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, 2022

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from__________ to __________

Commission file number: **0-31641**

SCI ENGINEERED MATERIALS, INC.

(Exact name of registrant as specified in its charter)

Ohio	**31-1210318**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2839 Charter Street, Columbus, Ohio 43228
(Address of principal executive offices) (Zip Code)

(614) 486-0261
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address, and former fiscal year, if changed since last report)

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

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common stock, without par value	SCIA	OTCQB

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 every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒ Smaller reporting company ☒ Emerging growth company ☐

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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

4,517,319 shares of Common Stock, without par value, were outstanding at October 27, 2022.

FORM 10-Q

SCI ENGINEERED MATERIALS, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SCI ENGINEERED MATERIALS, INC.

BALANCE SHEETS

ASSETS

	September 30, 2022 (UNAUDITED)	December 31, 2021
Current Assets		
Cash	$ 5,614,257	$ 4,140,942
Accounts receivable		
Trade, less allowance for doubtful accounts of $15,000	583,382	425,327
Tax - Employee Retention Credit	105,000	105,000
Other	—	1,250
Inventories, net	1,452,588	1,073,218
Prepaid expenses	91,792	678,357
Total current assets	7,847,019	6,424,094
Property and Equipment, at cost		
Machinery and equipment	8,636,524	7,949,746
Furniture and fixtures	142,471	132,365
Leasehold improvements	607,156	596,867
Construction in progress	58,198	287,510
	9,444,349	8,966,488
Less accumulated depreciation and amortization	(7,087,742)	(6,809,850)
	2,356,607	2,156,638
Right of use asset, net	207,958	274,298
Deferred tax asset	375,820	663,820
Other assets	86,242	89,552
Total other assets	670,020	1,027,670
TOTAL ASSETS	$ 10,873,646	$ 9,608,402

The accompanying notes are an integral part of these financial statements.

SCI ENGINEERED MATERIALS, INC.

BALANCE SHEETS

LIABILITIES AND SHAREHOLDERS' EQUITY

	September 30, 2022 (UNAUDITED)	December 31, 2021
Current Liabilities		
Finance lease obligations, current portion	$ 99,909	$ 96,702
Operating lease obligations, current portion	103,653	97,292
Accounts payable	506,748	250,383
Customer deposits	1,282,178	1,724,556
Accrued compensation	291,044	225,190
Accrued expenses and other	119,935	122,836
Total current liabilities	2,403,467	2,516,959
Finance lease obligations, net of current portion	71,178	146,516
Operating lease obligations, net of current portion	127,078	205,623
Total liabilities	2,601,723	2,869,098
Shareholders' Equity		
Common stock, no par value, authorized 15,000,000 shares; 4,517,319 and 4,466,969 shares issued and outstanding, respectively	10,610,938	10,573,843
Additional paid-in capital	2,230,625	2,227,078
Accumulated deficit	(4,569,640)	(6,061,617)
Total shareholders' equity	8,271,923	6,739,304
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 10,873,646	$ 9,608,402

The accompanying notes are an integral part of these financial statements.

SCI ENGINEERED MATERIALS, INC.

STATEMENTS OF INCOME

THREE MONTHS AND NINE MONTHS ENDED SEPTEMBER 30, 2022 AND 2021

(UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30, 2022	THREE MONTHS ENDED SEPTEMBER 30, 2021	NINE MONTHS ENDED SEPTEMBER 30, 2022	NINE MONTHS ENDED SEPTEMBER 30, 2021
Revenue	$ 5,816,838	$ 5,211,169	$ 17,648,275	$ 10,205,528
Cost of revenue	4,645,255	3,908,801	14,104,923	7,537,570
Gross profit	1,171,583	1,302,368	3,543,352	2,667,958
General and administrative expense	374,193	306,997	1,170,782	878,586
Research and development expense	93,081	56,612	272,197	149,208
Marketing and sales expense	94,594	61,732	284,922	159,559
Income from operations	609,715	877,027	1,815,451	1,480,605
Gain on extinguishment of debt	—	—	—	(325,300)
Interest (income) expense	(363)	8,156	11,899	24,808
Income before provision for income taxes	610,078	868,871	1,803,552	1,781,097
Income tax expense	167,375	200,189	311,575	338,282
Net income	442,703	668,682	1,491,977	1,442,815
Dividends on preferred stock	—	6,038	—	18,114
INCOME APPLICABLE TO COMMON STOCK	$ 442,703	$ 662,644	$ 1,491,977	$ 1,424,701
Earnings per share - basic and diluted (Note 7)				
Income per common share				
Basic	$ 0.10	$ 0.15	$ 0.33	$ 0.32
Diluted	$ 0.10	$ 0.15	$ 0.33	$ 0.32
Weighted average shares outstanding				
Basic	4,516,518	4,500,256	4,513,785	4,492,736
Diluted	4,544,651	4,531,523	4,541,590	4,521,746

The accompanying notes are an integral part of these financial statements.

SCI ENGINEERED MATERIALS, INC.

STATEMENTS OF SHAREHOLDERS' EQUITY

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2022 AND 2021

(UNAUDITED)

	Convertible Preferred Stock, Series B	Common Stock	Additional Paid-In Capital	Accumulated Deficit	Total
Balance 6/30/2022	$ —	$ 10,603,450	$ 2,229,443	$ (5,012,343)	$ 7,820,550
Stock based compensation expense (Note 4)	—	—	1,182	—	1,182
Common stock issued (Note 4)	—	7,488	—	—	7,488
Net income	—	—	—	442,703	442,703
Balance 9/30/2022	$ —	$ 10,610,938	$ 2,230,625	$ (4,569,640)	$ 8,271,923
Balance 6/30/2021	$ 502,362	$ 10,558,867	$ 2,236,790	$ (6,966,308)	$ 6,331,711
Accretion of cumulative dividends	6,038	—	(6,038)	—	—
Stock based compensation expense (Note 4)	—	—	1,182	—	1,182
Common stock issued (Note 4)	—	7,488	—	—	7,488
Net income	—	—	—	668,682	668,682
Balance 9/30/2021	$ 508,400	$ 10,566,355	$ 2,231,934	$ (6,297,626)	$ 7,009,063
Balance 12/31/2021	$ —	$ 10,573,843	$ 2,227,078	$ (6,061,617)	$ 6,739,304
Stock based compensation expense (Note 4)	—	—	3,547	—	3,547
Common stock issued (Note 4)	—	37,095	—	—	37,095
Net income	—	—	—	1,491,977	1,491,977
Balance 9/30/2022	$ —	$ 10,610,938	$ 2,230,625	$ (4,569,640)	$ 8,271,923
Balance 12/31/2020	$ 514,438	$ 10,530,669	$ 2,246,501	$ (7,740,441)	$ 5,551,167
Accretion of cumulative dividends	18,114	—	(18,114)	—	—
Payment of cumulative dividends (Note 5)	(24,152)	—	—	—	(24,152)
Stock based compensation expense (Note 4)	—	—	3,547	—	3,547
Common stock issued (Note 4)	—	35,686	—	—	35,686
Net income	—	—	—	1,442,815	1,442,815
Balance 9/30/2021	$ 508,400	$ 10,566,355	$ 2,231,934	$ (6,297,626)	$ 7,009,063

The accompanying notes are an integral part of these financial statements.

SCI ENGINEERED MATERIALS, INC.

STATEMENTS OF CASH FLOWS

NINE MONTHS ENDED SEPTEMBER 30, 2022 AND 2021

(UNAUDITED)

	2022	2021
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 1,491,977	$ 1,442,815
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and accretion	305,480	325,793
Amortization of right of use asset	66,340	61,756
Amortization of patents	3,311	3,311
Stock based compensation	40,642	39,233
Loss (gain) on disposal of equipment	5,959	(4,511)
Deferred tax asset	288,000	316,185
Gain on extinguishment of debt	—	(325,300)
Inventory reserve	(15,925)	900
Changes in operating assets and liabilities:		
Accounts receivable	(156,805)	(298,706)
Inventories	(363,445)	(802,569)
Prepaid expenses	586,565	31,810
Other assets	—	2,656
Accounts payable	256,365	165,371
Operating lease obligations	(72,184)	(65,915)
Accrued expenses and customer deposits	(384,601)	887,869
Net cash provided by operating activities	2,051,679	1,780,698
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds on sale of equipment	5,166	18,091
Purchases of property and equipment	(511,399)	(615,088)
Net cash used in investing activities	(506,233)	(596,997)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments of cumulative dividends on preferred stock	—	(24,152)
Principal payments on finance lease obligations and notes payable	(72,131)	(123,715)
Net cash used in financing activities	(72,131)	(147,867)
NET INCREASE IN CASH	$ 1,473,315	$ 1,035,834
CASH - Beginning of year	4,140,942	2,917,551
CASH - End of period	$ 5,614,257	$ 3,953,385
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the year for:		
Interest	$ 6,846	$ 9,256
Income taxes	17,986	22,097
SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Increase in asset retirement obligation	5,175	5,175

The accompanying notes are an integral part of these financial statements.

SCI ENGINEERED MATERIALS, INC
NOTES TO FINANCIAL STATEMENTS

Note 1. Business Organization and Purpose

SCI Engineered Materials, Inc. ("SCI," or the "Company"), an Ohio corporation, was incorporated in 1987. The Company operates in one segment as a global supplier and manufacturer of advanced materials for Physical Vapor Deposition ("PVD") thin film applications. The Company is focused on markets within the photonics industry including Aerospace, Automotive, Defense, Glass, Optical Coatings and Solar. Substantially all revenues are generated from customers with multi-national operations. The Company develops innovative customized solutions enabling commercial success through collaboration with end users and Original Equipment Manufacturers.

Note 2. Summary of Significant Accounting Policies

Basis of Presentation - The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for fair presentation of the results of operations for the periods presented have been included. The financial statements should be read in conjunction with the audited financial statements and the notes thereto for the year ended December 31, 2021. Interim results are not necessarily indicative of results for the full year.

Use of Estimates - The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue Recognition - The Company enters into contracts with its customers that generally represent purchase orders specifying general terms and conditions, order quantities and per unit product prices. The Company has determined that each unit of product purchased represents a separate performance obligation. The Company satisfies its performance obligations and recognizes revenue at a point in time when control of a unit of product is transferred to the customer. Revenue is measured as the amount of consideration the Company expects to receive in exchange for transferring products. For the majority of product sales, transfer of control occurs when the products are shipped from the Company's manufacturing facility to the customer. The cost of delivering products to the Company's customers is recorded as a component of cost of products sold. Those costs may include the amounts paid to a third party to deliver the products. Any freight costs billed to and paid by a customer are included in revenue.

The Company considers collectability of amounts due under a contract to be probable upon inception of a sale based on an evaluation of the credit worthiness of each customer. The Company sells its products typically under agreements with 30-day payment terms. The Company does not normally include extended payment terms or significant financing components in contracts with customers. The majority of the Company's contracts have an obligation to transfer products within one year. Thus, the Company elects to use the practical expedient where incremental cost of obtaining a contract, such as commissions, is expensed when incurred because the amortization period for those costs is one year or less. The Company treats shipping and handling activities that occur after control of the product transfers as fulfillment activities, and therefore, does not account for shipping and handling costs as a separate performance obligation. Customer deposits are funds received in advance from customers and are recognized as revenue when the Company has transferred control of product to the customer. Product revenues are recognized upon shipment of goods as the customer has assumed the significant risks and rewards of ownership and the Company is entitled to payment at this point. Service revenues are recognized upon completion as the customer cannot realize the benefit of the service until fully completed.

All revenue was from the photonics industry during the nine months ended September 30, 2022 and 2021. The top two customers represented approximately 89% and 84% of total revenue for the nine months ended September 30, 2022 and 2021, respectively. International shipments resulted in 1% and 2% of total revenue for the first nine months of 2022 and 2021, respectively.

Note 2. Summary of Significant Accounting Policies (continued)

Employee Retention Credit (ERC) - The Company qualified for federal government assistance through Employee Retention Credit provisions of the Consolidated Appropriations Act of 2021 during the first nine months of 2021 in the amount of $255,507 during the first quarter of 2021, $151,701 during the second quarter of 2021, and $153,713 during the third quarter of 2021. The purpose of the Employee Retention Credit was to encourage employers to keep employees on the payroll, even if they were not working during the covered period because of the coronavirus outbreak. These funds were recorded in the Statements of Income as an offset to payroll costs in their respective expense lines and as a tax receivable on the balance sheets. A balance of $105,000 appears as a tax receivable on the balance sheets at September 30, 2022 and December 31, 2021.

Note 3. Recent Accounting Pronouncements

In June 2016, the FASB issued ASU No. 2016-13 “Credit Losses - Measurement of Credit Losses on Financial Instruments.” ASU No. 2016-13 significantly changes how entities will measure credit losses for most financial assets, including accounts and notes receivables, by replacing today’s “incurred loss” approach with an “expected loss” model under which allowances will be recognized based on expected rather than incurred losses. ASU No. 2016-13 will become effective for us in the first quarter of 2023. We are evaluating the impact that the adoption of this update will have on our financial statements; however, it is not expected to be material.

Note 4. Common Stock and Stock Options

Stock based compensation cost for all stock awards is based on the grant date fair value and recognized over the required service (vesting) period. Noncash stock-based compensation expense was $8,670 for the three months ended September 30, 2022, and 2021. Noncash stock-based compensation expense was $40,642 and $39,233 for the nine months ended September 30, 2022, and 2021, respectively.

Unrecognized compensation expense was $2,758 as of September 30, 2022 and will be recognized through the second quarter of 2023. There was no tax benefit recorded for this compensation cost as the expense relates to incentive stock options that do not qualify for a tax deduction until, and only if, a qualifying disposition occurs.

The non-employee Board members received compensation of 6,550 and 7,605 aggregate shares of common stock of the Company during the nine months ended September 30, 2022 and 2021, respectively. The stock had an aggregate value of $22,470 and $22,475 for the nine months ended September 30, 2022 and 2021, respectively, and was recorded as non-cash stock compensation expense in the financial statements.

Employees received compensation of 4,500 and 4,804 aggregate shares of common stock of the Company during the nine months ended September 30, 2022 and 2021, respectfully. These shares had an aggregate value of $14,625 and $13,211 and was recorded as non-cash stock compensation expense in the financial statements for the nine months ended September 30, 2022 and 2021, respectively. In addition, during the nine months ended September 30, 2021, a total of 30,181 stock options were exercised by management.

The cumulative status of options granted and outstanding at September 30, 2022, and December 31, 2021, as well as options which became exercisable in connection with the Company’s stock option plans is summarized as follows:

<u>Employee Stock Options</u>

	Stock Options	Weighted Average Exercise Price
Outstanding at January 1, 2021	76,037	$ 1.03
Exercised	(34,733)	1.00
Outstanding at December 31, 2021	41,304	$ 1.05
Exercised	—	—
Outstanding at September 30, 2022	41,304	$ 1.05
Options exercisable at December 31, 2021	27,418	$ 0.95
Options exercisable at September 30, 2022	34,361	$ 1.01

Note 4. Common Stock and Stock Options (continued)

Exercise prices for options ranged from $0.84 to $1.25 at September 30, 2022. The weighted average option price for all options outstanding at September 30, 2022, was $1.05 with a weighted average remaining contractual life of 3.9 years.

Note 5. Preferred Stock

The Board of Directors voted in November 2021 to authorize full redemption of the 24,152 shares of the Company's Convertible Preferred Stock, Series B ("Series B") outstanding effective December 31, 2021. This involved cash payments of $248,766 ($10.30 per Series B share, which included a 3% premium to the stated value of $10 per share), plus unpaid annual dividends of $265,672 ($11.00 per Series B share).

Dividends on the Convertible Preferred Stock, Series B accrued at 10% annually on the outstanding shares prior to the redemption in 2021 and were $6,038 and $18,114 for the three and nine months ended September 30, 2021, respectively. During June 2021, a cash dividend payment of $24,152 was made to preferred shareholders.

Note 6. Inventories

Inventories consisted of the following:

	September 30, 2022	December 31, 2021
Raw materials	$ 196,784	$ 440,759
Work-in-process	951,009	549,369
Finished goods	314,288	108,508
	1,462,081	1,098,636
Inventory reserve	(9,493)	(25,418)
	$ 1,452,588	$ 1,073,218

Note 7. Earnings Per Share

Basic income per share is calculated as income applicable to common shareholders divided by the weighted average of common shares outstanding. Diluted earnings per share is calculated as diluted income applicable to common shareholders divided by the diluted weighted average number of common shares. Diluted weighted average number of common shares gives effect to all dilutive potential common shares outstanding during the period using the treasury stock method and convertible preferred stock using the if-converted method. Diluted earnings per share exclude all diluted potential shares if their effect is anti-dilutive. All common stock options listed in Note 4 that were out-of-the-money or anti-dilutive were excluded from diluted earnings per share. The following is provided to reconcile the earnings per share calculations:

	Three months ended September 30,		Nine months ended September 30,	
	2022	2021	2022	2021
Income applicable to common stock	$ 442,703	$ 662,644	$ 1,491,977	$ 1,424,701
Weighted average common shares outstanding - basic	4,516,518	4,500,256	4,513,785	4,492,736
Effect of dilution - stock options	28,133	31,267	27,805	29,010
Weighted average shares outstanding - diluted	4,544,651	4,531,523	4,541,590	4,521,746

Note 8. Notes Payable

On April 17, 2020, the Company entered into an unsecured promissory note under the Paycheck Protection Program (the "PPP"), with a principal amount of $325,300. Under the terms of the CARES Act, PPP loan recipients were eligible to apply for, and be granted, forgiveness for all or a portion of loans granted. Such forgiveness was subject to limitations and ongoing rulemaking by the SBA, based on the use of loan proceeds for payroll costs and mortgage interest, rent or utility costs and the maintenance of employee and compensation levels. The Company applied for forgiveness of the entire amount of the loan during the fourth quarter of 2020, and the SBA approved the Forgiveness Application in full during the first quarter of 2021. This amount is included in the Statements of Income as gain on extinguishment of debt for the nine months ended September 30, 2021.

The Company renewed its line of credit with Fifth Third Bank for $1 million during August 2022. The line of credit bears interest equal to the rate of interest per annum established by Fifth Third Bank as its Prime Rate. This line of credit has a maturity date of August 29, 2023. No amounts were drawn on this line of credit as of September 30, 2022.

Note 9. Income Taxes

The provision for income taxes for the nine months ended September 30, 2022 is based on our projected annual effective tax rate for fiscal year 2022, adjusted for permanent differences and specific items that are required to be recognized in the period in which they are incurred.

Following is the income tax expense for the three and nine months ended September 30:

	Three months ended September 30,		Nine months ended September 30,	
	2022	2021	2022	2021
Federal - deferred	$ 155,900	$ 185,183	$ 288,000	$ 316,185
State and local	11,475	15,006	23,575	22,097
	$ 167,375	$ 200,189	$ 311,575	$ 338,282

Deferred tax assets and liabilities result from temporary differences in the recognition of income and expense for tax and financial reporting purposes. The Company had net operating loss carryforwards available for federal and state tax purposes of approximately $2,100,000 at December 31, 2021, which expire in varying amounts through 2041.

As of December 31, 2021, management determined that there was sufficient positive evidence to conclude that it is more likely than not that deferred taxes of $663,820 were realizable principally because we achieved five consecutive years of pretax income, expect profits to continue for the foreseeable future and implemented new efficiencies in the Company's manufacturing process. As of each reporting date, management considers new evidence, both positive and negative, that could affect its view of the future realization of deferred tax assets. Accordingly, management determined that no valuation allowance was necessary, and the deferred tax asset was $375,820 at September 30, 2022.

Note 10. Operating Lease

The Company entered into an operating lease with a third party on March 18, 2014 for its headquarters in Columbus, Ohio. The terms of the lease include monthly payments ranging from $9,200 to $9,700 with a maturity date of November 30, 2024. The Company has the option to extend the lease period for an additional five years beyond the original expiration date. There are no restrictions or covenants associated with the lease. The lease costs were approximately $84,300 and $82,600 during the nine months ended September 30, 2022 and 2021, respectively.

Note 10. Operating Lease (continued)

The following is a maturity analysis, by year, of the annual undiscounted cash outflows of the operating lease liabilities as of September 30, 2022:

2022	$ 28,359
2023	114,857
2024	102,550
Total minimum lease payments	245,766
Less debt discount	15,035
Total operating lease obligations	$ 230,731

Operating cash outflows from operating leases	$ 72,183
Weighted average remaining lease term – operating leases	2.2 years
Weighted average discount rate – operating leases	5.5 %

Note 11. Finance Leases

The Company leases certain equipment under finance leases. Future minimum lease payments, by year, with the present value of such payments, as of September 30, 2022, are shown in the following table.

2022	$ 26,325
2023	101,675
2024	49,859
Total minimum lease payments	177,859
Less amount representing interest	6,772
Present value of minimum lease payments	171,087
Less current portion	99,909
Finance lease obligations, net of current portion	$ 71,178

The equipment under finance lease at September 30, 2022, and December 31, 2021, is included in the accompanying balance sheets as follows:

	September 30, 2022	Dec. 31, 2021
Machinery and equipment	$ 385,923	$ 385,923
Less accumulated depreciation and amortization	94,728	65,783
Net book value	$ 291,195	$ 320,140

These assets are amortized over a period of ten years using the straight-line method and amortization is included in depreciation expense.

The finance leases are structured such that ownership of the leased asset reverts to the Company at the end of the lease term. Accordingly, leased assets are depreciated using the Company's normal depreciation methods and lives. Ownership of certain assets were transferred to the Company in accordance with the terms of the leases and these assets have been excluded from the leased asset disclosure above.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the Financial Statements and Notes contained herein and with those in our Form 10-K for the year ended December 31, 2021.

Except for the historical information contained herein, the matters discussed in this Quarterly Report on Form 10-Q include certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which are intended to be covered by the safe harbors created thereby. Those statements include, but may not be limited to, all statements regarding our intent, belief, and expectations, such as statements concerning our future profitability and operating and growth strategy. Words such as "believe," "anticipate," "expect," "will," "may," "should," "intend," "plan," "estimate," "predict," "potential," "continue," "likely" and similar expressions are intended to identify forward-looking statements. Investors are cautioned that all forward-looking statements contained in this Quarterly Report on Form 10-Q and in other statements we make involve risks and uncertainties including, without limitation, the factors set forth under the caption "Risk Factors" included in our Annual Report on Form 10-K for the year ended December 31, 2021, and other factors detailed from time to time in our other filings with the Securities and Exchange Commission. One or more of these factors have affected, and in the future could affect our business and financial condition and could cause actual results to differ materially from plans and projections. Although we believe the assumptions underlying the forward-looking statements contained herein are reasonable, there can be no assurance that any of the forward-looking statements included in this Quarterly Report on Form 10-Q will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved.

Any forward-looking statement speaks only as of the date on which such statement is made, and we undertake no obligation to update any forward-looking statement or statements to reflect events or circumstances after the date on which such statements are made or reflect the occurrence of unanticipated events, unless necessary to prevent such statements from becoming misleading. New factors emerge from time to time, and it is not possible for us to predict all factors, nor can we assess the impact of each such factor on the business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Executive Summary

For the nine months ended September 30, 2022, we had record total revenue of $17,648,275. Higher pricing, primarily attributable to increased raw material costs, higher volume and product mix were key factors that contributed to the increase.

Gross profit was $3,543,352 for the nine months ended September 30, 2022 compared to $2,667,958 for the same nine months in 2021. The increase was due to higher volume, favorable product mix, and improved manufacturing efficiency. The first nine months of 2021 included a reduction of costs of approximately $323,000 related to the Employee Retention Credit ("ERC") enacted in 2020.

Operating expenses were $1,727,901 and $1,187,353 for the nine months ended September 30, 2022 and 2021, respectively. The first nine months of 2021 included a reduction of expenses of approximately $238,000 related to the ERC.

Income from operations was $1,815,451 and $1,480,605 for the nine months ended September 30, 2022 and 2021, respectively.

We received additional manufacturing equipment during the third quarter of 2022. This included a vacuum hot press that enables production of higher temperature materials with increased capacity. It was purchased and installed for approximately $500,000 which was paid in cash.

Consistent with our growth strategy, we have identified niche markets that can benefit from our expertise in custom powder solutions, such as near-infrared doped phosphors and short-wave infrared applications. These applications enable extended life of phosphors for specific nighttime identification needs of defense personnel and first responders.

New initiatives are also being pursued that utilize our vacuum hot presses, cold isostatic press, and kilns for increased production and development projects, including diffusion bonding. We recently manufactured and sold conductive metal oxides for direct current sputtering of Tungsten Oxide and Molybdenum Oxide materials. We continue to invest in developing new products for all our markets including specialty bonding processes for Aerospace customers. Those products continue to require research and development expense to accelerate time to market.

Several issues continue to affect national and global market conditions. First, inflation remains at historically high levels, impacting labor, raw material costs and transportation expenses. We have generally been able to pass on these increases to customers but are unable to predict how future or sustained inflationary pressure may impact our results. Second, supply chain disruptions are adversely impacting customers in certain markets. Thus far, we have not experienced material adverse effects regarding product shipments; however, timely deliveries and sourcing of certain materials is of increased concern. Third, published articles and corporate announcements continue to address the global semiconductor chip shortage, which is anticipated to continue into 2023. This shortage is affecting some of our customers which could impact the Company's revenue, volume, and profitability. Fourth, there are increased political uncertainties affecting global markets. Although we currently have no customers or vendors in Russia or Ukraine, we continue to monitor the situation as some raw material comes from Russia for the PVD industry. We continue to actively monitor these developments, including ongoing contact with our suppliers and customers, including identifying additional suppliers and adapting to our customers' specific circumstances and forecasts.

In March 2020, the World Health Organization declared the coronavirus disease (COVID-19) a global pandemic and recommended containment and mitigation measures worldwide. Since then, most federal, state, and local executive orders have been lifted. Based on ongoing conversations with customers, we do not expect to experience any material impairments or changes in accounting judgements related to COVID-19. We continue to follow practical safety procedures as needed. During the first nine months of 2022, we resumed in-person meetings, participated onsite in industry trade shows, and continue to maintain regular contact, via phone and other electronic means, with all customers and suppliers.

RESULTS OF OPERATIONS

Three and nine months ended September 30, 2022 (unaudited) compared to three and nine months ended September 30, 2021 (unaudited):

Revenue

For the three months ended September 30, 2022, we had revenue of $5,816,838. This was an increase of $605,669 compared to the three months ended September 30, 2021. For the nine months ended September 30, 2022, we had record total revenue of $17,648,275. This was an increase of $7,442,747 compared to the nine months ended September 30, 2021. Higher pricing, primarily attributable to increased raw material costs, higher volume and product mix were key factors that contributed to the increase.

Gross profit

Gross profit was $1,171,583 for the three months ended September 30, 2022, compared to $1,302,368 for the same three months in 2021, a decrease of $130,785. Increased raw material costs in the third quarter of 2022 combined with the impact of the Employee Retention Credit (ERC) for the third quarter of 2021 offset higher volume and product mix. Gross profit was $3,543,352 for the nine months ended September 30, 2022, compared to $2,667,958 for the first nine months of 2021, an increase of $875,394. The increase in gross profit for the nine months ended September 30, 2022 was due to higher revenue compared to the nine months ended September 30, 2021. Gross profit as a percentage of revenue (gross margin) was 20.1% for the third quarter and first nine months of 2022 compared to 25.0% for the third quarter of 2021 and 26.1% for the 2021 year-to-date period. The lower gross margin in 2022 compared to a year ago was due to higher raw material costs and product mix during 2022. The Employee Retention Credit (ERC) reduced cost of revenue in the three and nine months ended September 30, 2021, by $84,763 and $323,038, respectively.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

General and administrative expense

General and administrative expense for the three months ended September 30, 2022, and 2021, was $374,193 and $306,997, respectively, an increase of 21.9%. This increase is attributed to higher compensation of $25,369, disposal of assets with net book value of $18,860, and the ERC of $21,000 which reduced expenses in the third quarter of 2021. General and administrative expense for the nine months ended September 30, 2022, and 2021, was $1,170,782 and $878,586, respectively, an increase of 33.3%. During 2022 there was an increase in compensation of approximately $118,788, which included an increase in staff. Business liability insurance (due to higher revenue) and professional fees, primarily related to SEC compliance costs for legal, accounting and stockholder relations fees, increased approximately $52,000. The nine months ended September 30, 2021 included the ERC of $78,000.

Research and development expense

Research and development expense for the three months ended September 30, 2022, was $93,081 compared to $56,612 for the same period in 2021, an increase of 64.4%. Research and development expense for the nine months ended September 30, 2022, was $272,197 compared to $149,208 for the same period in 2021, an increase of 82.4%. The ERC of $26,950 and $88,700 was included in the three and nine months ended September 30, 2021, respectively. Specialty materials are being researched for use in niche markets which include custom applications and additive manufacturing. Our development efforts utilize a disciplined innovation approach focused on accelerating time to market for these applications and involve ongoing research and development expense.

Marketing and sales expense

Marketing and sales expense was $94,594 and $61,732 for the three months ended September 30, 2022, and 2021, respectively. This was an increase of 53.2%. Marketing and sales expense was $284,922 and $159,559 for the nine months ended September 30, 2022, and 2021, respectively, an increase of 78.6%.

Travel expenses increased approximately $2,000 and $41,000 during the three and nine months ended September 30, 2022, respectively, versus the same periods in 2021, as we resumed in-person meetings with some customers and participated onsite in additional industry trade shows. The three and nine months ended September 30, 2021, included the ERC of $21,000 and $71,183, respectively.

Stock compensation expense

Included in total expenses were noncash stock-based compensation costs of $8,670 for the three months ended September 30, 2022 and 2021, and $40,642 and $39,233 for the nine months ended September 30, 2022, and 2021, respectively. Compensation expense for all stock-based awards is based on the grant date fair value and recognized over the required service (vesting) period. Unrecognized non-cash stock-based compensation expense was $2,758 as of September 30, 2022 and will be recognized through the second quarter of 2023.

Interest

Interest income was $363 for the three months ended September 30, 2022. Interest expense was $8,156 for the three months ended September 30, 2021. Interest expense was $11,899 for the nine months ended September 30, 2022, and $24,808 for the nine months ended September 30, 2021. The improvement during 2022 was due to final payments of multiple finance leases during 2021 and the increase in interest rates during the third quarter of 2022.

Income taxes

Income tax expense was $167,375 and $200,189 for the three months ended September 30, 2022, and 2021, respectively, and $311,575 and $338,282 for the nine months ended September 30, 2022, and 2021, respectively. At December 31, 2021, the deferred tax asset was $663,820. As of each reporting date, management considers new evidence, both positive and negative, that could affect its view of the future realization of deferred tax assets. Accordingly, management determined that no valuation allowance was necessary, and the deferred tax asset was $375,820 at September 30, 2022.

Income applicable to common stock

Income applicable to common stock for the three months ended September 30, 2022, and 2021, was $442,703 and $662,644, respectively. The third quarter of 2021 included the ERC of $153,713 which reduced overall expenses. Income applicable to common stock for the nine months ended September 30, 2022, and 2021, was $1,491,977 and $1,424,701, respectively. The increase was primarily the result of higher revenue and gross profit. Included in the first nine months of 2021 was the ERC which reduced overall expenses by $560,921.

Liquidity and Capital Resources

Cash

As of September 30, 2022, cash on hand was $5,614,257 compared to $4,140,942 at December 31, 2021. The increase was principally due to record total revenue and higher gross profit for the first nine months of 2022.

Working capital

At September 30, 2022 working capital was $5,443,552 compared to $3,907,135 at December 31, 2021, an increase of $1,536,417 or 39.3%. Cash increased $1,473,315, inventories increased $379,370, accounts payable increased $256,365 and receivables increased $156,805 while prepaid expenses decreased $586,565, and customer deposits decreased $442,378.

Cash from operations

Net cash provided by operating activities during the nine months ended September 30, 2022, was $2,051,679 and $1,780,698 for the nine months ended September 30, 2021. In addition to the net income generated, this included depreciation and amortization of $308,791 and $329,104, and noncash stock-based compensation costs of $40,642 and $39,233 for the nine months ended September 30, 2022, and 2021, respectively.

The decrease in prepaid expenses was related to the receipt of inventory paid for in December 2021 and received in January 2022. Inventories and accounts payable increased due to orders received during the third quarter and throughout the first nine months of 2022. Customer orders remain strong, and deposits are lower as customers have monitored inventory more closely with continued emphasis on intra-quarter shipments.

Cash from investing activities

Cash of $511,399 and $615,088 was used in investing activities during the nine months ended September 30, 2022, and September 30, 2021, respectively, for the acquisition of production equipment. This included a vacuum hot press that enables production of higher temperature materials with increased capacity. It was purchased and installed for approximately $500,000. A deposit of $220,075 was paid in the first quarter of 2021 for this vacuum hot press and the remaining amount was paid in cash during the third quarter of 2022.

Cash from financing activities

Cash of $72,131 and $123,715 was used in financing activities for principal payments to third parties for finance lease obligations during the nine months ended September 30, 2022, and 2021, respectively. The decrease was due to final payments of multiple finance leases during 2021. A cash dividend payment of $24,152 was made to owners of our Series B preferred stock during the nine months ended September 30, 2021.

Debt outstanding

Total debt outstanding was $171,087 at September 30, 2022, compared to $243,218 at December 31, 2021, a decrease of 29.7%. As previously mentioned, cash of $72,131 was used for principal payments for finance lease obligations during 2022.

Off Balance Sheet Arrangements

We have no off-balance sheet arrangements including special purpose entities.

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make judgments, assumptions and estimates that affect the amounts reported in the Financial Statements and accompanying notes. Note 2 to the Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2021, describes the significant accounting policies and methods used in the preparation of the Financial Statements. Estimates are used for, but not limited to, accounting for the allowance for doubtful accounts, inventory allowances, property and equipment depreciable lives, patents and licenses useful lives, revenue recognition, income tax expense, deferred tax assets and liabilities, realization of deferred tax assets, stock-based compensation and assessing changes in which impairment of certain long-lived assets may occur. Actual results could differ from these estimates. The following critical accounting policies are impacted significantly by judgments, assumptions and estimates used in the preparation of the Financial Statements. The allowance for doubtful accounts is based on our assessment of the collectability of specific customer accounts and the aging of the accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than our historical experience, our estimates of the recoverability of amounts due us could be adversely affected. Inventory purchases and commitments are based upon future demand forecasts. If there is a sudden and significant decrease in demand for our products or there is a higher risk of inventory obsolescence because of rapidly changing technology and customer requirements, we may be required to increase our inventory allowances and our gross margin could be adversely affected. The tax valuation allowance is based on our consideration of new evidence, both positive and negative, that could affect our view of the future realization of deferred tax assets. If we were to determine we would not be able to realize all or part of the deferred tax asset in the future, an adjustment to the deferred tax asset would be necessary which would reduce our net income for that period. Depreciable and useful lives estimated for property and equipment, licenses and patents are based on initial expectations of the period of time these assets and intangibles will benefit us. Changes in circumstances related to a change in our business, change in technology or other factors could result in these assets becoming impaired, which could adversely affect the value of these assets.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and implemented, can only provide reasonable assurance of achieving the desired control objectives. Management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, to allow timely discussions regarding required disclosure.

Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective. Disclosure controls and procedures are defined by Rules 13a-15(e) and 15d-15(e) of the Exchange Act as controls and other procedures that are designed to ensure that information required to be disclosed by us in reports filed with the SEC under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms.

Inherent Limitations over Internal Controls

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

Management is responsible for the consistency, integrity, and presentation of information. We fulfill our responsibility by maintaining systems of internal control designed to provide reasonable assurance that assets are safeguarded, and transactions are executed in accordance with established procedures. The concept of reasonable assurance is based upon recognition that the cost of the controls should not exceed the benefit derived. We believe our systems of internal control provide this reasonable assurance.

The Board of Directors exercises its oversight role with respect to our systems of internal control primarily through its Audit Committee, which is comprised of independent directors. The Committee oversees our financial reporting, quarterly reviews, and audits to assess whether their quality, integrity, and objectivity are sufficient to protect shareholders' investments.

Changes in Internal Controls over Financial Reporting

There were no changes in our internal controls over financial reporting for the three months ended September 30, 2022, that materially affected or were reasonably likely to materially affect our disclosure controls and procedures. Additionally, there were no changes in our internal controls that could materially affect our disclosure controls and procedures subsequent to the date of their evaluation.

Item 6. Exhibits

3(a)		Certificate of Second Amended and Restated Articles of Incorporation of Superconductive Components, Inc. (Incorporated by reference to Exhibit 3(a) to the Company's initial Form 10-SB, filed on September 28, 2000)
3(b)		Restated Code of Regulations of Superconductive Components, Inc. (Incorporated by reference to Exhibit 3(b) to the Company's initial Form 10-SB, filed on September 28, 2000)
3(c)		Amendment to Articles of Incorporation recording the change of the corporate name to SCI Engineered Materials, Inc. (Incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-QSB filed November 7, 2007).
4(a)		SCI Engineered Materials, Inc. 2011 Stock Incentive Plan (Incorporated by reference to the Company's Definitive Proxy Statement for the 2011 Annual Meeting of Shareholders held on June 10, 2011, filed April 28, 2011).
4(b)		Superconductive Components, Inc. 2006 Stock Incentive Plan (Incorporated by reference to Appendix A to the Company's Definitive Proxy Statement for the 2006 Annual Meeting of Shareholders held on June 9, 2006, filed May 1, 2006).
10(a)		Description of Unsecured Promissory Note administered by the U.S. Small Business Administration for funds received April 24, 2020 (Incorporated by reference to the Company's Current Report on Form 8-K, dated April 29, 2020).
14(a)		SCI Engineered Materials Code of Ethics for the Chief Executive Officer and Chief Financial Officer (Incorporated by reference to the Company's Current Report via the Company's website at www.sciengineeredmaterials.com).
31.1	*	Rule 13a-14(a) Certification of Principal Executive Officer.
31.2	*	Rule 13a-14(a) Certification of Principal Financial Officer.
32.1	*	Section 1350 Certification of Principal Executive Officer.
32.2	*	Section 1350 Certification of Principal Financial Officer.
99.1	*	Press Release dated October 28, 2022, entitled "SCI Engineered Materials, Inc., Reports 2022 Third Quarter and Year-to-date Results."
101		The Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2022, formatted in iXBRL (Inline eXtensible Business Reporting Language): (i) Balance Sheets at September 30, 2022 and December 31, 2021 (ii) Statements of Income for the three and nine months ended September 30, 2022 and 2021, (iii) Statement of Changes in Equity for the three and nine months ended September 30, 2022 and 2021, (iv) Statements of Cash Flows for the nine months ended September 30, 2022 and 2021, and (v) Notes to Financial Statements.
104		Cover Page Interactive Data File (formatted as Inline XBRL and contained in Exhibit 101).

* Filed herewith

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.

SCI ENGINEERED MATERIALS, INC.

Date: October 28, 2022

/s/ Jeremiah R. Young
Jeremiah R. Young, President, and Chief Executive Officer
(Principal Executive Officer)

/s/ Gerald S. Blaskie
Gerald S. Blaskie, Vice President, and Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)

XBRL-Only Content Section

21

Element	Value
dei:EntityCentralIndexKey	0000830616
dei:CurrentFiscalYearEndDate	--12-31
dei:DocumentFiscalYearFocus	2022
deiDocumentFiscalPeriodFocus	Q3
dei:AmendmentFlag	false