

DGSE COMPANIES INC
Form 10-K
April 15, 2011

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

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO SECTIONS 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

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

For the fiscal year ended December 31, 2010

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

Commission File No. 001-11048

DGSE COMPANIES, INC.
(Exact name of registrant as specified in its charter)

Nevada	88-0097334
(State or other	(I.R.S.
jurisdiction of	Employer
incorporation or	Identification
organization)	No.)

11311 Reeder Road
Dallas, Texas 75229
972-484-3662
(Address, including zip code, and telephone
number, including area code, of registrant's
principal executive offices)

Securities registered pursuant to Section 12(b) of the Act: None

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

Common Stock, par value \$.01 per
share
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

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YES [] NO []

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

YES [] NO []

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. []

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

Large accelerated filer [] Accelerated filer []
Non-accelerated filer [] (Do not check if a smaller reporting company) Smaller Reporting Company []

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

YES [] NO []

Aggregate market value of the 3,774,762 shares of Common Stock held by non-affiliates of the registrant at the closing sales price as reported on the NYSE Amex on June 30, 2010	\$11,965,995
Number of shares of Common Stock outstanding as of the close of business on April 13, 2010:	9,986,100

Documents incorporated by reference:

Portions of the definitive proxy statement relating to the 2011 Annual Meeting of Stockholders of DGSE Companies, Inc. are incorporated by reference into Part III of this report.

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ITEM 1. BUSINESS.

Overview

Unless the context indicates otherwise, references to "we," "us", "our" and "DGSE" refers to the consolidated business operations of DGSE Companies, Inc., the parent, and all of its direct and indirect subsidiaries.

We buy and sell jewelry, bullion products and rare coins. Our customers include individual consumer, dealers and institutions throughout the United States. Our products and services are marketed through our facilities in Dallas and Euless, Texas; Mt. Pleasant, South Carolina; Woodland Hills, California and through our internet web sites DGSE.com; CGDEinc.com; SGBH.com; SuperiorPreciousMetals.com; SuperiorEstateBuyers.com; USBullionExchange.com; Americangoldandsilverexchange.com; and FairchildWatches.com.

We operate eight primary internet sites and over 900 related landing sites on the World Wide Web. Through the various sites we operate a virtual store, real-time auction of rare coin and jewelry products, free quotations of current prices on all commonly traded precious metal and related products, trading in precious metals, a mechanism for selling unwanted jewelry, rare coins and precious metals and wholesale prices and information exclusively for dealers on pre-owned fine watches. Over 7,500 items are available for sale on our internet sites including \$2,000,000 in diamonds.

On May 9, 2007 we purchased all of the tangible assets of Euless Gold and Silver, Inc., located in Euless, Texas. We opened a new retail store in the former Euless Gold & Silver facility and it operates under the name of Dallas Gold & Silver Exchange.

On May 30, 2007, we completed the acquisition of Superior Galleries, Inc. located in Beverly Hills, California. In June 2008, we moved Superior Galleries operations from Beverly Hills to Woodland Hills, California. Superior's principal line of business is the sale of rare coins on a retail and wholesale basis. Superior's retail and wholesale operations are conducted in virtually every state in the United States. Superior also conducted live and internet auctions for customers seeking to sell their own coins prior to management's decision to discontinue the live auction operations. Superior markets its services nationwide through broadcast and print media and independent sales agents, as well as on the internet through third party websites, and through its own website at SGBH.com.

On August 3, 2007 we announced the launch of Americangoldandsilverexchange.com along with the simultaneous activation of over 900 proprietary Internet sites related to the home page of Americangoldandsilverexchange.com. This site, along with our existing locations in Texas, California and South Carolina, provides customers from all over the United States with a seamless and secure way to value and sell gold, silver, rare coins, jewelry, diamonds and watches.

Late in 2007, Superior Estate Buyers was launched to bring our unique expertise in the purchase of gold, silver, diamonds, rare coins and other collectibles to local markets with a team of traveling professionals for short-term buying events. .

Superior Precious Metals was also launched in late 2007 and functions as a retail precious metals arm of DGSE. Professional account managers provide a convenient way for individuals and companies to buy and sell precious metals and rare coins. This activity is supported by the internally developed account management and trading platform created as part of DGSE's USBullionExchange.com precious metals system.

In June 2009 we sold the assets of National Jewelry Exchange, Inc. (our two pawn shops) to an unrelated third party.

Products and Services

Our jewelry operations include sales to both wholesale and retail customers. We sell finished jewelry, gem stones, and findings (gold jewelry components) and make custom jewelry to order. Jewelry inventory is readily available from wholesalers throughout the United States. In addition, we purchase inventory from pawn shops and individuals. Jewelry repair is also available to our customers in our all of our store locations.

Our bullion and rare coin trading operations buy and sell all forms of precious metals products including United States and other government coins, medallions, art bars and trade unit bars. Bullion and rare coin transactions are conducted at all of our store locations.

Bullion and rare coin products are purchased and sold based on current market price. The availability of precious metal products is a function of price as virtually all bullion items are actively traded. Precious metals sales amounted to 52.1% of total revenues for 2010, 50.0% in 2009 and 43.2% in 2008.

We have a jewelry super store located in Mt. Pleasant, South Carolina. The store operates through a wholly owned subsidiary, Charleston Gold and Diamond Exchange, Inc. (“CGDE”). CGDE operates in a leased facility located in Mt. Pleasant, South Carolina.

Our primary presence on the internet is through our websites DGSE.com, CGDEinc.com, SGBH.com, Superiorpreciousmetals.com, Superiorestatebuyers.com, USBullionexchange.com, Americangoldandsilverexchange.com, and Fairchildwatches.com. The DGSE.com web site serves as a corporate information site, a retail store where we sell our products and an auction site for jewelry and other products. The internet store functions as a CyberCash™ authorized site which allows customers to purchase products automatically and securely on line.

The SGBH.com website services as a primary rare coin marketing site and also includes a retail store.

Americangoldandsilverexchange.com provides customers from all over the United States with a simple and secure method to sell unwanted valuables by sending them directly to our corporate facilities for evaluation. Customers are provided with a firm purchase price which they can reject or accept for immediate payment.

Our internet activity also includes a web site, USBullionExchange.com, which allows customers unlimited access to current quotations for prices on approximately 200 precious metals, coins and other bullion related products. This web site allows customers to enter immediate real-time buy and sell orders in dozens of precious metal products. This functionality allows our customers to fix prices in real time and to manage their precious metals portfolios in a comprehensive way.

We also offer wholesale customers a virtual catalog of our fine watch inventory through our web site Fairchildwatches.com.

We did not have any customer or supplier that accounted for more than 10% of total sales or purchases during 2009 or 2008. However in 2010, 27.0% of our sales and 11.6% of our purchases were transactions with NTR Metals, LLC (“NTR”).

On May 25, 2010, we entered into a Closing Agreement, dated May 25, 2010 with NTR, a Texas limited liability company, and Dr. L.S. Smith, our CEO. Pursuant to the Closing Agreement and that certain Purchase and Sale Agreement (and Amendments thereto), dated January 27, 2010, by and among us and Stanford International Bank, Ltd. (“SIBL”), an entity organized under the laws of Antigua, we assigned our right to acquire three million (3,000,000)

shares of our common stock, par value \$0.01 per share (the “NTR Acquired Interest”), from SIBL to NTR, whereby NTR acquired the NTR Acquired Interest directly from SIBL for a cash purchase price of \$3,600,000 paid to SIBL by NTR.

Simultaneously with the Closing, NTR granted to Dr. Smith a 4-year proxy (the “NTR Proxy”) on the NTR Acquired Interest. NTR will not be represented on our Board of Directors, nor will NTR be otherwise involved in the management of the Registrant. In addition, NTR has entered into a one-year Lock-Up Agreement on the NTR Acquired Interest. In exchange for NTR’s grant of the NTR Proxy, Dr. Smith granted to NTR an option (the “Option”) to acquire one million (1,000,000) shares of our common stock owned by Dr. Smith, at an exercise price of \$6.00 per share for the first two years following the anniversary of the Closing. If the Option remains unexercised on the second anniversary following the Closing, then the exercise price shall increase to \$10.00 per share for the third and fourth years following the anniversary of Closing. The NTR Proxy shall terminate, and the voting rights on the NTR Acquired Interest shall revert back to NTR, upon the occurrence of: 1) NTR’s exercise of the Option at any time during the four-year Option period; or 2) the death of Dr. Smith.

Pursuant to the Closing Agreement, NTR has been granted piggy-back registration rights with respect to those shares of the NTR Acquired Interest that remain restricted securities (the "Remaining Shares"). The Remaining Shares may, in the event that we propose to register any of its securities for public sale under the Securities Act of 1933, as amended (the "Securities Act"), and upon timely written request from NTR, be included in the registration statement covering those securities being registered for sale by DGSE under the Securities Act.

Sales and Marketing

All of our activities rely heavily on local television, radio and print media advertising. Marketing activities emphasize our broad and unusual array of products and services and the attractiveness of its pricing and service.

We market our bullion and rare coin trading services through a combination of advertising in national coin publications, local print media, coin and bullion wire services and our internet web site. Trades are primarily with coin and bullion dealers on a "cash on confirmation" basis which is prevalent in the industry. Cash on confirmation means that once credit is approved the buyer remits funds by mail or wire concurrently with the mailing of the precious metals. Customer orders for bullion or rare coin trades are customarily delivered within three days of the order or upon clearance of funds depending on the customer's credit standing. Our backlogs for fabricated jewelry products were not significant as of December 31, 2010, 2009 and 2008.

Seasonality

The retail and wholesale jewelry business is seasonal. We realized 31.9%, 25.9% and 22.2% of our annual sales in the fourth quarters of 2010, 2009 and 2008, respectively.

While our bullion and rare coin business is not seasonal, management believes it is directly impacted by the perception of inflation trends. Historically, anticipation of increases in the rate of inflation has resulted in higher levels of interest in precious metals as well as higher prices for such metals. Our other business activities are not seasonal.

Competition

We operate in a highly competitive industry where competition is based on a combination of price, service and product quality. Our jewelry activities compete with numerous other retail jewelers in Dallas and Euless, Texas; Woodland Hills, California; and Mt. Pleasant, South Carolina and the surrounding areas.

The bullion and rare coin industry in which we compete is dominated by substantially larger enterprises which wholesale bullion, rare coin and other precious metal products.

We attempt to compete in all of our activities by offering high quality products and services at prices below that of our competitors and by maintaining a staff of highly qualified employees.

Employees

As of December 31, 2010, we employed 70 individuals, 66 of whom were full time employees.

Available Information

Our website is located at www.dgse.com. Through this website, we make available free of charge all of our Securities and Exchange Commission filings. In addition, a complete copy of our Code of Ethics is available through this

website.

Discontinued Operations and Acquisitions

Discontinued Operations.

In December 2008 we decided to discontinue the live auction segment of the Company's business activities. This decision was based on the substantial losses being incurred by this operating segment during 2008 and 2007. As a result, the operating results of the auction segment have been reclassified to discontinued operations for 2008 and 2009. During 2008 the auction segment incurred a pretax loss of \$2,379,151 and during 2009 the auction segment incurred a pretax loss of \$795,328. The 2009 loss is the last of the charges from the auction segment.

In June 2009 we sold the assets of National Jewelry Exchange, Inc. (our two pawn shops) to an unrelated third party for cash in the amount of \$1,324,450. The proceeds were used to retire \$400,000 of our bank debt and the balance was used for working capital. As a result, operating results from National Jewelry Exchange have been reclassified to discontinued operations for all periods presented.

In November 2009 we discontinued the operations of Superior Estate Buyers due to operating loss incurred during the first half of 2009 in the amount of \$87,120.

As a result, operating results from these business segments have been reclassified to discontinued operations for all periods presented. As of December 31, 2010 there were no operating assets to be disposed of or liabilities to be paid in completing the disposition of these operations.

ITEM 1A. RISK FACTORS.

You should carefully consider the risks described below before making an investment decision. We believe these are all the material risks currently facing our business. Our business, financial condition or results of operations could be materially adversely affected by these risks. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment. You should also refer to the other information included or incorporated by reference in this report, including our financial statements and related notes.

Changes in customer demand for our products and services could result in a significant decrease in revenues.

Although our customer base commonly uses our products and services, our failure to meet changing demands of our customers could result in a significant decrease in our revenues.

Changes in governmental rules and regulations applicable to the specialty financial services industry could have a negative impact on our lending activities.

Our lending is subject to extensive regulation, supervision and licensing requirements under various federal, state and local laws, ordinances and regulations. New laws and regulations could be enacted that could have a negative impact on our lending activities.

Fluctuations in our inventory turnover and sales.

We regularly experience fluctuations in our inventory balances, inventory turnover and sales margins, yields on loan portfolios and pawn redemption rates. Changes in any of these factors could materially and adversely affect our profitability and ability to achieve our planned results.

Changes in our liquidity and capital requirements could limit our ability to achieve our plans.

We require continued access to capital, and a significant reduction in cash flows from operations or the availability of credit could materially and adversely affect our ability to achieve our planned growth and operating results. Similarly, if actual costs to build new stores significantly exceeds planned costs, our ability to build new stores or to operate new stores profitably could be materially restricted. The DGSE credit agreement also limits the allowable amount of capital expenditures in any given fiscal year, which could limit our ability to build new stores.

Changes in competition from various sources could have a material adverse impact on our ability to achieve our plans.

In the coins and other collectibles business, we will compete with a number of comparably sized and smaller firms, as well as a number of larger firms throughout the United States. Our primary competitors are American Numismatic Rarities, a comparably-sized coin auctioneer. Many of our competitors have the ability to attract customers as a result of their reputation and the quality collectibles they obtain through their industry connections. Additionally, other reputable companies that sell rare coins and other collectibles may decide to enter our markets to compete with us. These companies have greater name recognition and have greater financial and marketing resources than we do. If these auction companies are successful in entering the specialized market for premium collectibles in which we participate or if dealers and sellers participate less in our auctions, we may attract fewer buyers and our revenue could decrease.

Our earnings could be negatively impacted by an unfavorable outcome of litigation, regulatory actions, or labor and employment matters.

From time to time, we are involved in litigation, regulatory actions and labor and employment matters arising from our normal operations. There can be no assurance as to the ultimate outcome of any future actions and that they will not have a material adverse effect on our financial condition, results of operation or liquidity.

A failure in our information systems could prevent us from effectively managing and controlling our business or serving our customers.

We rely on our information systems to manage and operate our stores and business. Each store is part of an information network that permits us to maintain adequate cash inventory, reconcile cash balances daily and report revenues and expenses timely. Any disruption in the availability of our information systems could adversely affect our operation, the ability to serve our customers and our results of operations.

A failure of our internal controls and disclosure controls and procedures could have a material adverse impact on us and our investors' confidence in our reported financial information.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls or internal controls over financial reporting will prevent all errors or all instances of fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and any design may not succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitation of a cost-effective control system, misstatements due to error or fraud may occur and not be detected. If we fail to maintain a system of effective internal controls, it could have a material adverse effect on our business, financial position or operating results. Additionally, adverse publicity related to a failure in our internal controls over financial reporting could have a negative impact on our reputation and business.

This Annual Report on Form 10-K does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this Annual Report on Form 10-K.

Changes in general economic conditions could negatively affect loan performance and demand for our products and services.

A sustained deterioration in the economic environment could adversely affect our operations by reducing consumer demand for the products we sell.

Interest rate fluctuations could increase our interest expense.

Although the U.S. Federal Reserve halted a sustained period of regular interest rate hikes in August 2006, interest rates could rise which would, in turn, increase our cost of borrowing.

Our success depends on our ability to attract, retain and motivate management and other skilled employees.

Our future success and growth depend on the continued services of our key management and employees. The loss of the services of any of these individuals or any other key employee or contractor could materially affect our business. Our future success also depends on our ability to identify, attract and retain additional qualified personnel. Competition for employees in our industry is intense and we may not be successful in attracting or retaining them. There are a limited number of people with knowledge of, and experience in, our industry. We do not have employment agreements with many of our key employees. We do not maintain life insurance policies on many of our employees. Our loss of key personnel, especially without advance notice, or our inability to hire or retain qualified personnel, could have a material adverse effect on sales and our ability to maintain our technological edge. We cannot guarantee that we will continue to retain our key management and skilled personnel, or that we will be able to attract, assimilate and retain other highly qualified personnel in the future.

The voting power in our company is substantially controlled by a small number of stockholders, which may, among other things, delay or frustrate the removal of incumbent directors or a takeover attempt, even if such events may be beneficial to our stockholders.

On May 25, 2010, we entered into a Closing Agreement, dated May 25, 2010 with NTR Metals, LLC, a Texas limited liability company, and Dr. L.S. Smith, our CEO. Pursuant to the Closing Agreement and that certain Purchase and Sale Agreement (and Amendments thereto), dated January 27, 2010, by and among us and Stanford International Bank, Ltd. ("SIBL"), an entity organized under the laws of Antigua, we assigned our right to acquire three million (3,000,000) shares of our common stock, par value \$0.01 per share (the "NTR Acquired Interest"), from SIBL to NTR, whereby NTR acquired the NTR Acquired Interest directly from SIBL for a cash purchase price of \$3,600,000 paid to SIBL by NTR.

Simultaneously with the Closing, NTR granted to Dr. Smith a 4-year proxy (the "NTR Proxy") on the NTR Acquired Interest. NTR will not be represented on our Board of Directors, nor will NTR be otherwise involved in the management of the Registrant. In addition, NTR has entered into a one-year Lock-Up Agreement on the NTR Acquired Interest. In exchange for NTR's grant of the NTR Proxy, Dr. Smith granted to NTR an option (the "Option") to acquire one million (1,000,000) shares of our common stock owned by Dr. Smith, at an exercise price of \$6.00 per share for the first two years following the anniversary of the Closing. If the Option remains unexercised on the second anniversary following the Closing, then the exercise price shall increase to \$10.00 per share for the third and fourth years following the anniversary of Closing. The NTR Proxy shall terminate, and the voting rights on the NTR Acquired Interest shall revert back to NTR, upon the occurrence of: 1) NTR's exercise of the Option at any time during the four-year Option period; or 2) the death of Dr. Smith.

We could be subject to sales taxes, interest and penalties on interstate sales for which we have not collected taxes.

Superior has not collected California sales tax on mail-order sales to out-of-state customers, nor has it collected use tax on its interstate mail order sales. We believe that our sales to interstate customers are generally tax-exempt due to varying state exemptions relative to the definitions of being engaged in business in particular states and the lack of current Internet taxation. While we have not been contacted by any state authorities seeking to enforce sales or use tax regulations, we cannot assure you that we will not be contacted by authorities in the future with inquiries concerning our compliance with current statutes, nor can we assure you that future statutes will not be enacted that affect the sales and use tax aspects of our business.

We may incur losses as a result of accumulating inventory.

A substantial portion of the products that we sell comes from our own inventory. We purchased these products from dealers and collectors and assume the inventory and price risks of these items until they are sold. If we are unable to resell the products that we purchase when we want or need to, or at prices sufficient to generate a profit from their resale, or if the market value of the inventory of purchased products were to decline, our revenue would likely decline.

Our planned expansion and enhancement of our websites and internet operations may not result in increased profitability.

The satisfactory performance, reliability and availability of our website and network infrastructure are and will be critical to our reputation and our ability to attract and retain customers and technical personnel and to maintain adequate customer service levels. Any system interruptions or reduced performance of our website could materially adversely affect our reputation and our ability to attract new customers and technical personnel. We are in the process of development and/or enhancement of several portions of our websites that will offer content and auctions for rare coins that may have a lower average selling price than many of the rare coins in the markets we currently serve, and in the future we plan to integrate various of our websites. Continued development of our websites will require significant resources and expense. If the planned expansion of our websites does not result in increased revenue, we may experience decreased profitability.

Our websites may be vulnerable to security breaches and similar threats which could result in our liability for damages and harm to our reputation.

Despite the implementation of network security measures, our websites are vulnerable to computer viruses, break-ins and similar disruptive problems caused by internet users. These occurrences could result in our liability for damages, and our reputation could suffer. The circumvention of our security measures may result in the misappropriation of customer or other confidential information. Any such security breach could lead to interruptions and delays and the cessation of service to our customers and could result in a decline in revenue and income.

Changes to financial accounting standards and new exchange rules could make it more expensive to issue stock options to employees, which would increase compensation costs and may cause us to change our business practices.

We prepare our financial statements to conform with generally accepted accounting principles, or GAAP, in the United States. These accounting principles are subject to interpretation by the Public Company Accounting Oversight Board, the SEC and various other bodies. A change in those policies could have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced.

We are subject to new corporate governance and internal control reporting requirements, and our costs related to compliance with, or our failure to comply with existing and future requirements could adversely affect our business.

We may incur significant legal, accounting and other expenses as a result of our required compliance with certain regulations. More specifically, the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”), as well as rules subsequently implemented by the SEC, impose various requirements on public companies. Our management and other personnel must devote a substantial amount of time to these compliance requirements. Moreover, these rules and regulations have increased our legal and financial compliance costs and make some activities more time-consuming and costly.

The Sarbanes-Oxley Act requires, among other things, that we maintain effective internal controls for financial reporting and disclosure controls and procedures. In particular, beginning with our year ended December 31, 2007, management was required to perform system and process evaluation and testing of the effectiveness of our internal controls over financial reporting, as required by Section 404(a) of the Sarbanes-Oxley Act. Section 404(b) of the Sarbanes-Oxley Act required companies to obtain auditor’s attestation related to their assessment of the effectiveness of our internal controls over financial reporting. The compliance deadline for smaller reporting companies to comply with Section 404(b) had been extended by the SEC to annual reports covering fiscal years ended on or after June 15, 2010, or in our case for our annual report covering our year ended December 31, 2010.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Wall Street Reform Act”). Section 989G of the Wall Street Reform Act expressly exempts issuers that are neither “large accelerated filers” nor “accelerated filers” (which includes smaller reporting companies) from the requirement contained in Section 404(b) of the Sarbanes Oxley Act to provide an auditor attestation of internal control over financial reporting.

Although we are no longer required to comply with Section 404(b), we remain subject to Section 404(a) (that is, management’s report on our internal controls over financial reporting). Our testing may reveal deficiencies in our internal controls over financial reporting that are deemed to be material weaknesses. As a result, our compliance with Section 404(a) may require that we incur substantial accounting expense and expend significant management efforts. We do not have an internal audit group, and we may need to hire additional accounting and financial staff with appropriate public company experience and technical accounting knowledge to ensure compliance with these regulations and/or to correct such material weaknesses. If we are not able to comply with the requirements of Section

404(a), or if we identify deficiencies in our internal controls over financial reporting, the market price of our common shares could decline, and we could be subject to sanctions or investigations by the SEC or other regulatory authorities, which would require additional financial and management resources.

The revolving credit facility with Texas Capital Bank, N.A. is collateralized by a general security interest in our assets. If we were to default under the terms of the credit facility, the lender would have the right to foreclose on our assets.

In December 2005, we entered into a revolving credit facility with Texas Capital Bank, N.A., which permits borrowings up to a maximum principal amount of \$4.5 million. Borrowings under the revolving credit facility are collateralized by a general security interest in substantially all of our assets (other than the assets of Superior). As of December 31, 2010, approximately \$4.5 million was outstanding under the term loan and revolving credit facility. If we were to default under the terms and conditions of the revolving credit facility, Texas Capital Bank would have the right to accelerate any indebtedness outstanding and foreclose on our assets in order to satisfy our indebtedness. Such a foreclosure could have a material adverse effect on our business, liquidity, results of operations and financial position.

We have not paid dividends on our common stock in the past and do not anticipate paying dividends on our common stock in the foreseeable future.

We have not paid common stock dividends since our inception and do not anticipate paying dividends in the foreseeable future. Our current business plan provides for the reinvestment of earnings in an effort to complete development of our technologies and products, with the goal of increasing sales and long-term profitability and value. In addition, our revolving credit facility with Texas Capital Bank currently restricts, and any other credit or borrowing arrangements that we may enter into may in the future restrict or limit, our ability to pay dividends to our stockholders.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES.