

LAWSON PRODUCTS INC/NEW/DE/

Form 10-Q

November 02, 2007

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D. C. 20549**  
**FORM 10-Q**

(Mark One)

**Quarterly Report under Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For quarterly period ended September 30, 2007**

or

**Transition Report under Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file Number: 0-10546**

**LAWSON PRODUCTS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

**36-2229304**

(State or other jurisdiction of  
incorporation or organization)

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

**1666 East Touhy Avenue, Des Plaines, Illinois**

**60018**

(Address of principal executive offices)

(Zip Code)

**(847) 827-9666**

(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated Filer  Non-accelerated filer

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

Yes  No

The number of shares outstanding of the registrant's common stock, \$1 par value, as of October 31, 2007 was 8,522,001.

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**Safe Harbor Statement under the Securities Litigation Reform Act of 1995:** This Quarterly Report on Form 10-Q contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties. The terms may, should, could, anticipate, believe, continues, expect, intend, objective, plan, potential, project and similar expressions are intended to identify forward-looking statements. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. These statements are based on management's current expectations, intentions or beliefs and are subject to a number of factors, assumptions and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. Factors that could cause or contribute to such differences or that might otherwise impact the business include the impact of governmental investigations, such as the investigation by the U.S. Attorney's Office for the Northern District of Illinois; excess and obsolete inventory; disruptions of the Company's information systems; risks of rescheduled or cancelled orders; increases in commodity prices; the influence of controlling stockholders; competition and competitive pricing pressures; the effect of general economic conditions and market conditions in the markets and industries the Company serves; the risks of war, terrorism, and similar hostilities; and, all of the factors discussed in the Company's Risk Factors set forth in its Annual Report on Form 10-K for the year ended December 31, 2006.

The Company undertakes no obligation to update any such factor or to publicly announce the results of any revisions to any forward-looking statements contained herein whether as a result of new information, future events or otherwise.

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**PART I FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements**

**LAWSON PRODUCTS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(UNAUDITED)**

<b>(in thousands, except share data)</b>	<b>September 30, 2007</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 1,664	\$ 3,391
Accounts receivable, less allowance for doubtful accounts	62,577	60,411
Inventories	91,008	90,272
Miscellaneous receivables and prepaid expenses	7,970	5,529
Deferred income taxes	3,098	3,538
Discontinued current assets	1,171	2,056
<b>Total Current Assets</b>	<b>167,488</b>	<b>165,197</b>
Property, plant and equipment, less allowances for depreciation and amortization		
	50,656	42,664
Deferred income taxes	22,803	20,341
Goodwill	27,999	27,999
Other assets	24,644	22,679
Discontinued non-current assets		3
<b>Total Assets</b>	<b>\$ 293,590</b>	<b>\$ 278,883</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Revolving line of credit	\$ 13,000	\$
Accounts payable	15,038	14,055
Accrued expenses and other liabilities	46,343	46,746
Income taxes		855
Discontinued current liabilities	1,065	1,770
<b>Total Current Liabilities</b>	<b>75,446</b>	<b>63,426</b>
Accrued liability under security bonus plans	26,549	25,522
Other	20,037	19,618
	46,586	45,140
Stockholders Equity:		
Preferred Stock, \$1 par value:		
Authorized - 500,000 shares		
Issued and outstanding None		
Common Stock, \$1 par value:		
Authorized - 35,000,000 shares		

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Issued and outstanding-(2007-8,522,001 shares; 2006-8,521,001 shares)	8,522	8,521
Capital in excess of par value	4,774	4,749
Retained earnings	158,301	158,008
Accumulated other comprehensive loss	(39)	(961)
Total Stockholders' Equity	171,558	170,317
Total Liabilities and Stockholders' Equity	\$ 293,590	\$ 278,883

See notes to condensed consolidated financial statements.

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**LAWSON PRODUCTS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
**(UNAUDITED)**

<b>(in thousands, except per share data)</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	2007	2006	2007	2006
Net sales	\$ 127,913	\$ 127,335	\$ 386,760	\$ 386,727
Cost of goods sold	51,456	50,786	157,779	156,974
Gross profit	76,457	76,549	228,981	229,753
Operating expenses:				
Selling, general and administrative expenses	67,435	70,740	205,124	209,620
Severance and other charges	3,659		10,571	
Loss on sale of equipment				806
Operating income	5,363	5,809	13,286	19,327
Investment and other income	160	260	555	1,201
Interest expense	(295)		(662)	
Income from continuing operations before income taxes and cumulative effect of accounting change	5,228	6,069	13,179	20,528
Provision for income taxes	2,818	2,768	6,063	8,587
Income from continuing operations before cumulative effect of accounting change	2,410	3,301	7,116	11,941
Loss from discontinued operations, net of income taxes	(11)	(226)	(496)	(312)
Income before cumulative effect of accounting change	2,399	3,075	6,620	11,629
Cumulative effect of accounting change, net of income taxes				(361)
Net income	\$ 2,399	\$ 3,075	\$ 6,620	\$ 11,268
Basic income (loss) per share of common stock:				
Continuing operations before cumulative effect of accounting change	\$ 0.28	\$ 0.37	\$ 0.84	\$ 1.33
Discontinued operations	(0.00)	(0.03)	(0.06)	(0.03)
Cumulative effect of accounting change				(0.04)

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	\$ 0.28	\$ 0.34	\$ 0.78	\$ 1.25
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Diluted income (loss) per share of common stock:  
Continuing operations before cumulative effect of  
accounting change

	\$ 0.28	\$ 0.37	\$ 0.83	\$ 1.33
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(in thousands, except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Discontinued operations	(0.00)	(0.03)	(0.06)	(0.03)
Cumulative effect of accounting change				(0.04)
	\$ 0.28	\$ 0.34	\$ 0.78	\$ 1.25
Cash dividends declared per share of common stock	\$ 0.20	\$ 0.20	\$ 0.60	\$ 0.60
Weighted average shares outstanding:				
Basic	8,522	8,998	8,522	8,987
Diluted	8,524	9,004	8,524	8,993

See notes to condensed consolidated financial statements.

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**LAWSON PRODUCTS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**

<b>(in thousands)</b>	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	2007	2006
Operating activities:		
Net income	\$ 6,620	\$ 11,268
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,003	6,196
Changes in operating assets and liabilities	(10,117)	(6,200)
Other	1,610	666
<b>Net Cash Provided by Operating Activities</b>	<b>4,116</b>	<b>11,930</b>
Investing activities:		
Additions to property, plant and equipment	(13,805)	(3,593)
Other		356
<b>Net Cash Used for Investing Activities</b>	<b>(13,805)</b>	<b>(3,237)</b>
Financing activities:		
Proceeds from revolving line of credit, net of payments	13,000	
Dividends paid	(5,113)	(5,389)
Other	27	676
<b>Net Cash Provided by (Used for) Financing Activities</b>	<b>7,914</b>	<b>(4,713)</b>
<b>Increase (Decrease) in Cash and Cash Equivalents</b>	<b>(1,775)</b>	<b>3,980</b>
<b>Cash and Cash Equivalents at Beginning of Period</b>	<b>4,320(a)</b>	<b>16,297(b)</b>
<b>Cash and Cash Equivalents at End of Period</b>	<b>2,545</b>	<b>20,277</b>
<b>Cash Held by Discontinued Operations</b>	<b>(881)</b>	<b>(1,369)</b>
<b>Cash and Cash Equivalents Held by Continuing Operations at End of Period</b>	<b>\$ 1,664</b>	<b>\$ 18,908</b>

(a) Includes \$929  
of cash and cash  
equivalents  
from  
discontinued

operations.

- (b) Includes \$1,791  
of cash and cash  
equivalents  
from  
discontinued  
operations.

See notes to condensed consolidated financial statements.

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**Lawson Products, Inc. and Subsidiaries**  
**Notes to Condensed Consolidated Financial Statements**  
**(Dollars in Thousands)**

**Note A Basis of Presentation and Summary of Significant Accounting Policies**

As contemplated by the Securities and Exchange Commission, the accompanying consolidated financial statements and footnotes have been condensed and, therefore, do not contain all disclosures required by generally accepted accounting principles. Reference should be made to Lawson Products, Inc.'s (the Company) Annual Report on Form 10-K for the year ended December 31, 2006. The Condensed Consolidated Balance Sheets as of September 30, 2007 and December 31, 2006, the Condensed Consolidated Statements of Income for the three month and nine month periods ended September 30, 2007 and 2006 and the Condensed Consolidated Statements of Cash Flows for the nine month periods ended September 30, 2007 and 2006 are unaudited. In the opinion of the Company, all adjustments (consisting only of normal recurring accruals) have been made, which are necessary to present fairly the results of operations for the interim periods. Operating results for the three and nine month periods ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

**FIN 48** We account for uncertain tax positions in accordance with FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). The application of income tax law is inherently complex. Laws and regulations in this area are voluminous and are often ambiguous. As such, we are required to make many subjective assumptions and judgments regarding our income tax exposures. Interpretations of and guidance surrounding income tax laws and regulations change over time. As such, changes in our subjective assumptions and judgments can materially affect amounts recognized in the condensed consolidated balance sheets and statements of income. See Note J Income Taxes to the condensed consolidated financial statements for additional detail on our uncertain tax positions.

There have been no significant changes in our significant accounting policies during the nine months ended September 30, 2007, except as noted above related to FIN 48, as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

Certain prior year amounts have been reclassified to conform to current year presentation.

**Note B Comprehensive Income (Loss)**

Comprehensive income was \$2,865 and \$3,104 for the third quarters of 2007 and 2006, respectively. Comprehensive income includes foreign currency translation adjustments, net of related income tax of \$466 and \$29 for the three month periods ended September 30, 2007 and 2006, respectively.

For the nine month periods ended September 30, 2007 and 2006, comprehensive income was \$7,542 and \$11,350, respectively. Comprehensive income includes foreign currency translation adjustments, net of related income tax of \$922 and \$82 for the nine months ended September 30, 2007 and 2006, respectively.

Accumulated comprehensive loss consists only of foreign currency translation adjustments, net of related income tax.



months ended September 30, 2007 severance and other charges of \$10,571 on the Condensed Consolidated Statement of Income includes \$9,129 of severance charges for executives and \$1,442 of compensation expense related to the retirement of Mr. Jeffrey Belford, the Company's former President and Chief Operating Officer.

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Trademarks and tradenames are being amortized over 15 years. The non-compete covenant associated with the 2005 acquisition of Rutland is being amortized over 5 years. Amortization expense for intangible assets is expected to be \$250 per year for each of the next four years and \$50 per year thereafter until the trademarks and tradenames are fully amortized.

#### **Note G Stock-Based Compensation**

The Amended Stock Performance Plan ( Plan ) provides for the issuance of incentive compensation to non-employee directors, officers and key employees in the form of stock performance rights ( SPRs ).

##### *Stock Performance Rights*

SPRs vest at 20% to 33% per year and entitle the recipient to receive a cash payment equal to the excess of the market value of the Company's common stock over the SPR exercise price when the SPRs are surrendered. The Company estimates the fair value of SPRs using the Black-Scholes valuation model each quarter. This model requires the input of subjective assumptions that will usually have a significant impact on the fair value estimate. The weighted-average estimated value of SPRs outstanding at September 30, 2007 was \$8.33 per SPR with the following assumptions:

	September 30, 2007
Expected volatility	36.99% to 41.86%
Risk-free interest rate	3.98% to 4.28%
Expected term (in years)	1.6 to 5.6
Expected dividend yield	2.30%

In the third quarter 2007, the Company recorded a reduction to expense of \$0.9 million for outstanding SPRs.

The following is a summary of the activity in the Company's stock performance rights during the three and nine month periods ended September 30, 2007:

	Average SPR Exercise Price	# of SPRs
Outstanding December 31, 2006 (1)	\$ 33.31	179,500
Granted		
Exercised	27.08	(500)
Forfeited		
Outstanding March 31, 2007 (2)	\$ 33.33	179,000
Granted	36.71	40,000
Exercised	26.93	(1,950)
Forfeited		
Outstanding June 30, 2007(3)	\$ 34.01	217,050
Granted		
Exercised	32.80	2,100
Forfeited	29.54	3,700
Outstanding September 30, 2007(4)	\$ 34.10	211,250



- (1) Includes  
113,500 SPRs  
vested and  
exercisable at  
December 31,  
2006 at a  
weighted  
average exercise  
price of \$28.88  
per SPR.
  - (2) Includes  
113,000 SPRs  
vested and  
exercisable at  
March 31, 2007  
at a weighted  
average exercise  
price of \$28.89  
per SPR.
  - (3) Includes  
133,317 SPRs  
vested and  
exercisable at  
June 30, 2007 at  
a weighted  
average exercise  
price of \$31.21  
per SPR.
  - (4) Includes  
131,117 SPRs  
vested and  
exercisable at  
September 30,  
2007 at a  
weighted  
average exercise  
price of \$31.18  
per SPR.
-

The aggregate intrinsic value of SPRs outstanding as of September 30, 2007 is \$0.9 million.

As of September 30, 2007, there was \$0.3 million of unrecognized compensation cost related to non-vested SPRs, which will be recognized over a weighted average period of 1.6 years.

As stock-based compensation expense recognized in the Condensed Consolidated Statements of Income for the three and nine month periods ended September 30, 2007 and 2006 is based on awards granted and ultimately expected to vest, the amounts calculated include a reduction for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.

*Stock Options*

The following is a summary of the activity in the Company's stock options during the three and nine month periods ended September 30, 2007:

	Average Option Exercise Price	# of Options
Outstanding December 31, 2006	\$ 23.72	6,000
Granted		
Exercised		
Forfeited/expired/cancelled		
Outstanding March 31, 2007	\$ 23.72	6,000
Granted		
Exercised	26.75	1,000
Forfeited/expired/cancelled		
Outstanding June 30, 2007	\$ 23.11	5,000
Granted		
Exercised		
Forfeited/expired/cancelled		
Outstanding September 30, 2007	\$ 23.11	5,000
	Weighted Average	Option Shares
Exercisable options at:	Price	
December 31, 2006	\$23.72	6,000
September 30, 2007	\$23.11	5,000
The aggregate intrinsic value for options outstanding and exercisable at September 30, 2007 is \$0.1 million.		
As of September 30, 2007, the Company had the following outstanding options:		
Exercise price	\$23.56	\$22.44
Options outstanding:	3,000	2,000
Weighted average exercise price	\$23.56	\$22.44
Weighted average remaining life (in years)	2.6	1.9

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Options exercisable:	3,000	2,000
Weighted average exercise price	\$23.56	\$22.44

As of December 31, 2006, all outstanding stock options were fully vested and therefore, there is no remaining unrecognized compensation expense as of September 30, 2007.

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**Note H Loss on Sale of Equipment**

In the second quarter of 2006, the Company incurred a loss of \$0.8 million (\$0.5 million, net of tax) on the sale of equipment related to the Company's decision to outsource the manufacturing of a product line in the Company's OEM business. Net book value for the disposed equipment was \$1.0 million.

**Note I Segment Reporting**

The Company has two reportable segments: Maintenance, Repair and Replacement distribution in North America (MRO), and Original Equipment Manufacturer distribution and manufacturing in North America (OEM).

The Company's MRO distribution segment distributes a wide range of MRO parts to repair and maintenance organizations primarily through the Company's force of independent field sales agents, as well as inside sales personnel.

The Company's OEM segment manufactures and distributes component parts to OEM manufacturers through a network of independent manufacturers' representatives as well as internal sales personnel.

The Company's reportable segments are distinguished by the nature of products, types of customers, and manner of servicing customers. The Company evaluates performance and allocates resources to reportable segments primarily based on operating income.

Financial information for the Company's reportable segments consisted of the following:

(in thousands)	Three Months Ended September 30	
	2007	2006
Net sales		
MRO	\$ 108,183	\$ 106,044
OEM	19,730	21,291
Consolidated total	\$ 127,913	\$ 127,335
Operating income		
MRO	\$ 5,065	\$ 4,792
OEM	298	1,017
Consolidated total	\$ 5,363	\$ 5,809

The reconciliation of segment profit to consolidated income from continuing operations before income taxes and cumulative effect of accounting change consisted of the following:

(in thousands)	Three Months Ended September 30	
	2007	2006
Total operating income from continuing operations from reportable segments	\$ 5,363	\$ 5,809
Investment and other income	160	260
Interest expense	(295)	
Income from continuing operations before income taxes and cumulative effect of accounting change	\$ 5,228	\$ 6,069

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(in thousands)	Nine Months Ended September 30	
	2007	2006
Net sales		
MRO	\$ 323,344	\$ 322,350
OEM	63,416	64,377
Consolidated total	\$ 386,760	\$ 386,727
Operating income		
MRO	\$ 10,263	\$ 16,115
OEM	3,023	3,212
Consolidated total	\$ 13,286	\$ 19,327

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The reconciliation of segment profit to consolidated income from continuing operations before income taxes and cumulative effect of accounting change consisted of the following:

(in thousands)	Nine Months Ended September 30	
	2007	2006
Total operating income from continuing operations from reportable segments	\$ 13,286	\$ 19,327
Investment and other income	555	1,201
Interest expense	(662)	
Income from continuing operations before income taxes and cumulative effect of accounting change	\$ 13,179	\$ 20,528

Asset information for continuing operations related to the Company's reportable segments consisted of the following:

(in thousands)	September	December
	30, 2007	31, 2006
Total assets		
MRO	\$ 216,480	\$ 203,126
OEM	50,038	49,819
Total for reportable segments	266,518	252,945
Corporate	25,901	23,879
Consolidated total	\$ 292,419	\$ 276,824

At September 30, 2007 and December 31, 2006, the carrying value of goodwill within each reportable segment was as follows:

MRO	\$ 25,748
OEM	2,251
Consolidated total	\$ 27,999

#### Note J Income Taxes

The Company adopted the provisions of FASB Interpretation 48, Accounting for Uncertainty in Income Taxes (FIN 48), on January 1, 2007. Previously, the Company had accounted for tax contingencies in accordance with Statement of Financial Accounting Standards (Statement) No. 5, *Accounting for Contingencies*. As required by FIN 48, which clarifies Statement No. 109, *Accounting for Income Taxes*, the Company currently recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more-likely-than-not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At the adoption date, the Company applied FIN 48 to all tax positions for which the statute of limitations remained open.

As a result of the implementation of FIN 48, the Company recognized an increase of approximately \$1.2 million in the liability for unrecognized tax benefits, which was accounted for as a reduction to the January 1, 2007, balance of retained earnings. At January 1, 2007, the Company had approximately \$4.1 million of unrecognized tax benefits, that

if recognized would be recorded as a component of the provision for income taxes. At January 1, 2007, the Company recorded interest payable of approximately \$675. The interest payable and related interest expense is classified as a component of income taxes on the Condensed Consolidated Balance Sheets and provision for income taxes on the Condensed Consolidated Statements of Income.

There have been no material changes in the amounts of unrecognized tax benefits or interest and penalties related to uncertain tax positions since the Company adopted FIN 48.

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The Company's federal returns for the tax years 2004 through 2006 remain open to examination. In addition, the years 2000 through 2002 remain open for federal purposes to the extent of a refund claim currently under review. Generally, the tax years 2002 through 2006 remain open to examination by major state taxing jurisdictions. Finally, the major foreign jurisdictions in which the Company files income tax returns are Canada and Mexico. Generally, the tax years 2001 through 2006 remain open for Mexico and 2002 through 2006 for Canada. Based on these open tax positions, it is possible that the amount of the liability for unrecognized tax benefits could change during the next twelve month period. An estimate of the range of the possible change cannot be made unless and until issues are further developed or examinations close.

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**Note K Discontinued Operations**

Discounted operations for the three and nine month periods ended September 30, 2007 include the Company's Mexico operation, which was closed in the second quarter of 2007, and its former UK subsidiary, which was closed in 2005.

The results of Lawson de Mexico discontinued operations for the three and nine months ended September 30, 2007 and 2006 are summarized as follows:

(in millions)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Revenue	\$ 0.2	\$ 1.8	\$ 2.6	\$ 5.3
Loss before income taxes	(0.0)	(0.2)	(0.5)	(0.3)
Income tax	(0.0)	(0.0)	(0.0)	(0.0)
Loss from discontinued operations	\$ (0.0)	\$ (0.2)	\$ (0.5)	\$ (0.3)

At September 30, 2007 and December 31, 2006, the major components of assets and liabilities of the Lawson de Mexico discontinued operations were as follows:

(in millions)	September	December
	30, 2007	31, 2006
Current assets	\$ 0.6	\$ 1.4
Total assets	\$ 0.6	\$ 1.4
Current liabilities	\$ 0.8	\$ 0.9
Total liabilities	\$ 0.8	\$ 0.9

Operating cash flows generated from the discontinued operations were immaterial to the Company and, therefore, are not disclosed separately.

As previously disclosed, the Company discontinued its former UK subsidiary in 2005. The remaining assets and liabilities continue to be reported as discontinued operations on the Condensed Consolidated Balance Sheets at September 30, 2007 and December 31, 2006 and include \$0.5 million and \$0.6 million of assets, respectively, and \$0.2 million and \$0.9 million of liabilities, respectively.

**Note L Legal Proceedings**

In December 2005, the FBI executed a search warrant for records at the Company's offices and informed the Company that it was conducting an investigation as to whether any of the Company's representatives improperly provided gifts or awards to purchasing agents (including government purchasing agents) through the Company's customer loyalty programs. The U.S. Attorney's Office for the Northern District of Illinois subsequently issued a subpoena for documents in connection with this investigation. In April 2007, thirteen people, including seven former sales agents of the Company, were indicted on federal criminal charges, including mail fraud, in connection with the U.S. Attorney's investigation. These indictments allege that under the Company's customer loyalty programs, sales agents would provide cash gift certificates to individuals purchasing Company merchandise on behalf of their employers as a way to increase their commissions and prices paid by customers. All of the cases involve commissioned sales agents of the Company. Although the Company was not charged in connection with these indictments, the U.S. Attorney has announced that its investigation is continuing.



The Company's internal investigation regarding these matters has consisted of a review of the Company's records and interviews with Company employees and independent agents and is not complete. In conjunction with the Company's internal investigation, several customer loyalty programs were terminated because the Company believes that these programs provided or had the potential of providing promotional considerations, such as gifts and awards, to purchasing agents that the Company has deemed inappropriate. The Company has modified another customer loyalty program to limit the amount and nature of customer gifts distributed under the program. In addition, twenty-three independent agents have been terminated or have resigned and the Company has terminated four employees. The Company is cooperating with the ongoing investigation of the U.S. Attorney; however, the Company cannot predict when the investigation will be completed or what the outcome or the effect of the investigation will be. The outcome of the investigation could result in criminal sanctions or civil remedies against the Company, including material fines, injunctions or the loss of the Company's ability to conduct business with governmental entities.

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

Lawson Products, Inc.

We have reviewed the condensed consolidated balance sheet of Lawson Products, Inc. and subsidiaries as of September 30, 2007 and the related condensed consolidated statements of income for the three and nine-month periods ended September 30, 2007 and 2006 and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2007 and 2006. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated interim financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Lawson Products, Inc. and subsidiaries as of December 31, 2006, and the related consolidated statements of income, changes in stockholders' equity and cash flows for the year then ended, not presented herein, and in our report dated March 9, 2007, we expressed an unqualified opinion on those consolidated financial statements. As discussed in Note K to the condensed consolidated financial statements, Lawson Products, Inc. and subsidiaries began reporting Lawson de Mexico, a subsidiary, as a discontinued operation resulting in a revision to the December 31, 2006 consolidated balance sheet. We have not audited the revised balance sheet reflecting the reporting of discontinued operations.

/s/ ERNST & YOUNG LLP

Chicago, Illinois

November 1, 2007

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Quarter ended September 30, 2007 compared to Quarter ended September 30, 2006**

The following table presents a summary of the Company's financial performance for the third quarter of 2007 and 2006:

(in thousands)	<b>2007</b>	<b>% of Net Sales</b>	<b>2006</b>	<b>% of Net Sales</b>
Net sales	\$ 127,913	100.0	\$ 127,335	100.0
Cost of goods sold	51,456	40.2	50,786	39.9
Gross profit	76,457	59.8	76,549	60.1
Operating expenses:				
Selling, general and administrative expenses	67,435	52.7	70,740	55.6
Severance and other charges	3,659	2.9		
Operating income	5,363	4.2	5,809	4.6
Other, net	(135)	(0.1)	260	0.2
Income from continuing operations before income taxes	5,228	4.1	6,069	4.8
Provision for income taxes	2,818	2.2	2,768	2.2
Income from continuing operations	2,410	1.9	3,301	2.6
Loss from discontinued operations, net of income taxes	(11)	(0.0)	(226)	(0.2)
Net income	\$ 2,399	1.9	\$ 3,075	2.4

**Net Sales and Gross Profit**

Consolidated net sales for the three month period ended September 30, 2007 increased slightly compared to the same period of 2006.

The following table presents the Company's net sales results for its MRO and OEM businesses for the third quarter of 2007 and 2006:

(in millions)	2007	2006
MRO	\$ 108.2	\$ 106.0
OEM	19.7	21.3
Net sales	\$ 127.9	\$ 127.3

Maintenance, Repair and Operations distribution (MRO) net sales increased \$2.2 million in the third quarter of 2007, to \$108.2 million from \$106.0 million in the prior year period, primarily due to increased penetration of existing customers. Sales increased in the U.S. and Canada by approximately \$1.8 million and \$0.4 million for the quarter, respectively.

Original Equipment Manufacturer (OEM) net sales decreased \$1.6 million in the third quarter of 2007 to \$19.7 million from \$21.3 million in 2006. Sales in the U.S. were lower due to the cancellation of some customer contracts.

Consolidated gross profit margins for the quarter ended September 30, 2007 decreased to 59.8% from 60.1% in the comparable prior year period. This decrease was primarily due to lower gross profit margins in the OEM segment in 2007 caused by product cost increases.

**Operating Expenses and Operating Income**

*Selling, General and Administrative Expenses ( SG&A )*

SG&A expenses were \$67.4 million and 52.7 percent of net sales for the third quarter of 2007, which represents a decline from the respective prior period amounts of \$70.7 million and 55.6% of net sales. Included in SG&A costs are legal costs associated with the ongoing investigation by the U.S. Attorney s Office for the Northern District of

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Illinois. The Company incurred expenses of \$1.2 million related to the investigation in the quarter ended September 30, 2007, which represents a \$0.6 million increase compared to \$0.6 million in the prior year period. This investigation is ongoing and the Company expects to incur legal and other costs throughout the remainder of 2007 related to this matter. See Note L – Legal Proceedings for more information.

The primary driver of lower SG&A in the third quarter 2007 was lower compensation costs, including a \$3.1 million reduction in costs associated with the Company's long-term incentive plans and lower variable selling expenses of \$0.6 million.

#### *Severance and Other Charges*

The Company recorded \$3.7 million of severance expense in the third quarter of 2007 related to contractual payments for several executives who have retired, have announced their retirement or have been terminated due to a sales management realignment.

#### *Operating Income*

Operating income for the three month period ended September 30, 2007 decreased to \$5.4 million, from \$5.8 million in the comparable period of 2006. This \$0.4 million decrease in operating income is principally attributable to higher operating expenses, principally the severance and other charges as discussed above.

#### **Investment and Other Income**

The following table presents investment and other income for the quarters ended September 30, 2007 and 2006:

(in millions)	2007	2006
Interest and other	\$ 0.2	\$ 0.3
	\$ 0.2	\$ 0.3

#### **Provision for Income Taxes**

The effective tax rate for the three months ended September 30, 2007 was 53.9%, which was higher than the 45.6% rate for the three months ended September 30, 2006. The higher rate for the third quarter 2007 was related to increases to estimated tax liabilities related to the Company's decision to exclude tax deductions for expenses associated with the Company's customer loyalty programs.

The Company's state tax rate estimate fluctuates based on the income tax rates in the various jurisdictions in which the Company operates, and based on the level of profits in those jurisdictions.

#### **Income from Continuing Operations before Cumulative Effect of Accounting Change**

Income from continuing operations before cumulative effect of accounting change for the third quarter of 2007 decreased to \$2.4 million (\$0.28 per diluted share), compared to \$3.3 million (\$0.37 per diluted share) in the comparable period of 2006. The \$0.9 million decrease is the result of lower operating income in the third quarter 2007 as discussed above, principally due to the severance charges.

#### **Loss from Discontinued Operations**

Discontinued operations reflect the results of operations of Lawson de Mexico, net of income taxes. See Note K in the Notes to Condensed Consolidated Financial Statements for information on the Company's discontinued operations.

**Nine Months ended September 30, 2007 compared to Nine Months ended September 30, 2006**

The following table presents a summary of the Company's financial performance for the first nine months of 2007 and 2006:

(in thousands)	<b>2007</b>	<b>% of Net Sales</b>	<b>2006</b>	<b>% of Net Sales</b>
Net sales	\$ 386,760	100.0	\$ 386,727	100.0
Cost of goods sold	157,779	40.8	156,974	40.6
Gross profit	228,981	59.2	229,753	59.4
Operating expenses:				
Selling, general and administrative expenses	205,124	53.0	209,620	54.2
Severance and other charges	10,571	2.7		
Loss on sale of equipment			806	0.2
Operating income	13,286	3.4	19,327	5.0
Other, net	(107)	(0.0)	1,201	0.3
Income from continuing operations before income taxes and cumulative effect of accounting change	13,179	3.4	20,528	5.3
Provision for income taxes	6,063	1.6	8,587	2.2
Income from continuing operations before cumulative effect of accounting change	7,116	1.8	11,941	3.1
Loss from discontinued operations, net of income taxes	(496)	(0.1)	(312)	(0.1)
Income before cumulative effect of accounting change	6,620	1.7	11,629	3.0
Cumulative effect of accounting change			(361)	(0.1)
Net income	\$ 6,620	1.7	\$ 11,268	2.9

**Net Sales and Gross Profit**

Net sales for the nine month period ended September 30, 2007 were \$386.8 million and comparable to \$386.7 million in the same period of 2006.

The following table presents the Company's net sales results for its MRO and OEM businesses for the first nine months of 2007 and 2006:

(in millions)	2007	2006
MRO	\$ 323.4	\$ 322.3
OEM	63.4	64.4
Net Sales	\$ 386.8	\$ 386.7



Maintenance, Repair and Operations distribution (MRO) net sales increased \$1.1 million for the first nine months of 2007, to \$323.4 million from \$322.3 million in the prior year period due to slight improvements in account penetration. Sales increased in the U.S. and Canada by approximately \$0.5 million and \$0.5 million for the quarter, respectively.

Original Equipment Manufacturer (OEM) net sales decreased \$1.0 million in the first nine months of 2007 to \$63.4 million from \$64.4 million in the prior year period, primarily due to the cancellation of several customer contracts that occurred throughout 2007.

Consolidated gross profit margins for the first nine months ended September 30, 2007 and 2006 decreased slightly to 59.2% from 59.4%, respectively. This decrease was primarily due to lower gross profit margins in the MRO segment associated with higher product costs.

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**Operating Expenses and Operating Income***Selling, General and Administrative Expenses ( SG&A )*

SG&A expenses were \$205.1 million and 53.0 percent of net sales for the first nine months of 2007, which represents a decline from the respective prior period amounts of \$209.6 million and 54.2 percent of net sales. Included in SG&A costs are legal costs associated with the ongoing investigation by the U.S. Attorney's Office for the Northern District of Illinois. The Company incurred expenses of \$4.9 million related to the investigation in the first nine months ended September 30, 2007, which represents a \$2.3 million increase compared to \$2.6 million in the prior year period. This investigation is ongoing and the Company expects to incur legal and other costs throughout the remainder of 2007 related to this matter. See Note L - Legal Proceedings for more information.

The primary driver of lower SG&A in the first nine months of 2007 was lower compensation costs, including a \$5.9 million reduction in costs associated with the Company's long-term incentive plans and lower variable selling expenses of \$1.7 million.

*Severance and Other Charges*

The Company recorded \$9.1 million of severance expense in the first nine months of 2007 related to contractual payments for several executives who have retired, have announced their retirement or have been terminated due to a sales force realignment and \$1.4 million of compensation expense related to the retirement of Mr. Jeffrey Belford, the Company's former President and Chief Operating Officer.

*Loss on Sale of Equipment*

In the second quarter of 2006, the Company incurred a loss of \$0.8 million (\$0.5 million, net of tax) on the sale of equipment related to the Company's decision to outsource the manufacturing of a product line in the Company's OEM business.

*Operating Income*

Operating income for the nine month period ended September 30, 2007 was \$13.3 million, compared to \$19.3 million in the prior year-to-date period. The \$6.0 million decrease in operating income over these periods is principally attributable to higher operating expenses as result of severance charges. The factors affecting these items were discussed above.

**Investment and Other Income**

The following table presents investment and other income for the nine months ended September 30, 2007 and 2006:

(in millions)	2007	2006
Realized foreign exchange gains	\$ 0.1	\$ 0.6
Interest and other	0.5	0.6
	\$ 0.6	\$ 1.2

The realized foreign exchange gains for the nine months ended September 30, 2007 and 2006 were related to payments of intercompany balances by the Company's Canadian subsidiary.

**Provision for Income Taxes**

The effective tax rate for the nine months ended September 30, 2007 was 46.0%, which was higher than the 41.8% rate for the nine months ended September 30, 2006. The higher rate for 2007 was related to increases to estimated tax liabilities related to the Company's decision to exclude tax deductions for expenses associated with the Company's customer loyalty programs.

The Company's state tax rate estimate fluctuates based on the income tax rates in the various jurisdictions in which the Company operates, and based on the level of profits in those jurisdictions.

**Income from Continuing Operations before Cumulative Effect of Accounting Change**

Income from continuing operations before cumulative effect of accounting change for the first nine months of 2007 decreased 40.4%, to \$7.1 million (\$0.83 per diluted share), compared to \$11.9 million (\$1.33 per diluted share) in the comparable period of 2006. The \$4.8 million decrease is the result of lower operating income in the first nine months of 2007, as discussed above.

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**Loss from Discontinued Operations**

Discontinued operations primarily represent the results of operations of Lawson de Mexico, net of income taxes. See Note K in the Notes to Condensed Consolidated Financial Statements for information on the Company's discontinued operations.

**Cumulative Effect of Accounting Change**

The \$0.4 million cumulative accounting change in 2006 represents the effect of adopting Financial Accounting Standards Board (FASB) Statement No. 123(R), Share-Based Payment, which is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation.

**Liquidity and Capital Resources**

Net cash provided by operating activities was \$4.1 million in the first nine months of 2007, a decrease from \$11.9 million for the first nine months of 2006 caused by lower earnings and an increase in cash used for working capital, primarily prepaid expenses and taxes payable.

Net cash used for investing activities increased \$10.6 million for the nine month period ended September 30, 2007 compared to the prior year period as a result of higher capital expenditures including \$10.0 million for the Reno, Nevada facility expansion. The Company anticipates the Reno facility expansion will be completed by the end of 2007 and will require no significant additional capital expenditures in the remainder of 2007 for this project. For 2006, capital expenditures of \$3.6 million were related to improvement of existing facilities and the purchase of related equipment.

Net cash provided by financing activities in the first nine months of 2007 was \$7.9 million compared to \$4.7 million net cash used for financing activities in the first nine months of 2006 primarily related to borrowings and payments on the revolving line of credit.

Working capital at September 30, 2007 was \$92.0 million as compared to \$101.8 million at December 31, 2006. At September 30, 2007 and December 31, 2006, the current ratio was 2.2 to 1 and 2.6 to 1, respectively.

In the third quarter of 2007 and 2006, the Company announced a cash dividend of \$0.20 per share on common shares. The third quarter 2007 cash dividend was paid October 16, 2007.

Net cash provided by operating activities, current cash and cash equivalents and the \$75 million unsecured revolving line of credit are expected to be sufficient to finance the Company's operations, cash dividends and capital expenditures for the next 12 months.

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**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

There have been no material changes in market risk at September 30, 2007 from that reported in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

**Item 4. Controls and Procedures**

The Company's chief executive officer and chief financial officer have concluded, based on their evaluation as of the end of the period covered by this report, that the Company's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) are effective to ensure that information required to be disclosed in the reports that the Company files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding financial disclosures. There was no change in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2007 that has materially affected or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II**  
**OTHER INFORMATION**

Items 1, 1A, 2, 3, 4 and 5 are inapplicable and have been omitted from this report.

**Item 6. Exhibits**

- 15 Letter from Ernst & Young LLP Regarding Unaudited Interim Financial Information
  
  - 31.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
  
  - 31.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
  
  - 32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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SIGNATURES

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

LAWSON PRODUCTS, INC.  
(Registrant)

Date: November 2, 2007

/s/ Thomas J. Neri

Thomas J. Neri  
Chief Executive Officer

Date: November 2, 2007

/s/ Scott F. Stephens

Scott F. Stephens  
Chief Financial Officer