,554                                 | \$ 2,598                               |
| Accrued Compensation   | 3,763                                   | 4,851                                  |
| Accrued Commissions and Sales Incentives                                 | 4,063                                   | 4,284                                  |
| Dividends Payable  | 2,422                                   | 2,220                                  |
| Taxes Payable  | -                                       | 568                                    |
| Other Liabilities  | 3,791                                   | 3,583                                  |
| <b>Total Current Liabilities</b>   | <b>16,593</b>                           | <b>18,104</b>                          |

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|  |                 |                  |
|--|-----------------|------------------|
| Deferred Taxes   | 348             | 209              |
| Long Term Taxes Payable  | -               | 761              |
| Other Long Term Liabilities  | 1,706           | 1,948            |
| <b>Total Liabilities</b>   | <b>18,647</b>   | <b>21,022</b>    |
| Commitments and Contingencies (Note 5)   |                 |                  |
| Shareholders' Equity:  |                 |                  |
| Omega Flex, Inc. Shareholders' Equity:   |                 |                  |
| Common Stock – par value \$0.01 Shares: authorized 20,000,000, issued 10,153,633 and outstanding 10,091,822 at both September 30, 2018 and December 31, 2017 | 102             | 102              |
| Treasury Stock   | (1 )            | (1 )             |
| Paid-in Capital  | 10,808          | 10,808           |
| Retained Earnings  | 52,508          | 45,457           |
| Accumulated Other Comprehensive Loss   | (879 )          | (908 )           |
| <b>Total Omega Flex, Inc. Shareholders' Equity</b>   | <b>62,538</b>   | <b>55,458</b>    |
| Noncontrolling Interest  | 230             | 611              |
| <b>Total Shareholders' Equity</b>  | <b>62,768</b>   | <b>56,069</b>    |
| <b>Total Liabilities and Shareholders' Equity</b>  | <b>\$81,415</b> | <b>\$ 77,091</b> |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

**OMEGA FLEX, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(unaudited)**

|  | For the<br>three-months<br>ended<br>September 30,<br>2018 |          | For the<br>nine-months<br>ended<br>September 30,<br>2018 |          |
|--|---|----------|--|----------|
|  | 2017  | 2018     | 2017   | 2018     |
|  | (Amounts in Thousands, except earnings per Common Share)  |          |  |          |
| Net Sales  | \$27,199  | \$24,923 | \$79,443   | \$74,335 |
| Cost of Goods Sold   | 10,652  | 9,716    | 31,649   | 29,650   |
| Gross Profit   | 16,547  | 15,207   | 47,794   | 44,685   |
| Selling Expense  | 4,265   | 4,004    | 12,960   | 12,356   |
| General and Administrative Expense                           | 4,385   | 4,495    | 12,939   | 13,312   |
| Engineering Expense  | 1,221   | 798      | 3,361  | 2,468    |
| Operating Profit   | 6,676   | 5,910    | 18,534   | 16,549   |
| Interest Income  | 130   | 27       | 275  | 76       |
| Other Income (Expense)                                       | (40 )   | 4        | (80 )  | (18 )    |
| Income Before Income Taxes                                   | 6,766   | 5,941    | 18,729   | 16,607   |
| Income Tax Expense   | 1,556   | 1,895    | 4,504  | 5,294    |
| Net Income   | 5,210   | 4,046    | 14,225   | 11,313   |
| Less: Net Income attributable to the Noncontrolling Interest | (34 )   | (32 )    | (110 )   | (127 )   |
| Net Income attributable to Omega Flex, Inc.                  | \$5,176   | \$4,014  | \$14,115   | \$11,186 |
| Basic and Diluted Earnings per Common Share                  | \$0.51  | \$0.40   | \$1.40   | \$1.11   |
| Cash Dividends Declared per Common Share                     | \$0.24  | \$0.22   | \$0.70   | \$0.44   |
| Basic and Diluted Weighted-Average Shares Outstanding        | 10,092  | 10,092   | 10,092   | 10,092   |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.





**OMEGA FLEX, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(unaudited)**

|  | For the<br>three-months<br>ended<br>September 30,<br>2018 |         | For the<br>nine-months<br>ended<br>September 30,<br>2017 |          |
|--|---|---------|--|----------|
|  | (Amounts in<br>Thousands)                                 |         | (Amounts in<br>Thousands)                                |          |
| Net Income   | \$5,210   | \$4,046 | \$14,225   | \$11,313 |
| Other Comprehensive Income (Loss):                                     |   |         |  |          |
| Foreign Currency Translation Adjustment                                | (38 )   | 299     | 29   | 724      |
| Other Comprehensive Income (Loss)                                      | (38 )   | 299     | 29   | 724      |
| Comprehensive Income   | 5,172   | 4,345   | 14,254   | 12,037   |
| Less: Comprehensive Income Attributable to the Noncontrolling Interest | (32 )   | (48 )   | (110 )   | (166 )   |
| Total Comprehensive Income   | \$5,140   | \$4,297 | \$14,144   | \$11,871 |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

**OMEGA FLEX, INC.****CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY**

(Amounts in Thousands)

|                                      | Common<br>Stock<br>Outstanding | Common<br>Stock | Treasury<br>Stock | Paid In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Noncontrolling<br>Interest | Shareholders'<br>Equity |
|--------------------------------------|--------------------------------|-----------------|-------------------|--------------------|----------------------|---|----------------------------|-------------------------|
| Balance - December 31,<br>2017       | 10,091,822                     | \$ 102          | \$ (1 )           | \$10,808           | \$45,457             | \$ (908 )   | \$ 611                     | \$ 56,069               |
| Net Income                           | -                              | -               | -                 | -                  | 14,115               | -   | 110                        | 14,225                  |
| Cumulative Translation<br>Adjustment | -                              | -               | -                 | -                  | -                    | 29  | -                          | 29                      |
| Dividends Declared                   | -                              | -               | -                 | -                  | (7,064 )             | -   | (491 )                     | (7,555 )                |
| Balance - September 30,<br>2018      | 10,091,822                     | \$ 102          | \$ (1 )           | \$10,808           | \$52,508             | \$ (879 )   | \$ 230                     | \$ 62,768               |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

**OMEGA FLEX, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)**

|  | For the nine-months<br>ended<br>September 30,<br>2018      2017<br>(Dollars in<br>thousands) |           |
|--|--|-----------|
| Cash Flows from Operating Activities:  |  |           |
| Net Income   | \$ 14,225  | \$ 11,313 |
| Adjustments to Reconcile Net Income to<br>Net Cash Provided By Operating Activities: |  |           |
| Non-Cash Compensation Expense  | 445  | 855       |
| Depreciation and Amortization  | 361  | 362       |
| Provision for Losses on Accounts Receivable  | 129  | (14 )     |
| Provision for Inventory Reserves   | (134 )   | 118       |
| Deferred Taxes   | 139  | (117 )    |
| Changes in Assets and Liabilities:   |  |           |
| Accounts Receivable  | (2,054 )   | (783 )    |
| Inventories  | 476  | (945 )    |
| Other Assets   | 1,219  | (564 )    |
| Accounts Payable   | (28 )  | (189 )    |
| Accrued Compensation   | (1,069 )   | (971 )    |
| Accrued Commissions and Sales Incentives   | (214 )   | 569       |
| Other Liabilities  | (1,779 )   | (193 )    |
| Net Cash Provided by Operating Activities  | 11,716   | 9,441     |
| Cash Flows from Investing Activities:  |  |           |
| Purchase of Investments  | (34,897)   | —         |
| Capital Expenditures   | (1,046 )   | (2,973 )  |
| Net Cash Used in Investing Activities  | (35,943)   | (2,973 )  |
| Cash Flows from Financing Activities:  |  |           |
| Dividends Paid   | (7,353 )   | (10,798)  |
| Net Cash Used in Financing Activities  | (7,353 )   | (10,798)  |
| Net Decrease in Cash and Cash Equivalents  | (31,580)   | (4,330 )  |
| Translation effect on cash   | 87   | 619       |
| Cash and Cash Equivalents – Beginning of Period                                      | 37,938   | 35,318    |
| Cash and Cash Equivalents – End of Period  | \$6,445  | \$31,607  |

Supplemental Disclosure of Cash Flow Information:

|                            |         |         |
|----------------------------|---------|---------|
| Cash paid for Income Taxes | \$5,708 | \$5,443 |
| Cash paid for Interest     | \$—     | \$—     |
| Declared Dividends         | \$7,555 | \$4,440 |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

**OMEGA FLEX, INC.**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. BASIS OF PRESENTATION AND DESCRIPTION OF BUSINESS**

**Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements include the accounts of Omega Flex, Inc. (Omega) and its subsidiaries (collectively the “Company”). The Company’s unaudited condensed consolidated financial statements for the three and nine months ended September 30, 2018 have been prepared in accordance with accounting principles generally accepted in the United States (GAAP), and with the instructions of Form 10-Q and Article 10 of Regulation S-X. Certain information and note disclosures normally included in annual financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading. It is suggested that these condensed consolidated financial statements be read in conjunction with the financial statements and the notes thereto included in the Company’s latest shareholders’ annual report (Form 10-K). All material inter-company accounts and transactions have been eliminated in consolidation. It is Management’s opinion that all adjustments necessary for a fair statement of the results for the interim periods have been made, and that all adjustments are of a normal recurring nature or a description is provided for any adjustments that are not of a normal recurring nature.

**Description of Business**

The Company’s business is controlled as a single operating segment that consists of the manufacture and sale of flexible metal hose (also described as corrugated tubing), as well as the sale of the Company’s related proprietary fittings and a vast array of accessories.

The Company is a leading manufacturer of flexible metal hose, which is used in a variety of ways to carry gases and liquids within their particular applications. Some of the more prominent uses include carrying fuel gases within residential and commercial buildings, the transfer of liquefied gases in certain processing applications, vibration absorbers in high vibration applications, industrial applications where the customer requires the piping to have both a degree of flexibility and/or an ability to carry corrosive compounds or mixtures, or to carry at both very high and very low (cryogenic) temperatures, and the Company’s corrugated tubing can also be used in the healthcare industry to carry

various medical related gases.

The Company manufactures flexible metal hose at its facilities in Exton, Pennsylvania, in the United States, and in Banbury, Oxfordshire in the United Kingdom, and primarily sells its products through distributors, wholesalers and to original equipment manufacturers (“OEMs”) throughout North America and Europe, and to a lesser extent other global markets.

-8-

## 2. SIGNIFICANT ACCOUNTING POLICIES

### Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The most significant estimates and assumptions relate to revenue recognition and related sales incentives, accounts receivable allowances, investment valuations, inventory valuations, goodwill valuation, product liability reserve, stock-based compensation valuations and accounting for income taxes. Actual amounts could differ significantly from these estimates.

### Revenue Recognition

Effective January 1, 2018, the Company adopted the requirements of Accounting Standards Update 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The standard is a comprehensive new revenue recognition model that requires revenue to be recognized in a manner to depict the transfer of goods or services to a customer at an amount that reflects the consideration expected to be received in exchange for those goods or services.

The guidance permits two methods of adoption: retrospectively to each prior reporting period presented (full retrospective method), or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the modified retrospective approach). The Company selected the modified retrospective approach however there was no material impact *which* required a cumulative effect adjustment.

The principle of Topic 606 was achieved through applying the following five-step approach:

*Identification of the contract, or contracts, with a customer* — a contract with a customer exists when the Company enters into an enforceable contract with a customer, typically a purchase order initiated by the customer, that defines each party's rights regarding the goods to be transferred and identifies the payment terms related to these goods.

*Identification of the performance obligations in the contract* — performance obligations promised in a contract are identified based on the goods that will be transferred to the customer that are distinct, whereby the customer can benefit from the goods on their own or together with other resources that are readily available from third parties or from us. Persuasive evidence of an arrangement for the sale of product must exist. The Company ships product in



accordance with the purchase order and standard terms as reflected within the Company's order acknowledgments and sales invoices.

-9-

*Determination of the transaction price* —the transaction price is determined based on the consideration to which the Company will be entitled in exchange for transferring goods to the customer. This would be the agreed upon quantity and price per product type in accordance with the customer purchase order, which is aligned with the Company's internally approved pricing guidelines.

*Allocation of the transaction price to the performance obligations in the contract* — if the contract contains a single performance obligation, the entire transaction price is allocated to the single performance obligation. This applies to the Company as there is only one performance obligation to ship the goods.

*Recognition of revenue when, or as, the Company satisfies a performance obligation* — the Company satisfies performance obligations at a point in time when control of the goods transfers to the customer. Determining the point in time when control transfers requires judgment. Indicators considered in determining whether the customer has obtained control of a good include:

- The Company has a present right to payment
- The customer has legal title to the goods
- The Company has transferred physical possession of the goods
- The customer has the significant risks and rewards of ownership of the goods
- The customer has accepted the goods

It is important to note that the indicators are not a set of conditions that must be met before the Company can conclude that control of the goods has transferred to the customer. The indicators are a list of factors that are often present if a customer has control of the goods.

The Company has typical, unmodified FOB shipping point terms. As the seller, the Company can determine that the shipped goods meet the agreed-upon specifications in the contract or customer purchase order (e.g. items, quantities, and prices) with the buyer, so customer acceptance would be deemed a formality, as noted in ASC 606-10-55-86. As a result, the Company has a legal right to payment upon shipment of the goods.

Based upon the above, the Company has concluded that transfer of control substantively transfers to the customer upon shipment.

Other considerations of Topic 606 include the following:

*Contract Costs* - costs to obtain a contract (e.g. customer purchase order) include sales commissions. Under Topic 606, these costs may be expensed as incurred for contracts with a duration of one year or less. The majority of the customer purchase orders are fulfilled (e.g. goods are shipped) within two days of receipt.

*Warranties* - the Company does not offer customers to purchase a warranty separately. Therefore there is not a separate performance obligation. The Company does account for warranties as a cost accrual and the warranties do not include any additional distinct services other than the assurance that the goods comply with agreed-upon specifications. There is no impact of warranties under Topic 606 upon the financial reporting of the Company.

-10-

*Returned Goods* - from time to time, the Company provides authorization to customers to return goods. If deemed to be material, the Company would record a “right of return” asset for the cost of the returned goods which would reduce cost of sales. Upon adoption of Topic 606, the Company will monitor pending authorized returns of goods and, if deemed appropriate, record the right of return asset accordingly.

*Volume Rebates (Promotional Incentives)* - volume rebates are variable (dependent upon the volume of goods purchased by our eligible customers) and, under Topic 606, must be estimated and recognized as a reduction of revenue as performance obligations are satisfied (e.g. upon shipment of goods). Also under Topic 606, to ensure that revenue recognized would not be probable of a significant reversal, the four following factors are considered:

The amount of consideration is highly susceptible to factors outside the company’s influence.  
The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.  
The Company’s experience with similar types of contracts is limited.  
The contract has a large number and broad range of possible consideration amounts.

If it was concluded that the above factors were in place for the Company, it would support the probability of a significant reversal of revenue. However, as none of the four factors apply to the Company, promotional incentives are recorded as a reduction of revenue based upon estimates of the eligible products expected to be sold.

Regarding disaggregated revenue disclosures, as previously noted, the Company’s business is controlled as a single operating segment that consists of the manufacture and sale of flexible metal hose. Most of the Company’s transactions are very similar in nature, contract, terms, timing, and transfer of control of goods. As indicated within Note 2, under the caption “Significant Concentration”, the majority of the Company’s sales were geographically contained within North America, with the remainder scattered internationally. All performance assessments and resource allocations are generally based upon the review of the results of the Company as a whole.

### **Cash Equivalents**

The Company considers all highly liquid investments with an original maturity of 90 days or less at the time of purchase to be cash equivalents. Cash equivalents include investments in an institutional money market fund, which invests in US Treasury bills, notes and bonds, and/or repurchase agreements, backed by such obligations. Carrying value approximates fair value. Cash and cash equivalents are deposited at various area banks, which at times may exceed federally insured limits. The Company monitors the viability of the banking institutions carrying its assets on a regular basis, and has the ability to transfer cash to various institutions during times of risk. The Company has not experienced any losses related to these cash balances, and believes its credit risk to be minimal.

### **Accounts Receivable and Provision for Doubtful Accounts**

Accounts receivable are reduced by an allowance for amounts that may become uncollectible in the future. The estimated allowance for uncollectible amounts is based primarily on specific analysis of accounts in the receivable portfolio and historical write-off experience. While management believes the allowance to be adequate, if the financial condition of the Company's customers were to deteriorate, resulting in their inability to make payments, additional allowances may be required.

The allowance for doubtful accounts reflects our best estimate of probable losses inherent in the accounts receivable balance. The Company determines the allowance based on any known collection issues, historical experience, and other currently available evidence. The reserve for future credits, discounts, and doubtful accounts was \$1,061,000 and \$920,000 as of September 30, 2018 and December 31, 2017, respectively. In regards to identifying uncollectible accounts, the Company reviews an aging report on a consistent basis to determine past due accounts, and utilizes a well-established credit rating agency. The Company charges off those accounts that are deemed uncollectible once all collection efforts have been exhausted.

### **Investments**

The Company invests excess funds in liquid interest earning instruments including US Treasury bills and bank time deposits. These investments are stated at fair value, which approximates amortized cost, and are classified as available-for-sale in accordance with Accounting Standards Codification 320, *Investments – Debt and Equity Securities* (or "ASC 320"). Investments were \$34,897,000 and \$0 as of September 30, 2018 and December 31, 2017. Maturities, from the date of purchase, were six months or less.

### **Inventories**

Inventories are valued at the lower of cost or market. The cost of inventories is determined by the first-in, first-out (FIFO) method. The Company generally considers inventory quantities beyond two-years usage, measured on a historical usage basis, to be excess inventory and reduces the carrying value of inventory accordingly.

### **Property and Equipment**

Property and equipment are carried at cost. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets or, for leasehold improvements, the life of the lease, if shorter. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in other income or expense for the period. The cost of maintenance and repairs is expensed as incurred; significant improvements are capitalized.

-12-

### **Goodwill**

In accordance with Financial Accounting Standards Board (FASB) ASC Topic 350, Intangibles – Goodwill and Other, the Company performed an annual impairment test in accordance with this guidance as of December 31, 2017. This analysis did not indicate any impairment of goodwill. There were no circumstances that indicate that Goodwill might be impaired at September 30, 2018.

### **Stock-Based Compensation Plans**

In 2006, the Company adopted a Phantom Stock Plan (the “Plan”), which allows the Company to grant phantom stock units (“Units”) to certain key employees, officers or directors. The Units each represent a contractual right to payment of compensation in the future based upon the market value of the Company’s common stock. The Units follow a vesting schedule of three years from the grant date, and are then paid upon maturity. In accordance with FASB ASC Topic 718, Stock Compensation, the Company uses the Black-Scholes option pricing model as its method for determining the fair value of the Units. Further details of the Plan are provided in Note 6.

### **Product Liability Reserves**

Product liability reserves represent the estimated unpaid amounts under the Company’s insurance policies with respect to existing claims. The Company uses the most current available data to estimate claims. As explained more fully under Note 5, Commitments and Contingencies, for various product liability claims covered under the Company’s general liability insurance policies, the Company must pay certain defense and settlement costs within its deductible or self-insured retention limits, ranging primarily from \$25,000 to \$1,000,000 per claim, depending on the terms of the policy in the applicable policy year, up to an aggregate amount. The Company is vigorously defending against all known claims.

### **Fair Value of Financial and Nonfinancial Instruments**

The Company measures financial instruments in accordance with FASB ASC Topic 820, Fair Value Measurements and Disclosures. The accounting standard defines fair value, establishes a framework for measuring fair value under GAAP, and enhances disclosures about fair value measurements. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of

unobservable inputs. The standard creates a fair value hierarchy which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels as follows: Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities; Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly; and Level 3 inputs are unobservable inputs that reflect the Company's own assumptions about the assumptions market participants would use in pricing the asset or liability. The Company relies upon Level 1 inputs in determining the fair value of investments and the fair value of the Company's reporting unit in its annual impairment test as described in the FASB ASC Topic 350, Intangibles - Goodwill and Other.



### **Earnings per Common Share**

Basic earnings per share have been computed using the weighted-average number of common shares outstanding. For the periods presented, there are no dilutive securities. Consequently, basic and dilutive earnings per share are the same.

### **Currency Translation**

Assets and liabilities denominated in foreign currencies, most of which relate to our foreign subsidiary whose functional currency is British pound sterling, are translated into US dollars at exchange rates prevailing on the balance sheet dates. The statements of income are translated into US dollars at average exchange rates for the period. Adjustments resulting from the translation of financial statements are excluded from the determination of income and are accumulated in a separate component of shareholders' equity. Exchange gains and losses resulting from foreign currency transactions are included in the statements of income (other expense) in the period in which they occur.

### **Income Taxes**

The Company accounts for tax liabilities in accordance with the FASB ASC Topic 740, Income Taxes. Under this method the Company recorded tax expense, related deferred taxes and tax benefits, and uncertainties in tax positions.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided for deferred tax assets if it is more likely than not that these items will either expire before the Company is able to realize the benefit, or that future deductibility is uncertain.

The FASB ASC Topic 740, Income Taxes, clarifies the criteria that an individual tax position must satisfy for some or all of the benefits of that position to be recognized in a company's financial statements. This guidance prescribes a recognition threshold of more-likely than-not, and a measurement attribute for all tax positions taken or expected to be taken on a tax return, in order for those tax positions to be recognized in the financial statements.

The Company follows the provisions of ASC 740-10 relative to accounting for uncertainties in tax positions. These provisions provide guidance on the recognition, de-recognition and measurement of potential tax benefits associated with tax positions.

The Company reflected the effects of the Tax Cuts and Jobs Act (the “Act”), in its 2017 financial statements. This included the effects of the change in the US corporate tax rate from 35% to 21% on deferred tax assets and liabilities, and a provision related to previously deferred taxes on earnings of the Company’s foreign subsidiary. The Company’s tax expense for the period ended September 30, 2018 includes the continuing effect of the reduction in the US corporate tax rate from 35% to 21%, effective for the Company’s 2018 tax year. The Company’s tax provision also reflects other changes as a result of the Act, including the impact of the Global Intangible Low Taxed Income (“GILTI”) provisions, and changes affecting the deductibility of certain executive compensation.

### **Other Comprehensive Income**

For the three and nine months ended September 30, 2018 and 2017, respectively, the components of other comprehensive income consisted solely of foreign currency translation adjustments.

### **Significant Concentration**

The Company has one significant customer who represents more than 10% of the Company’s Net Sales for the three and nine months ended September 30, 2018 and 2017, and more than 10% of the Company’s Accounts Receivable balance at September 30, 2018 and December 31, 2017. Geographically, the Company has a significant amount of sales in the United States versus internationally. These concentrations are consistent with those discussed in detail in the Company’s December 31, 2017 Form 10-K.

### **Subsequent Events**

The Company evaluates all events or transactions through the date of the related filing that may have a material impact on its condensed consolidated financial statements. Refer to Note 9 of the condensed consolidated financial statements.

### **Recent Accounting Pronouncements**

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard replaced most existing revenue recognition guidance in US GAAP once it

became effective and permits the use of either a full retrospective or retrospective with cumulative effect transition method. The updated standard became effective for the Company in the first quarter of fiscal year 2018. The Company completed its review of its customer contracts and its analysis of the impact of the disclosure requirements of ASU 2014-09 during 2017. The Company has adopted the revenue guidance effective January 1, 2018, using the modified retrospective approach. The adoption of ASU 2014-09 did not have a material impact on the Company's financial statements, and is not expected to have any material impact on an ongoing basis. Although there is no material impact on the financial statements our accounting policy for revenue recognition has been updated as described previously in Note 1 of the condensed consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. Under this ASU, lessees are required to recognize right-of-use assets and lease liabilities for all leases not considered short-term leases. By definition, a short-term lease is one in which: (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect an accounting policy by class of underlying asset under which right-of-use assets and lease liabilities are not recognized and lease payments are generally recognized as expense over the lease term on a straight-line basis. This change will result in lessees recognizing right-of-use assets and lease liabilities for most leases currently accounted for as operating leases under the legacy lease accounting guidance. ASU 2016-02 is effective for interim and annual periods beginning after December 15, 2018. Early adoption is permitted. The Company is currently evaluating its population of leases, and is continuing to assess all potential impacts of the standard, but currently believes the most significant impact relates to its accounting for real estate operating leases. The Company anticipates recognition of additional assets and corresponding liabilities related to leases upon adoption, but has not quantified these amounts at this time. The Company plans to adopt the standard effective January 1, 2019.

### 3. INVENTORIES

Inventories, net of reserves consisted of the following:

|                 | September                 | December |
|-----------------|---------------------------|----------|
|                 | 30,                       | 31,      |
|                 | 2018                      | 2017     |
|                 | (dollars in<br>thousands) |          |
| Finished Goods  | \$4,575                   | \$ 5,461 |
| Raw Materials   | 3,045                     | 2,546    |
| Inventories-Net | \$7,620                   | \$ 8,007 |

### 4. LINE OF CREDIT

On December 1, 2017, the Company agreed to a new Amended and Restated Revolving Line of Credit Note and Third Amendment to the Loan Agreement with Santander Bank, N.A. (the “Bank”). The Company established a line of credit facility in the maximum amount of \$15,000,000, maturing on December 1, 2022, with funds available for working capital purposes and other cash needs. The loan is unsecured. The loan agreement provides for the payment of any borrowings under the agreement at an interest rate range of either LIBOR plus 0.75% to plus 1.75% (for borrowings with a fixed term of 30, 60, or 90 days), or, Prime Rate up to Prime Rate plus 0.50% (for borrowings with no fixed term other than the December 1, 2022 maturity date), depending upon the Company’s then existing financial ratios. Currently, the Company’s ratio would allow for the most favorable rate under the agreement’s range, which would be a rate of 3.26%. The Company is also required to pay on a quarterly basis an unused facility fee of 10 basis points of the average unused balance of the note. The Company may terminate the line at any time during the five year term, as

long as there are no amounts outstanding. Prior to this, the Company had been operating in adherence with the December 29, 2014 agreement, as outlined in the December 31, 2017 Form 10-K, and filed as an Exhibit to the Current Report on Form 8-K on December 29, 2014.

As of September 30, 2018 and December 31, 2017, the Company had no outstanding borrowings on its line of credit, and was in compliance with all debt covenants.

## 5. COMMITMENTS AND CONTINGENCIES

### **Commitments:**

Under a number of indemnity agreements between the Company and each of its officers and directors, the Company has agreed to indemnify each of its officers and directors against any liability asserted against them in their capacity as an officer or director, or both. The Company's indemnity obligations under the indemnity agreements are subject to certain conditions and limitations set forth in each of the agreements. Under the terms of the Agreement, the Company is contingently liable for costs which may be incurred by the officers and directors in connection with claims arising by reason of these individuals' roles as officers and directors. The Company has obtained directors' and officers' insurance policies to fund certain obligations under the indemnity agreements.

The Company has salary continuation agreements with one current employee, and one former employee who retired at the end of 2010. These agreements provide for monthly payments to each of the employees or their designated beneficiary upon the employee's retirement or death. The payment benefits range from \$1,000 per month to \$3,000 per month with the term of such payments limited to 15 years after the employee's retirement. The agreements also provide for survivorship benefits if the employee dies before attaining age 65, and severance payments if the employee is terminated without cause; the amount of which is dependent on the length of company service at the date of termination. The net present value of the retirement payments associated with these agreements is \$472,000 at September 30, 2018, of which \$460,000 is included in Other Long Term Liabilities, and the remaining current portion of \$12,000 is included in Other Liabilities, associated with the retired employee previously noted who is now receiving benefit payments. The December 31, 2017 liability of \$496,000, had \$484,000 reported in Other Long Term Liabilities, and a current portion of \$12,000 in Other Liabilities.

The Company has obtained and is the beneficiary of three whole life insurance policies with respect to the two employees discussed above, and one other employee policy. The cash surrender value of such policies (included in Other Long Term Assets) amounts to \$1,334,000 at September 30, 2018 and \$1,281,000 at December 31, 2017.

As disclosed in detail in Note 8 of the Company's December 31, 2017 Form 10-K, under the caption "Leases", the Company has several lease obligations in place that will be paid out over time. Most notably, the Company leases a facility in Banbury, England that serves the manufacturing, warehousing and distribution functions. Additionally, the Company purchased the operating facility at 427 Creamery Way in Exton, PA in February 2017, which was previously under lease through January 2018.





## Contingencies:

In the ordinary and normal conduct of the Company's business, it is subject to periodic lawsuits, investigations and claims (collectively, the "Claims"). Most of the Claims, including a putative class-action claim, relate to potential lightning damage to our flexible gas piping products, which impact legal and product liability related expenses. The Company does not believe the Claims have legal merit, and therefore has commenced a vigorous defense in response to the Claims. It is possible that the Company may incur increased litigation costs in the future due to a variety of factors, including a higher number of Claims, higher legal costs, and higher insurance deductibles or retentions.

In 2010, the Company took its first Claim to trial in Pennsylvania, and the jury returned a verdict that the Company was not negligent in designing and selling the TracPipe® product, but also returned a verdict for plaintiff on strict liability. The Company appealed that portion of the verdict, and in December 2014, the Supreme Court of Pennsylvania ruled in favor of the Company, and returned the case to the trial court for further hearings. After further extended appellate review, on February 16, 2018 the appeals court ruled in favor of the Company, and the prior strict liability verdict for the plaintiff has been vacated and the case remanded for a new trial. As a result, the cash bond of \$1,600,000, which was previously included in Other Long Term Assets and posted as security for the subsequent appeal, was returned to the Company in May 2018. In conclusion, after a long arduous defense, and multiple victories in favor of the Company, this case was finally settled and closed on August 7, 2018, with the Company successfully cleared of any and all allegations.

In March 2017, a putative class action case was re-filed against the Company and other parties in Missouri state court after the predecessor case was dismissed without prejudice by the federal court. The Company successfully removed the case to federal court and is currently vigorously defending the case.

The Company has in place commercial general liability insurance policies that cover most Claims, which are subject to deductibles or retentions, ranging primarily from \$25,000 to \$1,000,000 per claim (depending on the terms of the policy and the applicable policy year), up to an aggregate amount. Litigation is subject to many uncertainties and management is unable to predict the outcome of the pending suits and claims. The potential liability for a given claim could range from zero to a maximum of \$1,000,000, depending upon the circumstances, and insurance deductible or retention in place for the respective claim year. The aggregate maximum exposure for all current open Claims as of September 30, 2018 is estimated to not exceed approximately \$2,500,000, which represents the potential costs that may be incurred over time for the Claims within the applicable insurance policy deductibles or retentions. From time to time, depending upon the nature of a particular case, the Company may decide to spend in excess of a deductible or retention to enable more discretion regarding the defense, although this is not common. It is possible that the results of operations or liquidity of the Company, as well as the Company's ability to procure reasonably priced insurance, could be adversely affected by the pending litigation, potentially materially. The Company is currently unable to estimate the ultimate liability, if any, that may result from the pending litigation, or potential litigation from future claims or claims that have not yet come to our attention, and accordingly, the liability in the consolidated financial statements primarily represents an accrual for legal costs for services previously rendered, and outstanding or anticipated settlements for Claims. The liabilities recorded on the Company's books at September 30, 2018 and December 31,

2017 were \$150,000 and \$175,000, respectively, and are included in Other Liabilities.

## 6. STOCK BASED PLANS

### Phantom Stock Plan

**Plan Description.** On April 1, 2006, the Company adopted the Omega Flex, Inc. 2006 Phantom Stock Plan (the “Plan”). The Plan authorizes the grant of up to one million units of phantom stock to employees, officers or directors of the Company. The phantom stock units (“Units”) each represent a contractual right to payment of compensation in the future based on the market value of the Company’s common stock. The Units are not shares of the Company’s common stock, and a recipient of the Units does not receive any of the following:

- ownership interest in the Company
- shareholder voting rights
- other incidents of ownership to the Company’s common stock

The Units are granted to participants upon the recommendation of the Company’s CEO, and the approval of the Compensation Committee. Each of the Units that are granted to a participant will be initially valued by the Compensation Committee, at an amount equal to the closing price of the Company’s common stock on the grant date, but are recorded at fair value using the Black-Sholes method as described below. The Units follow a vesting schedule, with a maximum vesting of three years after the grant date. Upon vesting, the Units represent a contractual right of payment for the value of the Unit. The Units will be paid on their maturity date, one year after all of the Units granted in a particular award have fully vested, unless an acceptable event occurs under the terms of the Plan prior to one year, which would allow for earlier payment. The amount to be paid to the participant on the maturity date is dependent on the type of Unit granted to the participant.

The Units may be *Full Value*, in which the value of each Unit at the maturity date, will equal the closing price of the Company’s common stock as of the maturity date; or *Appreciation Only*, in which the value of each Unit at the maturity date will be equal to the closing price of the Company’s common stock at the maturity date *minus* the closing price of the Company’s common stock at the grant date.

On December 9, 2009, the Board of Directors authorized an amendment to the Plan to pay an amount equal to the value of any cash or stock dividend declared by the Company on its common stock to be accrued to the phantom stock units outstanding as of the record date of the common stock dividend. The dividend equivalent will be paid at the same time the underlying phantom stock units are paid to the participant.

In certain circumstances, the Units may be immediately vested upon the participant's death or disability. All Units granted to a participant are forfeited if the participant is terminated from his relationship with the Company or its subsidiary for "cause," which is defined under the Plan. If a participant's employment or relationship with the Company is terminated for reasons other than for "cause," then any vested Units will be paid to the participant upon termination. However, Units granted to certain "specified employees" as defined in Section 409A of the Internal Revenue Code will be paid approximately 181 days after termination.

**Grants of Phantom Stock Units.** As of December 31, 2017, the Company had 21,296 unvested units outstanding, all of which were granted at *Full Value*. On February 12, 2018 and August 27, 2018, the Company granted an additional 6,450 and 950 *Full Value* Units, respectively, with a fair value of \$53.04 and \$85.43 per unit on grant date, again respectively, using historical volatility. As of September 30, 2018, the Company had 17,805 unvested units outstanding.

The Company uses the Black-Scholes option pricing model as its method for determining fair value of the Units. The Company uses the straight-line method of attributing the value of the stock-based compensation expense relating to the Units. The compensation expense (including adjustment of the liability to its fair value) from the Units is recognized over the vesting period of each grant or award.

The FASB ASC Topic 718, Stock Compensation, requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates in order to derive the Company's best estimate of awards ultimately to vest.

Forfeitures represent only the unvested portion of a surrendered Unit and are typically estimated based on historical experience. Based on an analysis of the Company's historical data, which has limited experience related to any stock-based plan forfeitures, the Company applied a 0% forfeiture rate to Plan Units outstanding in determining its Plan Unit compensation expense as of September 30, 2018.

The total Phantom Stock related liability as of September 30, 2018 was \$2,018,000 of which \$774,000 is included in Other Liabilities, as it is expected to be paid in February 2019, and the balance of \$1,244,000 is included in Other Long Term Liabilities. At December 31, 2017, the total Phantom Stock liability was \$2,238,000, with \$776,000 in Other Liabilities, and \$1,462,000 included in Other Long Term Liabilities.

Related to the Phantom Stock Plan, in accordance with FASB ASC Topic 718, Stock Compensation, the Company recorded compensation expense of approximately \$445,000 and \$855,000 for the nine months ended September 30, 2018 and 2017, respectively. Compensation income or expense for a given period largely depends upon fluctuations in the Company's stock price.



The following table summarizes information about the Company's nonvested phantom stock Units at September 30, 2018:

|  | Units    | Weighted<br>Average<br>Grant<br>Date Fair<br>Value |
|--|----------|--|
| Number of Phantom Stock Unit Awards:       |          |  |
| Nonvested at December 31, 2017             | 21,296   | \$ 34.74   |
| Granted                                    | 7,400    | \$ 57.20   |
| Vested                                     | (10,891) | \$ 33.74   |
| Forfeited                                  | ---      | ---  |
| Canceled                                   | ---      | ---  |
| Nonvested at September 30, 2018            | 17,805   | \$ 46.08   |
| Phantom Stock Unit Awards Expected to Vest | 17,805   | \$ 46.08   |

The total unrecognized compensation costs calculated at September 30, 2018 are \$863,000 which will be recognized through August of 2021. The Company will recognize the related expense over the weighted average period of 1.2 years.

## 7. SHAREHOLDERS' EQUITY

For the periods ending September 30, 2018 and December 31, 2017, the Company had authorized 20,000,000 common stock shares with par value of \$0.01 per share. At these dates, the number of shares issued was 10,153,633, and the total number of outstanding shares was 10,091,822, with the 61,811 variance representing shares held in Treasury.

During 2018, the Board of Directors (the "Board") announced regular quarterly dividends per share of \$0.22 in April, and \$0.24 in both June and September, to all Shareholders of record. The respective 2018 dividend payments were \$2,220,000 in April, and \$2,422,000 in both July and October. Additionally, there was a dividend that was paid in April by the Company's foreign subsidiary, which amounted to an outlay of cash of \$491,000 to the foreign subsidiary's noncontrolling interest.

During 2017, the Board revised its dividend policy to allow for and establish a record of paying regular quarterly dividends. In furtherance of this policy, during 2017 the Company announced in June, September, and December that

the Board had approved a quarterly dividend in the amount of \$0.22 per share to all Shareholders of record, amounting to the respective dividend payments of \$2,220,000 in July, October, and January of 2018.

On December 14, 2016, the Board declared a special dividend of \$0.85 per share to all Shareholders of record as of December 26, 2016, payable on or before January 6, 2017. The total payment to shareholders made in January 2017 was \$8,578,000.

On April 4, 2014, the Company's Board of Directors authorized an extension of its stock repurchase program without expiration, up to a maximum amount of \$1,000,000. The original program established in December 2007 authorized the purchase of up to \$5,000,000 of its common stock. The purchases may be made from time-to-time in the open market or in privately negotiated transactions, depending on market and business conditions. The Board retained the right to cancel, extend, or expand the share buyback program, at any time and from time-to-time. Since inception, the Company has purchased a total of 61,811 shares for approximately \$932,000, or approximately \$15 per share. The Company has not made any stock repurchases since 2014.

## **8. RELATED PARTY TRANSACTIONS**

From time to time the Company may have related party transactions (“RPTs”). In short, RPTs represent any transaction between the Company and any Company employee, director or officer, or any related entity, or relative, etc. The Company performs a review of transactions each year to determine if any RPTs exist. Through this investigation, the Company is currently not aware of any RPTs between the Company and any of its current directors or officers outside the scope of their normal business functions or expected contractual duties. The Company does on occasion share a small amount of services with its former parent Mestek, Inc., mostly related to board meeting expenses. Additionally, the Company is aware of transactions between a few service providers which employ individuals indirectly associated to Omega Flex employees, but these have been determined to be independent transactions with no indication that they are influenced by the related relationships. The Company currently also has note agreement assets with related parties amounting to approximately \$5,000 and \$147,000 at September 30, 2018 and December 31, 2017, respectively, which are contractually secured by the Company. In April 2018, a majority of the amounts due from related parties was collected.

## **9. SUBSEQUENT EVENTS**

The Company evaluated all events or transactions that occurred through the date of this filing. During this period, the Company did not have any material subsequent events that impacted its condensed consolidated financial statements.



## **Item 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations**

*This report contains forward-looking statements, which are subject to inherent uncertainties. These uncertainties include, but are not limited to, variations in weather, changes in the regulatory environment, customer preferences, general economic conditions, increased competition, the outcome of outstanding litigation, and future developments affecting environmental matters. All of these are difficult to predict, and many are beyond the ability of the Company to control.*

*Certain statements in this Quarterly Report on Form 10-Q that are not historical facts, but rather reflect the Company’s current expectations concerning future results and events, constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The words “believes”, “expects”, “intends”, “plans”, “anticipates”, “hopes”, “likely”, “will”, and similar expressions identify such forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements of the Company, or industry results, to differ materially from future results, performance or achievements expressed or implied by such forward-looking statements.*

*Readers are cautioned not to place undue reliance on these forward-looking statements, which reflect management’s view only as of the date of this Form 10-Q. The Company undertakes no obligation to update the result of any revisions to these forward-looking statements which may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events, conditions or circumstances.*

### **OVERVIEW**

The Company is a leading manufacturer of flexible metal hose (also described as corrugated tubing), and is currently engaged in a number of different markets, including construction, manufacturing, transportation, petrochemical, pharmaceutical, healthcare and other industries.

The Company’s business is managed as a single operating segment that consists of the manufacture and sale of flexible metal hose, as well as the sale of the Company’s related proprietary fittings and a vast array of accessories. The Company’s products are concentrated in residential and commercial construction, and general industrial markets, with a comprehensive portfolio of intellectual property and patents issued in various countries around the world. The Company’s primary product, flexible gas piping, is used for gas piping within residential and commercial buildings. Through its flexibility and ease of use, the Company’s TracPipe® and TracPipe® CounterStrike® flexible gas piping, along with its fittings distributed under the trademarks AutoSnap® and AutoFlare®, allows users to substantially cut the time required to install gas piping, as compared to traditional methods. The Company’s products are manufactured at its Exton, Pennsylvania facilities in the United States, and in Banbury, Oxfordshire in the United Kingdom.

Through the use of its broad network of independent outside sales organizations, such as sales representatives, the Company primarily sells its products to distributors, wholesalers and OEM's, mostly throughout North America, and to a lesser extent in other global markets.

**CHANGES IN FINANCIAL CONDITION**

Cash was \$6,445,000 and \$37,938,000 at September 30, 2018 and December 31, 2017, respectively, decreasing \$31,493,000 (83.0%). The decrease is mainly the result of the Company purchasing short-term investments of \$34,897,000 mainly during August 2018 for the purpose of earning a higher level of investment income while maintaining a minimal level of risk.

Accounts Receivable were \$17,480,000 and \$15,636,000 at September 30, 2018 and December 31, 2017, respectively, increasing \$1,844,000 (11.8%). The related Net Sales associated with these balances were correspondingly higher for these periods.

Other Long Term Assets were \$1,343,000 and \$3,079,000 at September 30, 2018 and December 31, 2017, respectively, decreasing \$1,736,000 (56.4%). During May 2018, the Company received back the cash bond of approximately \$1,600,000, which was previously held as security during an appeals process as detailed in Note 5, Commitments and Contingencies.

**RESULTS OF OPERATIONS****Three-months ended September 30, 2018 vs. September 30, 2017**

The Company reported comparative results from operations for the three-months ended September 30, 2018 and 2017 as follows:

|                  | Three-months ended September 30,<br>(in thousands) |        |          |        |
|------------------|--|--------|----------|--------|
|                  | 2018   | 2018   | 2017     | 2017   |
|                  | (\$000)  |        | (\$000)  |        |
| Net Sales        | \$27,199   | 100.0% | \$24,923 | 100.0% |
| Gross Profit     | \$16,547   | 60.8 % | \$15,207 | 61.0 % |
| Operating Profit | \$6,676  | 24.6 % | \$5,910  | 23.7 % |

**Net Sales.** The Company's 2018 third quarter net sales (sales) of \$27,199,000 exceeded the 2017 third quarter sales of \$24,923,000 by \$2,276,000 or 9.1%. A majority of the increase was due to unit growth, with a portion related to

higher selling prices.

Gross Profit. The Company's gross profit margins were fairly consistent between periods, being 60.8% and 61.0% for the three-months ended September 30, 2018 and 2017, respectively.

-24-

**Selling Expense.** Selling expenses consist primarily of employee salaries and associated overhead costs, commissions, and the cost of marketing programs such as advertising, trade shows and related communication costs, and freight. Selling expense was \$4,265,000 and \$4,004,000 for the three-months ended September 30, 2018 and 2017, respectively, representing an increase of \$261,000 (6.5%). The increase largely related to freight and commissions, which typically move in relation to sales. As a percent of sales, Selling expenses were 15.7% for the three-months ended September 30, 2018, compared to 16.1% for the three-months ended September 30, 2017.

**General and Administrative Expense.** General and administrative expenses consist primarily of employee salaries, benefits for administrative, executive and finance personnel, legal and accounting, insurance, and corporate general and administrative services. General and administrative expenses were \$4,385,000 and \$4,495,000 for the three-months ended September 30, 2018 and 2017, respectively, decreasing \$110,000 or 2.5% between periods. Incentive compensation expenses decreased, mainly related to the Company's phantom stock plan, which was the result of a decrease in the Company's stock price. These savings were however partially offset by higher staffing related costs and additional, other less significant items. As a percentage of sales, general and administrative expenses were 16.1% and 18.0% for the three-months ended September 30, 2018 and 2017, respectively.

**Engineering Expense.** Engineering expenses consist of development expenses associated with the development of new products, and costs related to enhancements of existing products and manufacturing processes. Engineering expenses increased \$423,000 (53.0%) for the quarter. They were \$1,221,000 and \$798,000 for the three-months ended September 30, 2018 and 2017, respectively. The most significant increase was related to staffing, experimental materials, consulting, and product certification expenses, which includes costs associated with the progression of the Company's new MediTra® corrugated medical tubing product. Engineering expenses as a percentage of sales were 4.5% and 3.2% for the three-months ended September 30, 2018, and 2017, respectively.

**Operating Profit.** Reflecting all of the factors mentioned above, operating profits increased by \$766,000, or 13.0% compared to last year. The Company had a profit of \$6,676,000 in the three-month period ended September 30, 2018, versus a profit of \$5,910,000 in the three-months ended September 30, 2017.

**Interest Income.** Interest income is recorded on cash investments, and when applicable, interest expense is recorded at times when the Company has debt amounts outstanding on its line of credit. The Company purchased short-term investments of \$34,897,000 which resulted in an increase of interest income. The Company recognized \$130,000 and \$27,000 of interest income for the third quarters of 2018 and 2017, respectively.

**Other Income (Expense).** Other income (expense) primarily consists of foreign currency exchange gains (losses) on transactions within our foreign subsidiaries, and therefore tends to fluctuate with the strengthening and or weakening of the British Pound. The Company recognized other expense of \$40,000 for the third quarter of 2018, while recording other income of \$4,000 for the third quarter of 2017.



**Income Tax Expense.** Income tax expense was \$1,556,000 for the third quarter of 2018, compared to \$1,895,000 for the same period in 2017. The \$339,000 (17.9%) decrease was primarily due to a lower rate which was in effect during 2018 attributable to the Tax Cuts and Jobs Act (the “Act”) enacted at the end of 2017. The Act reduced the US corporate tax rate from 35% to 21%, effective for the Company’s 2018 tax year. The Company’s tax provision also reflects other changes as a result of the Act, including the impact of Global Intangible Low Taxed Income (“GILTI”) provisions, and changes affecting the deductibility of certain executive compensation.

### **Nine-months ended September 30, 2018 vs. September 30, 2017**

The Company reported comparative results from operations for the nine-months ended September 30, 2018 and 2017 as follows:

|                  | Nine-months ended September 30,<br>(in thousands) |        |          |        |
|------------------|---|--------|----------|--------|
|                  | 2018  | 2018   | 2017     | 2017   |
|                  | (\$000)   |        | (\$000)  |        |
| Net Sales        | \$79,443  | 100.0% | \$74,335 | 100.0% |
| Gross Profit     | \$47,794  | 60.2 % | \$44,685 | 60.1 % |
| Operating Profit | \$18,534  | 23.3 % | \$16,549 | 22.3 % |

**Net Sales.** The Company’s sales for the first nine months of 2018 increased \$5,108,000, or 6.9% over the same period in 2017, ending at \$79,443,000 and \$74,335,000 in 2018 and 2017, respectively.

**Gross Profit.** The Company’s gross profit margins were very similar between the two periods, being 60.2% and 60.1% for the nine-months ended September 30, 2018 and 2017, respectively.

**Selling Expense.** Selling expenses consist primarily of employee salaries and associated overhead costs, commissions, and the cost of marketing programs such as advertising, trade shows and related communication costs, and freight. Selling expense was \$12,960,000 and \$12,356,000 for the nine-months ended September 30, 2018 and 2017, respectively, representing an increase of \$604,000 or 4.9%. The primary increases related to freight and commissions, which largely move in relation to sales. Selling expense as a percent of sales was 16.3% for the nine-months ended September 30, 2018, and 16.6% for the nine-months ended September 30, 2017.

**General and Administrative Expense.** General and administrative expenses consist primarily of employee salaries, benefits for administrative, executive and finance personnel, legal and accounting, insurance, and corporate general

and administrative services. General and administrative expenses were \$12,939,000 and \$13,312,000 for the nine-months ended September 30, 2018 and 2017, respectively, decreasing \$373,000 or 2.8% between periods. The decrease was primarily driven by lower legal and product liability defense costs compared to last year. These savings were however partially offset by additional expenses accrued related to staffing and other less significant items. As a percentage of sales, general and administrative expenses decreased to 16.3% for the nine-months ended September 30, 2018 from 17.9% for the nine-months ended September 30, 2017.



**Engineering Expense.** Engineering expenses consist of development expenses associated with the development of new products, and costs related to enhancements of existing products and manufacturing processes. Engineering expenses increased \$893,000 or 36.2% between periods, as they were \$3,361,000 and \$2,468,000 for the nine-months ended September 30, 2018 and 2017, respectively. The primary increase was related to experimental materials, staffing, product certification, and consulting expenses, which includes costs associated with the progression of the Company's new MediTrac® corrugated medical tubing product. Engineering expenses also increased as a percentage of sales, being 4.2% and 3.3% for the nine-months ended September 30, 2018 and 2017.

**Operating Profit.** Reflecting all of the factors mentioned above, operating profits were up \$1,985,000 or 12.0%, ending with a profit of \$18,534,000 for the first nine months of 2018, compared to \$16,549,000 in 2017.

**Interest Income.** Interest income is recorded on cash investments, and when applicable, interest expense is recorded at times when the Company has debt amounts outstanding on its line of credit. The Company purchased short-term investments of \$34,897,000 which resulted in an increase of interest income. There was \$275,000 of interest income recorded during the first nine months of 2018, and \$76,000 during the same period in 2017.

**Other Income (Expense).** Other income (expense) primarily consists of foreign currency exchange gains (losses) on transactions within our foreign subsidiaries, and therefore tends to fluctuate with the strengthening and or weakening of the British Pound. The Company recognized other expense of \$80,000 and \$18,000 during the first nine months of 2018 and 2017, respectively.

**Income Tax Expense.** Income tax expense was \$4,504,000 and \$5,294,000 for the first nine months of 2018 and 2017, respectively, decreasing \$790,000 or 14.9% between periods. There was a lower tax rate in effect during 2018 attributable to the Act enacted at the end of 2017. The Act reduced the US corporate tax rate from 35% to 21%, effective for the Company's 2018 tax year. The Company's tax provision also reflects other changes as a result of the Act, including the impact of GILTI provisions, and changes affecting the deductibility of certain executive compensation. The decrease in taxes attributable to the Act, was partially offset by higher taxes associated with an increase in income before taxes.

## **CRITICAL ACCOUNTING POLICIES AND USE OF ESTIMATES**

Financial Reporting Release No. 60, released by the Securities and Exchange Commission, requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements. Note 2 of the Notes to the Condensed Consolidated Financial Statements includes a summary of the significant accounting policies and methods used in the preparation of our condensed Consolidated Financial Statements. The following is a brief discussion of the Company's more significant accounting policies.



The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The most significant estimates and assumptions relate to revenue recognition and related sales incentives, accounts receivable allowances, inventory valuations, goodwill valuation, product liability reserve, stock-based compensation valuations and accounting for income taxes. Actual amounts could differ significantly from these estimates.

Our critical accounting policies and significant estimates and assumptions are described in more detail as follows:

### **Revenue Recognition**

Effective January 1, 2018, the Company adopted the requirements of Accounting Standards Update 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The standard is a comprehensive new revenue recognition model that requires revenue to be recognized in a manner to depict the transfer of goods or services to a customer at an amount that reflects the consideration expected to be received in exchange for those goods or services.

The guidance permits two methods of adoption: retrospectively to each prior reporting period presented (full retrospective method), or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the modified retrospective approach). The Company selected the modified retrospective approach however there was no material impact which required a cumulative effect adjustment.

The principle of Topic 606 was achieved through applying the following five-step approach:

*Identification of the contract, or contracts, with a customer* — a contract with a customer exists when the Company enters into an enforceable contract with a customer, typically a purchase order initiated by the customer, that defines each party's rights regarding the goods to be transferred and identifies the payment terms related to these goods.

*Identification of the performance obligations in the contract* — performance obligations promised in a contract are identified based on the goods that will be transferred to the customer that are distinct, whereby the customer can benefit from the goods on their own or together with other resources that are readily available from third parties or from us. Persuasive evidence of an arrangement for the sale of product must exist. The Company ships product in accordance with the purchase order and standard terms as reflected within the Company's order acknowledgments and sales invoices.



*Determination of the transaction price* —the transaction price is determined based on the consideration to which the Company will be entitled in exchange for transferring goods to the customer. This would be the agreed upon quantity and price per product type in accordance with the customer purchase order, which is aligned with the Company's internally approved pricing guidelines.

*Allocation of the transaction price to the performance obligations in the contract* — if the contract contains a single performance obligation, the entire transaction price is allocated to the single performance obligation. This applies to the Company as there is only one performance obligation to ship the goods.

*Recognition of revenue when, or as, the Company satisfies a performance obligation* — the Company satisfies performance obligations at a point in time when control of the goods transfers to the customer. Determining the point in time when control transfers requires judgment. Indicators considered in determining whether the customer has obtained control of a good include:

- The Company has a present right to payment
- The customer has legal title to the goods
- The Company has transferred physical possession of the goods
- The customer has the significant risks and rewards of ownership of the goods
- The customer has accepted the goods

It is important to note that the indicators are not a set of conditions that must be met before the Company can conclude that control of the goods has transferred to the customer. The indicators are a list of factors that are often present if a customer has control of the goods.

The Company has typical, unmodified FOB shipping point terms. As the seller, the Company can determine that the shipped goods meet the agreed-upon specifications in the contract or customer purchase order (e.g. items, quantities, and prices) with the buyer, so customer acceptance would be deemed a formality, as noted in ASC 606-10-55-86. As a result, the Company has a legal right to payment upon shipment of the goods.

Based upon the above, the Company has concluded that transfer of control substantively transfers to the customer upon shipment.

Other considerations of Topic 606 include the following:

*Contract Costs* - costs to obtain a contract (e.g. customer purchase order) include sales commissions. Under Topic 606, these costs may be expensed as incurred for contracts with a duration of one year or less. The majority of the customer purchase orders are fulfilled (e.g. goods are shipped) within two days of receipt.

*Warranties* - the Company does not offer customers to purchase a warranty separately. Therefore there is not a separate performance obligation. The Company does account for warranties as a cost accrual and the warranties do not include any additional distinct services other than the assurance that the goods comply with agreed-upon specifications. There is no impact of warranties under Topic 606 upon the financial reporting of the Company.

*Returned Goods* - from time to time, the Company provides authorization to customers to return goods. If deemed to be material, the Company would record a “right of return” asset for the cost of the returned goods which would reduce cost of sales. Upon adoption of Topic 606, the Company will monitor pending authorized returns of goods and, if deemed appropriate, record the right of return asset accordingly.

*Volume Rebates (Promotional Incentives)* - volume rebates are variable (dependent upon the volume of goods purchased by our eligible customers) and, under Topic 606, must be estimated and recognized as a reduction of revenue as performance obligations are satisfied (e.g. upon shipment of goods). Also under Topic 606, to ensure that revenue recognized would not be probable of a significant reversal, the four following factors are considered:

The amount of consideration is highly susceptible to factors outside the company’s influence.  
The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.  
The Company’s experience with similar types of contracts is limited.  
The contract has a large number and broad range of possible consideration amounts.

If it was concluded that the above factors were in place for the Company, it would support the probability of a significant reversal of revenue. However, as none of the four factors apply to the Company, promotional incentives are recorded as a reduction of revenue based upon estimates of the eligible products expected to be sold.

Regarding disaggregated revenue disclosures, as previously noted, the Company’s business is controlled as a single operating segment that consists of the manufacture and sale of flexible metal hose. Most of the Company’s transactions are very similar in nature, contract, terms, timing, and transfer of control of goods. As indicated within Note 2, under the caption “Significant Concentration”, the majority of the Company’s sales were geographically contained within North America, with the remainder scattered internationally. All performance assessments and resource allocations are generally based upon the review of the results of the Company as a whole.

### **Cash Equivalents**

The Company considers all highly liquid investments with an original maturity of 90 days or less at the time of purchase to be cash equivalents. Cash equivalents include investments in an institutional money market fund, which invests in US Treasury bills, notes and bonds, and/or repurchase agreements, backed by such obligations. Carrying value approximates fair value. Cash and cash equivalents are deposited at various area banks, which at times may exceed federally insured limits. The Company monitors the viability of the banking institutions carrying its assets on a regular basis, and has the ability to transfer cash to various institutions during times of risk. The Company has not experienced any losses related to these cash balances, and believes its credit risk to be minimal.

### **Accounts Receivable and Provision for Doubtful Accounts**

Accounts receivable are reduced by an allowance for amounts that may become uncollectible in the future. The estimated allowance for uncollectible amounts is based primarily on specific analysis of accounts in the receivable portfolio and historical write-off experience. While management believes the allowance to be adequate, if the financial condition of the Company's customers were to deteriorate, resulting in their inability to make payments, additional allowances may be required.

The allowance for doubtful accounts reflects our best estimate of probable losses inherent in the accounts receivable balance. The Company determines the allowance based on any known collection issues, historical experience, and other currently available evidence. The reserve for future credits, discounts, and doubtful accounts was \$1,061,000 and \$920,000 as of September 30, 2018 and December 31, 2017, respectively. In regards to identifying uncollectible accounts, the Company reviews an aging report on a consistent basis to determine past due accounts, and utilizes a well established credit rating agency. The Company charges off those accounts that are deemed uncollectible once all collection efforts have been exhausted.

### **Investments**

The Company invests excess funds in liquid interest earning instruments including US Treasury bills and bank time deposits. These investments are stated at fair value, which approximates amortized cost, and are classified as available-for-sale in accordance with Accounting Standards Codification 320, *Investments – Debt and Equity Securities* (or “ASC 320”). Investments were \$34,897,000 and \$0 as of September 30, 2018 and December 31, 2017. Maturities, from the date of purchase, were six months or less.

### **Inventories**

Inventories are valued at the lower of cost or market. The cost of inventories is determined by the first-in, first-out (FIFO) method. The Company generally considers inventory quantities beyond two-years usage, measured on a historical usage basis, to be excess inventory and reduces the carrying value of inventory accordingly.

### **Property and Equipment**



Property and equipment are carried at cost. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets or, for leasehold improvements, the life of the lease, if shorter. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in other income or expense for the period. The cost of maintenance and repairs is expensed as incurred; significant improvements are capitalized.

### **Goodwill**

In accordance with Financial Accounting Standards Board (FASB) ASC Topic 350, Intangibles – Goodwill and Other, the Company performed an annual impairment test in accordance with this guidance as of December 31, 2017. This analysis did not indicate any impairment of goodwill. There were no circumstances that indicate that Goodwill might be impaired at September 30, 2018.

### **Stock-Based Compensation Plans**

In 2006, the Company adopted a Phantom Stock Plan (the “Plan”), which allows the Company to grant phantom stock units (Units) to certain key employees, officers or directors. The Units each represent a contractual right to payment of compensation in the future based upon the market value of the Company’s common stock. The Units follow a vesting schedule of three years from the grant date, and are then paid upon maturity. In accordance with FASB ASC Topic 718, Stock Compensation, the Company uses the Black-Scholes option pricing model as its method for determining the fair value of the Units. Further details of the Plan are provided in Note 6.

### **Product Liability Reserves**

Product liability reserves represent the estimated unpaid amounts under the Company’s insurance policies with respect to existing claims. The Company uses the most current available data to estimate claims. As explained more fully under Note 5, Commitments and Contingencies, for various product liability claims covered under the Company’s general liability insurance policies, the Company must pay certain defense costs within its deductible or self-insured retention limits, ranging primarily from \$25,000 to \$1,000,000 per claim, depending on the terms of the policy in the applicable policy year, up to an aggregate amount. The Company is vigorously defending against all known claims.

### **Fair Value of Financial and Nonfinancial Instruments**

The Company measures financial instruments in accordance with FASB ASC Topic 820, Fair Value Measurements and Disclosures. The accounting standard defines fair value, establishes a framework for measuring fair value under GAAP, and enhances disclosures about fair value measurements. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard creates a fair value hierarchy which prioritizes the inputs to valuation techniques

used to measure fair value into three broad levels as follows: Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities; Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly; and Level 3 inputs are unobservable inputs that reflect the Company's own assumptions about the assumptions market participants would use in pricing the asset or liability. The Company relies upon Level 1 inputs in determining the fair value of investments and the fair value of the Company's reporting unit in its annual impairment test as described in the FASB ASC Topic 350, Intangibles - Goodwill and Other.

### **Earnings per Common Share**

Basic earnings per share have been computed using the weighted-average number of common shares outstanding. For the periods presented, there are no dilutive securities. Consequently, basic and dilutive earnings per share are the same.

### **Currency Translation**

Assets and liabilities denominated in foreign currencies, most of which relate to our foreign subsidiary whose functional currency is British pound sterling, are translated into US dollars at exchange rates prevailing on the balance sheet dates. The statements of income are translated into US dollars at average exchange rates for the period. Adjustments resulting from the translation of financial statements are excluded from the determination of income and are accumulated in a separate component of shareholders' equity. Exchange gains and losses resulting from foreign currency transactions are included in the statements of income (other income (expense)) in the period in which they occur.

### **Income Taxes**

The Company accounts for tax liabilities in accordance with the FASB ASC Topic 740, Income Taxes. Under this method the Company recorded tax expense, related deferred taxes and tax benefits, and uncertainties in tax positions.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided for deferred tax assets if it is more likely than not that these items will either expire before the Company is able to realize the benefit, or that future deductibility is uncertain.

The FASB ASC Topic 740, Income Taxes, clarifies the criteria that an individual tax position must satisfy for some or all of the benefits of that position to be recognized in a company's financial statements. This guidance prescribes a recognition threshold of more-likely than-not, and a measurement attribute for all tax positions taken or expected to be taken on a tax return, in order for those tax positions to be recognized in the financial statements.

The Company follows the provisions of ASC 740-10 relative to accounting for uncertainties in tax positions. These provisions provide guidance on the recognition, de-recognition and measurement of potential tax benefits associated with tax positions.

-33-

The Company reflected the effects of the Act, in its 2017 financial statements. This included the effects of the change in the US corporate tax rate from 35% to 21% on deferred tax assets and liabilities, and a provision related to previously deferred taxes on earnings of the Company's foreign subsidiary. The Company's tax expense for the period ended September 30, 2018 includes the continuing effect of the reduction in the US corporate tax rate from 35% to 21%, effective for the Company's 2018 tax year. The Company's tax provision also reflects other changes as a result of the Act, including the impact of the GILTI provisions, and changes affecting the deductibility of certain executive compensation.

### **Other Comprehensive Income**

For the three and nine months ended September 30, 2018 and 2017, respectively, the components of other comprehensive income consisted solely of foreign currency translation adjustments.

### **Significant Concentration**

The Company has one significant customer who represents more than 10% of the Company's Net Sales for the three and nine months ended September 30, 2018 and 2017, and more than 10% of the Company's Accounts Receivable balance at September 30, 2018 and December 31, 2017. Geographically, the Company has a significant amount of sales in the United States versus internationally. These concentrations are discussed in detail in the Company's December 31, 2017 Form 10-K, and there has been no significant change as of this quarterly report.

### **Subsequent Events**

The Company evaluates all events or transactions through the date of the related filing that may have a material impact on its condensed consolidated financial statements. Refer to Note 9 of the condensed consolidated financial statements.

### **Recent Accounting Pronouncements**

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard replaced most existing revenue recognition guidance in US GAAP once it

became effective and permits the use of either a full retrospective or retrospective with cumulative effect transition method. The updated standard became effective for the Company in the first quarter of fiscal year 2018. The Company completed its review of its customer contracts and its analysis of the impact of the disclosure requirements of ASU 2014-09 during 2017. The Company has adopted the revenue guidance effective January 1, 2018, using the modified retrospective approach. The adoption of ASU 2014-09 did not have a material impact on the Company's financial statements, and is not expected to have any material impact on an ongoing basis. Although there is no material impact on the financial statements our accounting policy for revenue recognition has been updated as described previously in Note 1 of the condensed consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. Under this ASU, lessees are required to recognize right-of-use assets and lease liabilities for all leases not considered short-term leases. By definition, a short-term lease is one in which: (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect an accounting policy by class of underlying asset under which right-of-use assets and lease liabilities are not recognized and lease payments are generally recognized as expense over the lease term on a straight-line basis. This change will result in lessees recognizing right-of-use assets and lease liabilities for most leases currently accounted for as operating leases under the legacy lease accounting guidance. ASU 2016-02 is effective for interim and annual periods beginning after December 15, 2018. Early adoption is permitted. The Company is currently evaluating its population of leases, and is continuing to assess all potential impacts of the standard, but currently believes the most significant impact relates to its accounting for real estate operating leases. The Company anticipates recognition of additional assets and corresponding liabilities related to leases upon adoption, but has not quantified these amounts at this time. The Company plans to adopt the standard effective January 1, 2019.

## **LIQUIDITY AND CAPITAL RESOURCES**

Historically, the Company's primary cash needs have been related to working capital items, which the Company has largely funded through cash generated from operations.

As of September 30, 2018, the Company had a cash balance of \$6,445,000 and short-term investments of \$34,897,000. Additionally, the Company has a \$15,000,000 line of credit available, as discussed in detail in Note 4, which had no borrowings outstanding upon it at September 30, 2018. At December 31, 2017, the Company had a cash balance of \$37,938,000, with no borrowings against the line of credit.

We believe our existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next twelve months. Our future capital requirements will depend upon many factors including our rate of revenue growth, the timing and extent of any expansion efforts, and the potential for investments in, or the acquisition of any complementary products, businesses or supplementary facilities for additional capacity. The details of our operating, investing and financing activities are provided below.

### **Operating Activities**

Cash provided from operating activities is net income adjusted for certain non-cash items and changes in certain assets and liabilities, such as those included in working capital.



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For the first nine months of 2018, the Company's operating activities provided cash of \$11,716,000, compared to the first nine months of 2017 which provided cash of \$9,441,000, thus increasing cash by \$2,275,000. For details of the operating cash flows refer to the condensed consolidated statements of cash flows in Part I – Financial Information on page seven.

-35-

### **Investing Activities**

Cash used in investing activities for the first nine months of 2018 and 2017 was \$35,943,000 and \$2,973,000, respectively, reflecting a \$32,970,000 increase in cash used between periods. The Company purchased short-term investments of \$34,897,000 mainly in August 2018. In February 2017, the Company purchased a building in Exton, PA for approximately \$2,500,000. All other investing activities related to capital expenditures for both periods.

### **Financing Activities**

All financing activities relate to dividend payments, which are detailed in Note 7, Shareholders' Equity. Dividend payments through the first nine months of 2018 and 2017, amounted to \$7,353,000 and \$10,798,000 respectively.

### **CONTINGENT LIABILITIES AND GUARANTEES**

See Note 5 to the Company's condensed consolidated financial statements.

### **OFF-BALANCE SHEET ARRANGEMENTS**

Refer to Item 7 of the Company's 2017 Form 10-K under the caption "Off-Balance Sheet Obligations or Arrangements".

### **Item 3 - Quantitative and Qualitative Information about Market Risks**

The Company does not engage in the purchase or trading of market risk sensitive instruments. The Company does not presently have any positions with respect to hedge transactions such as forward contracts relating to currency fluctuations. No market risk sensitive instruments are held for speculative or trading purposes.

### **Item 4 – Controls and Procedures**

(a) Evaluation of Disclosure Controls and Procedures.

At the end of the fiscal third quarter of 2018, the Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures. The Company's disclosure controls and procedures are designed to ensure that the Company records, processes, summarizes and reports in a timely manner the information required to be disclosed in the periodic reports filed by the Company with the Securities and Exchange Commission. The Company's management, including the chief executive officer and chief financial officer, have conducted an evaluation of the effectiveness of the design and operation of the Company's Disclosure Controls and Procedures as defined in the Rule 13a-15(e) of Securities Exchange Act of 1934. Based on that evaluation, the chief executive officer and chief financial officer have concluded that, as of the date of this report, the Company's disclosure controls and procedures are effective to provide reasonable assurance of achieving the purposes described in Rule 13a-15(e), and no changes are required at this time.

(b) Changes in Internal Controls.

There was no change in the Company's "internal control over financial reporting" (as defined in rule 13a-15(f) of the Securities Exchange Act of 1934) identified in connection with the evaluation required by Rule 13a-15(d) of the Securities Exchange Act of 1934 that occurred during the three-month period covered by this Report on Form 10-Q that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting subsequent to the date the chief executive officer and chief financial officer completed their evaluation.

**PART II - OTHER INFORMATION**

Item 1 – Legal Proceedings

In the ordinary and normal conduct of the Company's business, it is subject to periodic lawsuits, investigations and claims (collectively, the "Claims"). Most of the Claims, including a putative class-action claim, relate to potential lightning damage to our flexible gas piping products, which impact legal and product liability related expenses. The Company does not believe the Claims have legal merit, and therefore has commenced a vigorous defense in response to the Claims. It is possible that the Company may incur increased litigation costs in the future due to a variety of factors, including a higher number of Claims, higher legal costs, and higher insurance deductibles or retentions.

In 2010, the Company took its first Claim to trial in Pennsylvania, and the jury returned a verdict that the Company was not negligent in designing and selling the TracPipe® product, but also returned a verdict for plaintiff on strict liability. The Company appealed that portion of the verdict, and in December 2014, the Supreme Court of Pennsylvania ruled in favor of the Company, and returned the case to the trial court for further hearings. After further extended appellate review, on February 16, 2018 the appeals court ruled in favor of the Company, and the prior strict liability verdict for the plaintiff has been vacated and the case remanded for a new trial. As a result, the cash bond of \$1,600,000, which was previously included in Other Long Term Assets and posted as security for the subsequent appeal, was returned to the Company in May 2018. In conclusion, after a long arduous defense, and multiple victories in favor of the Company, this case was finally settled and closed on August 7, 2018, with the Company successfully cleared of any and all allegations.

In March 2017, a putative class action case was re-filed against the Company and other parties in Missouri state court after the predecessor case was dismissed without prejudice by the federal court. The Company successfully removed the case to federal court and is currently vigorously defending the case.



The Company has in place commercial general liability insurance policies that cover most Claims, which are subject to deductibles or retentions, ranging primarily from \$25,000 to \$1,000,000 per claim (depending on the terms of the policy and the applicable policy year), up to an aggregate amount. Litigation is subject to many uncertainties and management is unable to predict the outcome of the pending suits and claims. The potential liability for a given claim could range from zero to a maximum of \$1,000,000, depending upon the circumstances, and insurance deductible or retention in place for the respective claim year. The aggregate maximum exposure for all current open Claims is estimated to not exceed approximately \$2,500,000, which represents the potential costs that may be incurred over time for the Claims within the applicable insurance policy deductibles or retentions. From time to time, depending upon the nature of a particular case, the Company may decide to spend in excess of a deductible or retention to enable more discretion regarding the defense, although this is not common. It is possible that the results of operations or liquidity of the Company, as well as the Company's ability to procure reasonably priced insurance, could be adversely affected by the pending litigation, potentially materially. The Company is currently unable to estimate the ultimate liability, if any, that may result from the pending litigation, or potential litigation from future claims or claims that have not yet come to our attention, and accordingly, the liability in the consolidated financial statements primarily represents an accrual for legal costs for services previously rendered, and outstanding or anticipated settlements for Claims. The liabilities recorded on the Company's books at September 30, 2018 and December 31, 2017 were \$150,000 and \$175,000, respectively, and are included in Other Liabilities.

#### **Item 1A – Risk Factors**

Risk factors are discussed in detail in the Company's December 31, 2017 Form 10-K. There are no additional risks attributable to the quarter.

#### **Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds**

None.

#### **Item 3 – Defaults Upon Senior Securities**

None.

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

Not Applicable.

**Item 5 – Other Information**

None.

-38-

Item 6 - Exhibits

**Exhibit**

**Description**

| <b>No.</b> | <b>Description</b>  |
|------------|---|
| 31.1       | <u>Certification of Chief Executive Officer of Omega Flex, Inc. pursuant to Rule 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.</u>   |
| 31.2       | <u>Certification of Chief Financial Officer of Omega Flex, Inc. pursuant to 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.</u>  |
| 32.1       | <u>Certification of Chief Executive Officer and Chief Financial Officer of Omega Flex, Inc., pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |



**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

OMEGA FLEX, INC.  
(Registrant)

Date: November 6, 2018 By: */s/ Paul J. Kane*  
Paul J. Kane  
Vice President – Finance and Chief Financial Officer

