

Omega Flex, Inc.  
Form 10-Q  
November 06, 2017

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended **September 30, 2017**

**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**  
(Address of principal executive offices)

**19341**  
(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, 2017 was 10,091,822.

**OMEGA FLEX, INC.**

**QUARTERLY REPORT ON FORM 10-Q**

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2017**

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

	September 30, 2017 (unaudited)	December 31, 2016 (unaudited)
<b>ASSETS</b>		
Current Assets:		
Cash and Cash Equivalents	\$31,607	\$ 35,318
Accounts Receivable - less allowances of \$912 and \$926, respectively	15,949	15,005
Inventories-Net	8,306	7,372
Other Current Assets	2,442	1,981
<b>Total Current Assets</b>	<b>58,304</b>	<b>59,676</b>
Property and Equipment-Net	7,017	4,402
Goodwill-Net	3,526	3,526
Deferred Taxes	20	19
Other Long Term Assets	3,053	2,939
<b>Total Assets</b>	<b>\$71,920</b>	<b>\$ 70,562</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current Liabilities:		
Accounts Payable	\$2,163	\$ 2,311
Accrued Compensation	3,394	4,319
Accrued Commissions and Sales Incentives	4,277	3,700
Dividends Payable	2,220	8,578
Taxes Payable	553	487
Other Liabilities	3,855	3,340
<b>Total Current Liabilities</b>	<b>16,462</b>	<b>22,735</b>
Deferred Taxes	28	145
Other Long Term Liabilities	1,772	1,621

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Total Liabilities	18,262	24,501
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, 2017 and December 31, 2016	102	102
Treasury Stock	(1 )	(1 )
Paid-in Capital	10,808	10,808
Retained Earnings	43,201	36,455
Accumulated Other Comprehensive Loss	(1,000 )	(1,685 )
Total Omega Flex, Inc. Shareholders' Equity	53,110	45,679
Noncontrolling Interest	548	382
Total Shareholders' Equity	53,658	46,061
Total Liabilities and Shareholders' Equity	\$71,920	\$ 70,562

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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

	For the three-months ended September 30, 2017		For the nine-months ended September 30, 2016	
	2017	2016	2017	2016
	(Amounts in Thousands, except earnings per Common Share)			
Net Sales	\$24,923	\$23,942	\$74,335	\$68,408
Cost of Goods Sold	9,716	9,165	29,650	26,450
Gross Profit	15,207	14,777	44,685	41,958
Selling Expense	4,004	3,913	12,356	11,666
General and Administrative Expense	4,495	4,209	13,312	12,432
Engineering Expense	798	808	2,468	2,299
Operating Profit	5,910	5,847	16,549	15,561
Interest Income	27	28	76	68
Other Income (Expense)	4	(110 )	(18 )	(288 )
Income Before Income Taxes	5,941	5,765	16,607	15,341
Income Tax Expense	1,895	1,848	5,294	4,980
Net Income	4,046	3,917	11,313	10,361
Less: Net Income attributable to the Noncontrolling Interest	(32 )	(29 )	(127 )	(117 )
Net Income attributable to Omega Flex, Inc.	\$4,014	\$3,888	\$11,186	\$10,244
Basic and Diluted Earnings per Common Share	\$0.40	\$0.39	\$1.11	\$1.02
Cash Dividends Declared per Common Share	\$0.22	\$0.00	\$0.44	\$0.00
Basic and Diluted Weighted-Average Shares Outstanding	10,092	10,092	10,092	10,092



See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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

	For the three-months ended September 30, 2017		For the nine-months ended September 30, 2016	
	2017	2016	2017	2016
	(Amounts in Thousands)		(Amounts in Thousands)	
Net Income	\$4,046	\$3,917	\$11,313	\$10,361
Other Comprehensive Income, Net of Tax:				
Foreign Currency Translation Adjustment, Net of Tax	299	(110 )	724	(724 )
Other Comprehensive Income, Net of Tax	299	(110 )	724	(724 )
Comprehensive Income	4,345	3,807	12,037	9,637
Less: Comprehensive Income Attributable to the Noncontrolling Interest	(48 )	(23 )	(166 )	(77 )
Total Comprehensive Income	\$4,297	\$3,784	\$11,871	\$9,560

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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

	Common Stock Outstanding	Common Stock	Treasury Stock	Paid In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interest	Shareholders' Equity
	(Dollars in Thousands)							
Balance - December 31, 2016	10,091,822	\$ 102	(\$ 1 )	\$10,808	\$36,455	(\$ 1,685 )	\$ 382	\$ 46,061
Net Income					11,186		127	11,313
Cumulative Translation Adjustment						685	39	724
Dividends Declared					(2,220 )			(2,220 )
Dividends Paid					(2,220 )			(2,220 )
Balance - September 30, 2017	10,091,822	\$ 102	(\$ 1 )	\$10,808	\$43,201	(\$ 1,000 )	\$ 548	\$ 53,658

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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

	For the nine-months ended September 30, 2017      2016 (Dollars in thousands)	
Cash Flows from Operating Activities:		
Net Income	\$11,313	\$10,361
Adjustments to Reconcile Net Income to Net Cash Provided By Operating Activities:		
Non-Cash Compensation Expense	855	409
Depreciation and Amortization	362	342
Provision for Losses on Accounts Receivable	(14 )	(63 )
Provision for Inventory Reserves	118	33
Deferred Taxes	(117 )	164
Changes in Assets and Liabilities:		
Accounts Receivable	(783 )	1,129
Inventories	(945 )	1,373
Other Assets	(564 )	(3,155 )
Accounts Payable	(189 )	(410 )
Accrued Compensation	(971 )	(1,479 )
Accrued Commissions and Sales Incentives	569	(1,076 )
Other Liabilities	(193 )	(303 )
Net Cash Provided by Operating Activities	9,441	7,325
Cash Flows from Investing Activities:		
Capital Expenditures	(2,973 )	(191 )
Net Cash Used in Investing Activities	(2,973 )	(191 )
Cash Flows from Financing Activities:		
Dividends Paid	(10,798)	(8,578 )
Net Cash Used in Financing Activities	(10,798)	(8,578 )
Net (Decrease) in Cash and Cash Equivalents	(4,330 )	(1,444 )
Translation effect on cash	619	(543 )
Cash and Cash Equivalents – Beginning of Period	35,318	30,152
Cash and Cash Equivalents – End of Period	\$31,607	\$28,165

Supplemental Disclosure of Cash Flow Information:

Cash paid for Income Taxes	\$5,443	\$5,025
Cash paid for Interest	\$—	\$—
Declared Dividend	\$2,220	\$—

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 quarter ended September 30, 2017 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 is a leading manufacturer of flexible metal hose, and is currently engaged in a number of different markets, including construction, manufacturing, petrochemical transfer, pharmaceutical 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 and 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 primarily at its Exton, Pennsylvania facilities in the United States, and in Banbury, Oxfordshire in the United Kingdom. A majority of the Company's sales across all industries are generated through independent outside sales organizations such as sales representatives, wholesalers and distributors, or a combination of both. The Company has a broad distribution network in North America and to a lesser extent in other global markets.

## 2. SIGNIFICANT ACCOUNTING POLICIES

### Use of Estimates

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.

### Revenue Recognition

The Company's revenue recognition activities relate almost entirely to the manufacture and sale of flexible metal hose and pipe. Under GAAP, revenues are considered to have been earned when the Company has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. The following criteria represent preconditions to the recognition of revenue:

- Persuasive evidence of an arrangement for the sale of product or services must exist.
- Delivery has occurred or services rendered.
- The sales price to the customer is fixed or determinable.
- Collection is reasonably assured.

The Company recognizes revenue upon shipment in accordance with the above principles.

Gross sales are reduced for all consideration paid to customers for which no identifiable benefit is received by the Company. This includes promotional incentives, which includes various programs including year-end rebates and discounts. The amounts of certain incentives are known with reasonable certainty at the time of sale, while others are projected based upon the most reliable information available at the reporting date. Commissions are accounted for as a sales expense.



**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 U.S. 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 \$912,000 and \$926,000 as of September 30, 2017 and December 31, 2016, 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.

### **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, 2016. This analysis did not indicate any impairment of goodwill. There were no circumstances that indicate that Goodwill might be impaired at September 30, 2017.

### **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 on its actively traded share value – a Level 1 input – in determining the fair value of the 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.

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### **Currency Translation**

Assets and liabilities denominated in foreign currencies, most of which relate to our United Kingdom subsidiary whose functional currency is British pound sterling, are translated into U.S. dollars at exchange rates prevailing on the balance sheet dates. The statements of income are translated into U.S. 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 records 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 elected to recognize interest and penalties related to income tax matters as a component of the income tax provision in the consolidated statements of income. For additional information regarding ASC 740-10, see Note 8 of the Company's December 31, 2016 Form 10-K.

**Other Comprehensive Income**

For the three and nine months ended September 30, 2017 and 2016, respectively, the components of other comprehensive income consisted solely of foreign currency translation adjustments.

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### **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, 2017 and 2016, and more than 10% of the Company's Accounts Receivable balance at September 30, 2017 and December 31, 2016. 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, 2016 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 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either a full retrospective or retrospective with cumulative effect transition method. The updated standard becomes effective for the Company in the first quarter of fiscal year 2018. The Company plans to adopt the revenue guidance effective January 1, 2018, using the modified retrospective approach. The Company has substantially completed its assessment of the potential impact on its financial statements and currently does not expect the adoption to have a material impact on its financial statements or related disclosures. Further, it does not expect to change the manner or timing of recognizing revenue as a majority of its revenue transactions are recognized when product is shipped.

In July 2015, the FASB issued ASU 2015-11, *Simplifying the Measurement of Inventory (Topic 330)*. Under this ASU, inventory will be measured at the "lower of cost and net realizable value" and options that currently exist for "market value" will be eliminated. The ASU defines net realizable value as the "estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation." No other changes were made to the current guidance on inventory measurement. ASU 2015-11 is effective for interim and annual periods beginning after December 15, 2016. The Company has evaluated the provisions of this statement, and concluded that the adoption of ASU 2015-11 did not have a material impact on the Company's financial position or results of operations.





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 30, 2017	December 31, 2016
	(dollars in thousands)	
Finished Goods	\$5,640	\$ 5,254
Raw Materials	2,666	2,118
Inventories-Net	\$8,306	\$ 7,372

### 4. LINE OF CREDIT

As of October 2, 2017, the Company agreed to new proposed terms provided by Santander Bank, N.A. (“Santander”) which would allow the Company to potentially borrow up to \$20,000,000 on an unsecured line of credit for a period of five years with interest rates slightly more favorable to the Company than provided in the December 29, 2014 agreement, which is detailed below. The revised formal Revolving Line of Credit Note and Loan Agreement are currently being constructed, with finalization anticipated on or before December 31, 2017.

On December 29, 2014, the Company entered into an Amended and Restated Committed Revolving Line of Credit Note (“the Line”) and a Second Amendment to the Loan Agreement with Santander. The Line facility in the maximum amount of \$15,000,000, has a five year term maturing on December 31, 2019, with funds available for working capital purposes and to fund dividends, and is unsecured. The Line provides for the payment of any borrowings at an interest rate of either LIBOR plus 1.00% to plus 1.35% (for borrowings with a fixed term of 30, 60, or 90 days), or Prime from 0.00% to plus 0.10%, depending upon the Company’s then existing financial ratios. At September 30, 2017, the Company’s financial ratios would allow for the most favorable rate under the agreement’s range, which would be a rate of 2.3%. Under the terms of the agreement, the Company is required to pay on a quarterly basis an unused facility fee equal to 10 basis points of the average unused balance of the total Line commitment.

As of September 30, 2017 and December 31, 2016, 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 at age 65. 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 \$509,000 at September 30, 2017, of which \$497,000 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, 2016 liability of \$515,000, had \$503,000 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 \$1,257,000 at September 30, 2017 and \$1,169,000 at December 31, 2016.

As disclosed in detail in Note 9 of the Company's December 31, 2016 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 numbers 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. The Company is currently appealing the trial court's decision not to grant a new trial in this matter in spite of the Supreme Court decision. As a result of this new appeal, the Company was required during the second quarter of 2016 to post approximately \$1,600,000 as security to proceed with the current appeal, and that collateral security is included in Other Long Term Assets as of September 30, 2017.

In February 2012, the Company was made aware of a fraud perpetrated by a third party broker involving insurance related premiums that the Company had prepaid for umbrella coverage. Upon discovery of the fraud, the Company replaced the aforementioned insurance coverage. The stolen assets were seized by a governmental agency investigating the case, and in the second quarter of 2016, the Company received restitution from the United States Department of Justice in the amount of \$282,000. Of the amount received, \$213,000 relieved the value of the assets on the books and the remaining \$69,000 was recorded as a reduction of operating expenses. The Company also filed suit against a third party advisor arising from the transaction, alleging failure to exercise due diligence into the qualifications of the broker. In December 2016, the Company settled its suit with the advisor and its insurer for \$132,500, which was included in Other Current Assets at December 31, 2016, and the case was dismissed, thus reducing insurance costs. These settlement proceeds were collected in January 2017.

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 is vigorously defending the case.

The Company has in place commercial general liability insurance policies that cover the 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 \$3,600,000, 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 settlements for existing claims. The liabilities recorded on the Company's books at September 30, 2017 and December 31, 2016 were \$300,000 and \$273,000, 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, 2016, the Company had 23,671 unvested units outstanding, all of which were granted at *Full Value*. On February 14, 2017, the Company granted an additional 7,750 *Full Value* Units with a fair value of \$41.68 per unit on grant date, using historical volatility. As of September 30, 2017, the Company had 20,046 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, 2017.

The total Phantom Stock related liability as of September 30, 2017 was \$2,051,000 of which \$776,000 is included in Other Liabilities, as it is expected to be paid in February 2018, and the balance of \$1,275,000 is included in Other Long Term Liabilities. At December 31, 2016, the total Phantom Stock liability was \$1,624,000, with \$506,000 in Other Liabilities, and \$1,118,000 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 \$855,000 and \$409,000 for the nine months ended September 30, 2017 and 2016, 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, 2017:

	Units	Weighted Average Grant Date Fair Value
Number of Phantom Stock Unit Awards:		
Nonvested at December 31, 2016	23,671	\$ 27.87
Granted	7,750	\$ 41.68
Vested	(11,375)	\$ 26.26
Forfeited	—	—
Canceled	—	—
Nonvested at September 30, 2017	20,046	\$ 34.74
Phantom Stock Unit Awards Expected to Vest	20,046	\$ 34.74

The total unrecognized compensation costs calculated at September 30, 2017 are \$977,000 which will be recognized through February of 2020. The Company will recognize the related expense over the weighted average period of 1.3 years.

## 7. SHAREHOLDERS' EQUITY

As of September 30, 2017 and December 31, 2016, the Company had authorized 20,000,000 common stock shares with par value of \$0.01 per share. At both 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 2017, the Board of Directors (Board) revised its dividend policy to allow for and establish a record of paying regular quarterly dividends. In furtherance of this policy, the Company announced on June 9, 2017 and again on September 11, 2017 that the Board had approved a quarterly dividend in the amount of \$0.22 per share to all Shareholders of record, amounting to payments of \$2,220,000 in July and October 2017. In determining the amount of a regular quarterly dividend, the Board will review the cash needs of the Company, the results of operations, financial condition, capital expenditure plans, possible acquisitions, as well as such other factors as the Board may consider relevant.

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, and payable on or before January 6, 2017. The total payment to shareholders made in January 2017 was \$8,578,000.

On December 10, 2015, the Board declared a special dividend of \$0.85 per share to all Shareholders of record as of December 21, 2015, and payable on or before January 6, 2016. The total payment to shareholders made in January 2016 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 of 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 2009.

## **8. RELATED PARTY TRANSACTIONS**

From time to time the Company may have related party transactions (RPT's). In short, RPT's 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 RPT's exist. Through this investigation, the Company is currently not aware of any related party transactions 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 \$145,000, which are contractually secured by the Company.

## **9. SUBSEQUENT EVENTS**

The Company evaluated all events and transactions that occurred through the date of this filing. With the exception of the new proposed line of credit terms agreed to with Santander on October 2, 2017, as described in Note 4, the Company did not have any material subsequent events that impacted its condensed consolidated financial statements during the period.

## **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, and is currently engaged in a number of different markets, including construction, manufacturing, petrochemical transfer, pharmaceutical 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 and 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 primarily manufactured at its Exton, Pennsylvania facilities in the United States, and in Banbury, Oxfordshire in the United Kingdom. A majority of the Company’s sales across all industries

are generated through independent outside sales organizations such as sales representatives, wholesalers and distributors, or a combination of both. The Company has a broad distribution network in North America and to a lesser extent in other global markets.

## **CHANGES IN FINANCIAL CONDITION**

The Company's cash balance of \$31,607,000 at September 30, 2017, decreased \$3,711,000 (10.5%) from the \$35,318,000 balance at December 31, 2016. The Company paid a dividend of \$8,578,000 during the first quarter of 2017 which was accrued at December 31, 2016, and also purchased a building in Exton, PA for approximately \$2,500,000 in February 2017. In July of 2017, the Company paid another dividend in the amount of \$2,220,000, as detailed below, and in Note 6, "Shareholders' Equity". Those cash outflows were partially offset by income generated from operations during 2017.

Property and Equipment was \$7,017,000 at September 30, 2017, compared to \$4,402,000 at December 31, 2016, increasing \$2,615,000 (59.4%). As noted above, the Company purchased a building in Exton, PA for approximately \$2,500,000. This facility was previously leased.



Dividends Payable was \$2,220,000 and \$8,578,000 at September 30, 2017 and December 31, 2016, respectively, decreasing \$6,358,000 (74.1%). On June 9, 2017, the Company announced that it would pay a regular quarterly dividend in the amount of \$0.22 per share, which was then paid to shareholders in July 2017. At December 31, 2016, Dividends Payable reflected the \$0.85 special dividend per share declared by the Board earlier that month. This dividend was then paid to shareholders in January of 2017, thus reducing the cash balance, as described above.

## RESULTS OF OPERATIONS

### Three-months ended September 30, 2017 vs. September 30, 2016

The Company reported comparative results from operations for the three-months ended September 30, 2017 and 2016 as follows:

	<b>Three-months ended September 30,</b>			
	<b>(in thousands)</b>			
	2017	2017	2016	2016
	(\$000)		(\$000)	
Net Sales	\$24,923	100.0%	\$23,942	100.0%
Gross Profit	\$15,207	61.0 %	\$14,777	61.7 %
Operating Profit	\$5,910	23.7 %	\$5,847	24.4 %

Net Sales. The Company's 2017 third quarter net sales (sales) of \$24,923,000 were \$981,000 (4.1%) higher than the third quarter of 2016, which were \$23,942,000. It should be noted that the increase in sales has been accomplished despite higher sales deductions for items such as promotional incentive costs, as more customers have been able to earn higher payouts based upon growth.

Gross Profit. The Company's gross profit margins for the three-months ended September 30, 2017 and 2016, were largely consistent, being 61.0% and 61.7%, 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 \$4,004,000 and \$3,913,000 for the three-months ended September 30, 2017 and 2016, respectively, representing an increase of \$91,000 (2.3%). As a percent of sales, Selling expenses were 16.1% for the

three-months ended September 30, 2017, compared to 16.3% for the three-months ended September 30, 2016.

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 \$4,495,000 and \$4,209,000 for the three-months ended September 30, 2017 and 2016, respectively, increasing \$286,000 or 6.8% between periods. The increase was related to various factors, including additional expenses accrued related to the Company's phantom stock plan, resulting primarily from an increase in the Company's stock price, and there was also an increase in insurance costs. The impact of these costs were however softened by a decrease in legal and product liability related defense costs. As a percentage of sales, general and administrative expenses were 18.0% and 17.6% for the three months ended September 30, 2017 and 2016, 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 were \$798,000 and \$808,000 for the three months ended September 30, 2017 and 2016, respectively. Engineering expenses as a percentage of sales were 3.2% and 3.4% for the three months ended September 30, 2017, and 2016, respectively.

Operating Profit. Reflecting all of the factors mentioned above, operating profits increased by \$63,000, or 1.0% compared to last year. The Company had a profit of \$5,910,000 in the three-month period ended September 30, 2017, versus a profit of \$5,847,000 in the three-months ended September 30, 2016.

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 recognized a modest amount of interest income for the third quarter of 2017 and 2016.

Other Income (Expense). Other income (expense) primarily consists of foreign currency exchange gains (losses) on transactions with Omega Flex Limited, our United Kingdom (“UK”) subsidiary. During 2016, the British Pound weakened, largely as a result of the UK’s vote to exit the European Union. As a result, the Company recognized currency related losses of \$110,000 for the third quarter of 2016. The British Pound has stabilized during 2017 and for the third quarter of 2017, the Company recognized \$4,000 of other income.

Income Tax Expense. Income tax expense was \$1,895,000 for the third quarter of 2017, compared to \$1,848,000 for the same period in 2016. The \$47,000 increase was primarily due to higher income before taxes. The Company’s effective tax rate in 2017 approximates the 2016 rate and does not differ materially from expected statutory rates.

**Nine-months ended September 30, 2017 vs. September 30, 2016**

The Company reported comparative results from operations for the nine-months ended September 30, 2017 and 2016 as follows:

	<b>Nine-months ended September 30,</b>			
	<b>(in thousands)</b>			
	2017	2017	2016	2016
	(\$000)		(\$000)	
Net Sales	\$74,335	100.0%	\$68,408	100.0%
Gross Profit	\$44,685	60.1%	\$41,958	61.3%
Operating Profit	\$16,549	22.3%	\$15,561	22.8%

**Net Sales.** The Company's sales for the first nine months of 2017 increased \$5,927,000, or 8.7% over the same period in 2016, ending at \$74,335,000 and \$68,408,000 in 2017 and 2016, respectively. The majority of the sales growth is the result of an increase in unit volume. It should be noted that the increase in sales has been accomplished despite higher sales deductions for items such as promotional incentive costs, as more customers have been able to earn higher payouts based upon growth.

**Gross Profit.** The Company's gross profit margins were reasonably similar between years, being 60.1% and 61.3% for the nine-months ended September 30, 2017 and 2016, respectively. The Company incurred higher raw material costs during the first nine months of 2017 in comparison to the same period last year, but has been able to largely offset this imbalance through its own pricing actions.

**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 \$12,356,000 and \$11,666,000 for the nine-months ended September 30, 2017 and 2016, respectively, representing an increase of \$690,000 or 5.9%. There was an increase in freight and commissions, which largely move in relation to sales, and there were also additional staffing related expenses. Selling expense as a percent of sales was 16.6% for the nine-months ended September 30, 2017, and 17.1% for the nine-months ended September 30, 2016.

**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 \$13,312,000 and \$12,432,000 for the nine-months ended September 30, 2017 and 2016, respectively, increasing \$880,000 (7.1%) between periods.

Incentive compensation was higher primarily as a result of higher profits, and there were additional expenses incurred related to the Company's phantom stock plan, resulting primarily from an increase in the Company's stock price. To a lesser extent, the Company also recognized an increase in insurance costs. The impact of those items were however softened by a decrease in legal and product liability related defense costs, which were higher during the first nine months of 2016 due to a few specific matters which required a heightened defense. As a percentage of sales, general and administrative expenses were 17.9% and 18.2% for the nine months ended September 30, 2017 and 2016, 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 \$169,000 or 7.4% between periods, as they were \$2,468,000 and \$2,299,000 for the nine months ended September 30, 2017 and 2016, respectively. Engineering expenses were largely consistent as a percentage of sales, being 3.3% and 3.4% for the nine months ended September 30, 2017 and 2016, respectively.

Operating Profit. Reflecting all of the factors mentioned above, operating profits were up \$988,000 or 6.4%, ending with a profit of \$16,549,000 for the first nine months of 2017, compared to \$15,561,000 during the same period in 2016.

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. There was \$76,000 of interest income recorded during the first nine months of 2017, and \$68,000 during the same period in 2016.

Other Income (Expense). Other income (expense) primarily consists of foreign currency exchange gains (losses) on transactions with Omega Flex Limited, our UK subsidiary. During 2016, the British Pound weakened, largely as a result of the UK's vote to exit the European Union. As a result, the Company recognized currency related losses of \$288,000 for the nine months ended September 30, 2016. The British Pound has stabilized in 2017, and during the first nine months of 2017, the Company recognized a loss of only \$18,000.

Income Tax Expense. Income tax expense was \$5,294,000 for the first nine months of 2017, compared to \$4,980,000 for the same period in 2016, increasing by \$314,000, largely in correlation with the change in income before taxes. The Company's effective tax rate in 2017 approximates the 2016 rate and does not differ materially from expected statutory rates.

## **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**

The Company's revenue recognition activities relate almost entirely to the manufacture and sale of flexible metal hose and pipe. Under GAAP, revenues are considered to have been earned when the Company has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. The following criteria represent preconditions to the recognition of revenue:

- Persuasive evidence of an arrangement for the sale of product or services must exist.
- Delivery has occurred or services rendered.
- The sales price to the customer is fixed or determinable.
- Collection is reasonably assured.

The Company recognizes revenue upon shipment in accordance with the above principles.

Gross sales are reduced for all consideration paid to customers for which no identifiable benefit is received by the Company. This includes promotional incentives, which includes various programs including year-end rebates and discounts. The amounts of certain incentives are known with reasonable certainty at the time of sale, while others are projected based upon the most reliable information available at the reporting date. Commissions are accounted for as a sales expense.

### **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 U.S. 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 \$912,000 and \$926,000 as of September 30, 2017 and December 31, 2016, 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.

### **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, 2016. This analysis did not indicate any impairment of goodwill. There were no circumstances that indicate that Goodwill might be impaired at September 30, 2017.

### **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 on its actively traded share value – a Level 1 input – in determining the fair value of the 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 United Kingdom subsidiary whose functional currency is British pound sterling, are translated into U.S. dollars at exchange rates prevailing on the balance sheet dates. The statements of income are translated into U.S. 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 records 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 elected to recognize interest and penalties related to income tax matters as a component of the income tax provision in the consolidated statements of income. For additional information regarding ASC 740-10, see Note 8 of the Company's December 31, 2016 Form 10-K.

## **Other Comprehensive Income**

For the three and nine months ended September 30, 2017 and 2016, respectively, the components of other comprehensive income consisted solely of foreign currency translation adjustments.

## **Significant Concentration**

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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, 2017 and 2016, and more than 10% of the Company's Accounts Receivable balance at September 30, 2017 and December 31, 2016. 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, 2016 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 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either a full retrospective or retrospective with cumulative effect transition method. The updated standard becomes effective for the Company in the first quarter of fiscal year 2018. The Company plans to adopt the revenue guidance effective January 1, 2018, using the modified retrospective approach. The Company has substantially completed its assessment of the potential impact on its financial statements and currently does not expect the adoption to have a material impact on its financial statements or related disclosures. Further, it does not expect to change the manner or timing of recognizing revenue as a majority of its revenue transactions are recognized when product is shipped.

In July 2015, the FASB issued ASU 2015-11, Simplifying the Measurement of Inventory (Topic 330). Under this ASU, inventory will be measured at the “lower of cost and net realizable value” and options that currently exist for “market value” will be eliminated. The ASU defines net realizable value as the “estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation.” No other changes were made to the current guidance on inventory measurement. ASU 2015-11 is effective for interim and annual periods beginning after December 15, 2016. The Company has evaluated the provisions of this statement, and concluded that the adoption of ASU 2015-11 did not have a material impact on the Company’s financial position or results of operations.

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 cannot quantify these at this time. The Company plans to adopt the standard effective January 1, 2019.

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## **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, 2017, the Company had a cash balance of \$31,607,000. Additionally, the Company has a \$15,000,000 line of credit available with Santander, as discussed in detail in Note 4, which had no borrowings outstanding upon it at September 30, 2017. At December 31, 2016, the Company had cash of \$35,318,000, and also had no borrowings against the line of credit at that time.

### **Operating Activities**

Cash provided by 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.

For the first nine months of 2017, the Company's cash provided from operating activities was \$9,441,000, compared to \$7,325,000 of cash provided during the first nine months of 2016, thus increasing by \$2,116,000 between periods. Regarding the increases, the Company grew Net Income by \$952,000, which increased cash, additionally, there were increases in cash attributable to Other Assets, and Accrued Commissions and Sales Incentives of \$2,591,000 and \$1,645,000, respectively. Last year the Company posted a \$1,600,000 security deposit to proceed with further hearings related to the Company's 2010 Pennsylvania Claim, which was recorded in Other Assets, while there was no such event in the current year. Accrued Commissions and Sales Incentives typically fluctuate based upon sales volume, and our customer's ability to achieve sales growth over the previous year. A substantial portion of the sales incentives programs are accrued though the year, and paid in the following year. The accrual for sales incentives was higher in 2015, thus leading to higher payouts in 2016, while the accrual at the end of the year in 2016 and eventual payout in 2017 was not as significant. The more significant decreases to cash from operating activities related to Inventory and Accounts Receivable, which decreased \$2,318,000 and \$1,912,000, respectively. The reduction in Accounts Receivable was mostly timing related based upon payment terms and normal cash collection. A greater portion of cash generated from sales during the last portion of 2015 flowed into 2016 than was experienced with cash collection in 2017 from 2016 sales. Regarding inventory, the Company had a program in place during 2016 to reduce inventory levels, while the inventory purchases during 2017 are of a more normal nature.

### **Investing Activities**

Cash used in investing activities for the first nine months of 2017 and 2016 was \$2,973,000 and \$191,000, respectively, reflecting a \$2,782,000 increase in cash used between periods. The Company purchased a building in Exton, PA for approximately \$2,500,000 in February 2017. All other investing activities related to capital expenditures for both periods.

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. There are currently no known material commitments for capital expenditures.

### **Financing Activities**

For 2017, dividends were declared in December of 2016 of \$8,578,000 and June of 2017 of \$2,220,000, amounting in total to \$10,798,000, with payment due and paid during January of 2017 and July of 2017 respectively. For 2016, a dividend of \$8,578,000 was declared in December of 2015 which was paid in January of 2016. This reflects all of the cash flows from financing activities for those respective years.

The Company did not borrow any funds from its line of credit during the first nine months of 2017 or 2016, and had no outstanding borrowings on its line of credit as of September 30, 2017, or as of December 31, 2016.

### **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 2016 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 2017, 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 numbers 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. The Company is currently appealing the trial court's decision not to grant a new trial in this matter in spite of the Supreme Court decision. As a result of this new appeal, the Company was required during the second quarter of 2016 to post approximately \$1,600,000 as security to proceed with the current appeal, and that collateral security is included in Other Long Term Assets as of September 30, 2017.

In February 2012, the Company was made aware of a fraud perpetrated by a third party broker involving insurance related premiums that the Company had prepaid for umbrella coverage. Upon discovery of the fraud, the Company replaced the aforementioned insurance coverage. The stolen assets were seized by a governmental agency investigating the case, and in the second quarter of 2016, the Company received restitution from the United States Department of Justice in the amount of \$282,000. Of the amount received, \$213,000 relieved the value of the assets on the books and the remaining \$69,000 was recorded as a reduction of operating expenses. The Company also filed suit against a third party advisor arising from the transaction, alleging failure to exercise due diligence into the

qualifications of the broker. In December 2016, the Company settled its suit with the advisor and its insurer for \$132,500, which was included in Other Current Assets at December 31, 2016, and the case was dismissed, thus reducing insurance costs. These settlement proceeds were collected in January 2017.

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 is vigorously defending the case.

The Company has in place commercial general liability insurance policies that cover the 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 \$3,600,000, 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 settlements for existing claims. The liabilities recorded on the Company's books at September 30, 2017 and December 31, 2016 were \$300,000 and \$273,000, respectively, and are included in Other Liabilities.

### **Item 1A – Risk Factors**

Risk factors are discussed in detail in the Company's December 31, 2016 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.

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**Item 5 – Other Information**

None.

**Item 6 - Exhibits**

**Exhibit**

No.	Description
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>

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**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, 2017 By: */S/ Paul J. Kane*  
Paul J. Kane  
Vice President – Finance  
and Chief Financial Officer

