

WINLAND ELECTRONICS INC

Form 10QSB

November 10, 2005

**Table of Contents**

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

**FORM 10-QSB  
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF  
THE SECURITIES EXCHANGE ACT OF 1934**

**For the Quarter Ended September 30, 2005**

**Commission File Number: 0-15637**

**WINLAND ELECTRONICS, INC.**

(Name of small business issuer in its charter)

**Minnesota**

(state or other jurisdiction of  
incorporation or organization)

**41-0992135**

(I.R.S. Employer  
Identification Number)

**1950 Excel Drive, Mankato, Minnesota 56001**

(Address of principal executive offices)

**(507) 625-7231**

(Issuer's telephone number)

Check whether the Issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the Issuer 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 shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

There were 3,521,848 shares of Common Stock, \$.01 par value, outstanding as of November 9, 2005.

Transitional Small Business Disclosure Format (check one): Yes  No

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**TABLE OF CONTENTS**

**PART I-FINANCIAL INFORMATION**

**ITEM 1: FINANCIAL STATEMENTS**

**ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

**ITEM 3. CONTROLS AND PROCEDURES**

**PART II OTHER INFORMATION**

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

**ITEM 6. EXHIBITS**

**SIGNATURES**

**EXHIBIT INDEX TO FORM 10-QSB**

**Certification of CEO Pursuant to Section 302**

**Certification of CFO Pursuant to Section 302**

**Certification of CEO Pursuant to Section 906**

**Certification of CFO Pursuant to Section 906**

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**Table of Contents****PART I-FINANCIAL INFORMATION****ITEM 1: FINANCIAL STATEMENTS****WINLAND ELECTRONICS, INC.****BALANCE SHEETS**

|                                     | <b>September 30<br/>2005<br/>(UNAUDITED)</b> | <b>December 31,<br/>2004</b> |
|-------------------------------------|--|------------------------------|
| <b>ASSETS</b>                       |  |                              |
| Current Assets                      |  |                              |
| Cash                                | \$ 1,016,058                                 | \$ 457,576                   |
| Accounts receivable, net            | 3,541,692                                    | 2,774,373                    |
| Income tax receivable               |  | 30,293                       |
| Inventories                         |  |                              |
| Raw materials                       | 3,430,524                                    | 1,697,483                    |
| Work in process                     | 205,520                                      | 257,050                      |
| Finished goods                      | 1,496,575                                    | 1,573,614                    |
| Allowance for obsolete inventory    | (154,800)                                    | (150,000)                    |
| Total inventories                   | 4,977,819                                    | 3,378,147                    |
| Prepaid expenses                    | 505,132                                      | 285,337                      |
| Deferred taxes                      | 197,700                                      | 197,700                      |
| <b>Total current assets</b>         | <b>10,238,401</b>                            | <b>7,123,426</b>             |
| Other Assets                        | 1,434  | 85                           |
| Property and Equipment, at cost:    |  |                              |
| Land and land improvements          | 272,901                                      | 272,901                      |
| Building                            | 3,040,435                                    | 3,002,880                    |
| Machinery and equipment             | 4,849,575                                    | 4,675,060                    |
| Data processing equipment           | 1,162,177                                    | 1,372,474                    |
| Office furniture and equipment      | 407,309                                      | 366,915                      |
| <b>Total property and equipment</b> | <b>9,732,397</b>                             | <b>9,690,230</b>             |
| Less accumulated depreciation       | (5,482,373)                                  | (5,447,274)                  |
| <b>Net property and equipment</b>   | <b>4,250,024</b>                             | <b>4,242,956</b>             |
| <b>Total assets</b>                 | <b>\$ 14,489,859</b>                         | <b>\$ 11,366,467</b>         |

See Notes to the Interim Financial Statements

**Table of Contents****WINLAND ELECTRONICS, INC.  
BALANCE SHEETS**

|  | <b>September 30<br/>2005<br/>(UNAUDITED)</b> | December 31,<br>2004 |
|--|--|----------------------|
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>       |  |                      |
| Current Liabilities                              |  |                      |
| Revolving credit agreement                       | \$   | \$ 270,000           |
| Current maturities of long-term debt             | <b>542,168</b>                               | 396,017              |
| Accounts payable                                 | <b>2,536,314</b>                             | 960,423              |
| Accrued expenses:                                |  |                      |
| Compensation                                     | <b>909,246</b>                               | 618,411              |
| Other  | <b>133,784</b>                               | 261,173              |
| <b>Total current liabilities</b>                 | <b>4,121,512</b>                             | 2,506,024            |
| Long Term Liabilities                            |  |                      |
| Long-term debt, less current maturities          | <b>1,554,611</b>                             | 1,579,610            |
| Deferred taxes                                   | <b>263,800</b>                               | 263,800              |
| Deferred revenue                                 | <b>156,573</b>                               | 162,678              |
| <b>Total long-term liabilities</b>               | <b>1,974,984</b>                             | 2,006,088            |
| <b>Total liabilities</b>                         | <b>6,096,496</b>                             | 4,512,112            |
| Stockholders Equity                              |  |                      |
| Common stock                                     | <b>35,166</b>                                | 34,239               |
| Additional paid-in capital                       | <b>4,149,321</b>                             | 3,989,425            |
| Retained earnings                                | <b>4,208,876</b>                             | 2,830,691            |
| <b>Total stockholders equity</b>                 | <b>8,393,363</b>                             | 6,854,355            |
| <b>Total liabilities and stockholders equity</b> | <b>\$ 14,489,859</b>                         | \$ 11,366,467        |

See Notes to the Interim Financial Statements

**Table of Contents****WINLAND ELECTRONICS, INC.****STATEMENTS OF INCOME****For the Three Months and Nine Months Ended September 30, 2005 and 2004****(UNAUDITED)**

|   | Three Months Ended |              | Nine Months Ended   |               |
|---|--------------------|--------------|---------------------|---------------|
|   | 2005               | 2004         | 2005                | 2004          |
| Net sales   | \$ 7,399,885       | \$ 6,613,692 | \$ 21,542,640       | \$ 17,625,148 |
| Cost of sales   | 5,700,612          | 5,079,296    | 16,265,235          | 13,689,375    |
| <b>Gross profit</b>                                   | <b>1,699,273</b>   | 1,534,396    | <b>5,277,405</b>    | 3,935,773     |
| Operating expenses:                                   |                    |              |                     |               |
| General and administrative                            | 432,673            | 397,607      | 1,390,657           | 1,223,025     |
| Sales and marketing                                   | 321,205            | 315,789      | 997,904             | 946,287       |
| Research and development                              | 211,994            | 151,753      | 611,062             | 567,486       |
|   | 965,872            | 865,149      | 2,999,623           | 2,736,798     |
| <b>Operating income</b>                               | <b>733,401</b>     | 669,247      | <b>2,277,782</b>    | 1,198,975     |
| Other income (expenses):                              |                    |              |                     |               |
| Interest expense                                      | (32,564)           | (46,413)     | (92,537)            | (110,595)     |
| Other, net  | 15,195             | (4,880)      | 74,040              | 16,964        |
|   | (17,369)           | (51,293)     | (18,497)            | (93,631)      |
| <b>Income before income taxes</b>                     | <b>716,032</b>     | 617,954      | <b>2,259,285</b>    | 1,105,344     |
| Income tax expense                                    | (279,200)          | (241,000)    | (881,100)           | (431,000)     |
| <b>Net income</b>                                     | <b>\$ 436,832</b>  | \$ 376,954   | <b>\$ 1,378,185</b> | \$ 674,344    |
| Earnings per common share data:                       |                    |              |                     |               |
| Basic   | \$ 0.12            | \$ 0.11      | \$ 0.39             | \$ 0.20       |
| Diluted   | 0.12               | 0.11         | 0.38                | 0.19          |
| Weighted-average number of common shares outstanding: |                    |              |                     |               |
| Basic   | 3,519,476          | 3,366,542    | 3,493,663           | 3,360,980     |
| Diluted   | 3,690,430          | 3,485,670    | 3,649,174           | 3,535,633     |
| See Notes to the Interim Financial Statements         |                    |              |                     |               |

**Table of Contents**

**WINLAND ELECTRONICS, INC.**  
**STATEMENTS OF CASH FLOWS**  
**For the Nine Months Ended September 30, 2005 and 2004**  
**(UNAUDITED)**

|   | 2005             | 2004               |
|---|------------------|--------------------|
| Cash Flows From Operating Activities  |                  |                    |
| Net income  | \$ 1,378,185     | \$ 674,344         |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                  |                    |
| Depreciation and amortization   | 419,529          | 487,464            |
| Loss on disposal of equipment   | 1,202            | 3,196              |
| Investor relations expense, warrants issued   | 27,957           | 16,193             |
| Deferred taxes  |                  | (14,000)           |
| Changes in assets and liabilities:  |                  |                    |
| Accounts receivable   | (767,319)        | (951,414)          |
| Income tax receivable   | 30,293           | 122,749            |
| Inventories   | (1,599,671)      | (1,621,750)        |
| Prepaid expenses  | (210,275)        | (104,518)          |
| Accounts payable  | 1,575,891        | (268,980)          |
| Accrued expenses, including deferred revenue and income taxes payable                       | 157,340          | 123,903            |
| <b>Net cash provided by (used in) operating activities</b>                                  | <b>1,013,132</b> | <b>(1,532,813)</b> |
| Cash Flows From Investing Activities  |                  |                    |
| Purchases of property and equipment   | (429,148)        | (1,268,523)        |
| Proceeds from the sale of equipment   |                  | 18,500             |
| <b>Net cash used in investing activities</b>  | <b>(429,148)</b> | <b>(1,250,023)</b> |
| Cash flows From Financing Activities  |                  |                    |
| Net borrowings (payments) on revolving line of credit                                       | (270,000)        | 1,379,000          |
| Proceeds from note payable to bank  | 500,000          | 2,000,000          |
| Payments on long-term borrowings, including capital lease obligations                       | (378,848)        | (1,514,451)        |
| Proceeds from issuance of common stock  | 123,346          | 31,345             |
| <b>Net cash used in (provided by) financing activities</b>                                  | <b>(25,502)</b>  | <b>1,895,894</b>   |
| <b>Net increase (decrease) in cash</b>  | <b>558,482</b>   | <b>(886,942)</b>   |
| Cash  |                  |                    |
| Beginning   | 457,576          | 1,412,058          |
| End   | \$ 1,016,058     | \$ 525,116         |

Supplemental Disclosures of Cash Flow Information

Cash payments for:

|              |    |                |    |         |
|--------------|----|----------------|----|---------|
| Interest     | \$ | <b>84,104</b>  | \$ | 110,480 |
| Income taxes |    | <b>857,425</b> |    | 169,314 |

Supplemental Schedule of Noncash Financing Activities

|  |    |               |    |  |
|--|----|---------------|----|--|
| Warrants Issued in Connection with Investors Relations Services to be Provided | \$ | <b>37,477</b> | \$ |  |
|--|----|---------------|----|--|

See Notes to the Interim Financial Statements



**Table of Contents**

**WINLAND ELECTRONICS, INC.  
NOTES TO THE INTERIM FINANCIAL STATEMENTS  
(UNAUDITED)**

**Note 1. Basis of Presentation**

The accompanying unaudited financial information has been prepared by Winland Electronics Inc. (the Company) in accordance with accounting principles generally accepted in the United States of America for the preparation of interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair representation have been included. Financial results for the interim three month and nine month periods ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

The balance sheet at December 31, 2004 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

This financial information should be read in conjunction with the consolidated financial statements and notes included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2004.

**Reclassifications:** Certain income statement amounts for the three month and nine month periods ended September 30, 2004 have been reclassified, with no effect on net income or earnings per common share amounts, to be consistent with the classifications adopted for the three month and nine month periods ended September 30, 2005.

**Note 2. Earnings Per Common Share**

Basic earnings per common share are computed by dividing net earnings by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share is computed by dividing net earnings by the weighted-average number of common shares outstanding during the period, including potentially dilutive shares such as options and warrants to purchase shares of common stock at various amounts per share. The dilutive effect of the additional shares for the three months ended September 30, 2005 and 2004 was to increase weighted-average shares outstanding by 170,954 and 119,128, respectively. The dilutive effect of the additional shares for the nine months ended September 30, 2005 and 2004 was to increase weighted-average shares outstanding by 155,511 and 174,653, respectively.

**Note 3. Financing Arrangement**

The Company has a \$2,500,000 revolving line of credit agreement with M&I Bank of Minneapolis, Minnesota, expiring June 30, 2006, if not renewed. Advances are due on demand, secured by substantially all assets of the Company, and are subject to a defined borrowing base equal to 80% of qualified accounts receivable and 50% of qualified inventory. Interest on advances accrues at the bank's reference rate or prime rate (6.75 % at September 30, 2005) and is due monthly. There were no advances outstanding on the revolving line of credit agreement at September 30, 2005 and \$270,000 outstanding at December 31, 2004. This agreement contains certain reporting and operating covenants.

**Table of Contents**

On April 15, 2004, the Company signed an amendment to the original credit agreement that provides the Company with a \$1.5 million term loan for the purpose of purchasing capital equipment. In April 2004, the Company drew \$1,000,000 under this agreement, which amount is to be repaid in monthly installments of \$20,833 plus interest at 4.91% through March of 2008. In May 2005, the Company drew the remaining \$500,000, which amount is to be repaid in monthly installment of \$10,416 plus interest at 6.50% through May 31, 2009. This agreement is subject to the same restrictive covenants as the revolving line of credit agreement.

**Note 4. Major Customers and Enterprisewide Disclosures**

**Major Customers:** Customer A accounted for 54% and 57% of net sales for the three months ended September 30, 2005 and 2004, respectively and 55% and 59% of net sales for the nine months ended September 30, 2005 and 2004, respectively. Customer B accounted for 10% of net sales for the three months ended September 30, 2004. Customer A also accounted for 39% and 51% of Accounts Receivable balances as of the end of the same periods. Customer B accounted for 8% of Accounts Receivable balance at September 30, 2004. No other customer accounted for more than 10% of net sales of either period in 2005.

**Enterprisewide Disclosures:** The following table presents revenues from external customers for each of the Company's groups of products and services:

|  | Three Months<br>Ended<br>September 30,<br>2005 | Three Months<br>Ended<br>September 30,<br>2004 |
|--|--|--|
| Proprietary microprocessors and mechanically controlled sensors and alarms | \$ 714,801                                     | \$ 913,653                                     |
| Electronic controls and assemblies for OEM customers                       | 6,611,794                                      | 5,626,961                                      |
| Engineering Design Services  | 58,041   | 51,616   |
| Freight Out  | 15,250   | 21,462   |
|  | \$ 7,399,885                                   | \$ 6,613,692                                   |
|  | Nine Months<br>Ended<br>September 30,<br>2005  | Nine Months<br>Ended<br>September 30,<br>2004  |
| Proprietary microprocessors and mechanically controlled sensors and alarms | \$ 2,157,576                                   | \$ 2,142,791                                   |
| Electronic controls and assemblies for OEM customers                       | 19,077,407                                     | 15,305,173                                     |
| Engineering Design Services  | 260,253  | 106,951  |
| Freight Out  | 47,404   | 70,232   |
|  | \$ 21,542,640                                  | \$ 17,625,148                                  |

**Table of Contents****Note 5. Warrants and Stock-Based Compensation Plans**

**Warrants:** On February 19, 2003, the Company granted to Hayden Communications, Inc., an investor relations firm, warrants to purchase 39,697 shares of common stock. Warrants to purchase 1,654 shares of common stock vest each month beginning March 19, 2003 and continuing for the two-year contractual period. Hayden Communications, Inc. exercised all 39,697 warrants on February 24, 2005 at an exercise price of \$1.85 per share.

On February 1, 2005, the Company granted to Hayden Communications, Inc. warrants to purchase 20,000 shares of common stock that vest to the extent of 10,000 shares on August 1, 2005 and 10,000 shares on February 1, 2006. The term of each 10,000 share increment will extend three years from the date of vesting. The contract for services to be provided by Hayden Communications, Inc. does provide both parties with a cancellation right. Such a cancellation would limit the warrants to those vested up to the time of termination. On June 30, 2005, warrants to purchase 20,000 shares of common stock were outstanding, of which no shares were exercisable. The exercise price of such outstanding warrants is \$3.96 per share.

The warrants were valued using the Black-Scholes pricing model. Because the contract can be terminated, the Company is reflecting the value of the warrants as a prepaid expense and amortizing the expense as investor relations expense over the term of the agreement. In addition, the total value of the outstanding warrants, \$37,477, is reflected in the stockholders' equity section at September 30, 2005.

**Stock-Based Compensation Plans:** As allowed by Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation, and by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, the Company has elected to continue to apply the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. Accordingly, no compensation cost is recognized in the Company's net income for options granted with exercise prices that are equal to the market values of the underlying common stock on the dates of grant. The Company issued 22,000 options to purchase shares to directors during the nine months ended September 30, 2005. Had compensation cost for the stock options been based on the estimated fair values at grant dates, the Company's pro forma net income and net income per common share would have been as follows:

|  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2005                                | 2004      | 2005                               | 2004      |
| Net Income:  |                                     |           |                                    |           |
| As reported  | \$436,832                           | \$376,954 | \$1,378,185                        | \$674,344 |
| Deduct total stock-based employee<br>compensation expense determined under the<br>fair value-based method for all awards net of<br>related tax effects | (12,762)                            | (13,715)  | (65,283)                           | (50,675)  |
| Pro forma  | \$424,070                           | \$363,239 | \$1,312,902                        | \$623,669 |
| Basic Earnings per share   |                                     |           |                                    |           |
| As reported  | \$ 0.12                             | \$ 0.11   | \$ 0.39                            | \$ 0.20   |
| Pro forma  | \$ 0.12                             | \$ 0.11   | \$ 0.38                            | \$ 0.19   |
| Diluted Earnings per per share   |                                     |           |                                    |           |
| As reported  | \$ 0.12                             | \$ 0.11   | \$ 0.38                            | \$ 0.19   |
| Pro forma  | \$ 0.11                             | \$ 0.10   | \$ 0.36                            | \$ 0.18   |

**Table of Contents****Note 6. New Accounting Standards**

In December 2004, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 123 (revised 2004) ( SFAS 123R ), Share-Based Payment. SFAS 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods and services or incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. SFAS 123R requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the fair value of the award on the date of the grant and to recognize that cost over the period during which an employee is required to provide service in exchange for the award. Public entities filing as small business issuers will be required to apply SFAS 123R in the first interim or annual reporting period beginning after December 15, 2005. The Company will adopt this statement for its first fiscal quarter ending on March 31, 2006. The adoption of SFAS 123R will likely have an impact on our financial statements.

The Company is unable to estimate the impact of adoption of this statement as the impact will depend, in part, on the option pricing model used, stock option awards made prior to the adoption date of the statement, whether awards granted were non-qualified or qualified, the vesting period of those awards and cancellation or forfeitures related to both existing awards and new awards.

In November 2004, the FASB issued Statement No. 151 ( SFAS No. 151 ), Inventory Costs. SFAS No. 151 amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4, previously stated that . . . under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and re-handling costs may be so abnormal as to require treatment as current period charges . . . . SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The requirements of SFAS No. 151 are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of this statement is not expected to have a material impact on the Company's financial statements.

In May 2005, the FASB issued FASB Statement No. 154, *Accounting Changes and Error Corrections*. This new standard replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. Among other changes, Statement 154 requires retrospective application of a voluntary change in accounting principle with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. Statement 154 also requires accounting for a change in method of depreciating or amortizing a long-lived non-financial asset as a change in estimate (prospectively) effected by a change in accounting principle. Further, the Statement requires that correction of errors in previously issued financial statements be termed a restatement. The new standard is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. Early adoption of this standard is permitted for accounting changes and correction of errors made in fiscal years beginning after June 1, 2005. We do not believe the adoption of FASB Statement 154 will have a material effect on our financial position or results of operations.

**Table of Contents****ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION****Overview**

Winland Electronics, Inc ( Winland or the Company ) is an electronic manufacturing services ( EMS ) company, providing product development and manufacturing expertise and innovation for more than 20 years. Winland also markets proprietary products for the security/industrial marketplace. Winland's product development offering includes program management, analog circuit design, digital circuit design, printed circuit board design and embedded software design. Winland differentiates itself from the contract manufacturer competition with its integrated product development and manufacturing services to offer end-to-end product launch capability, including design for manufacturability, design for testability, transition to manufacturing and order fulfillment. Winland's core competency is delivering time-to-market through superior program management, experience, integrated development processes, and cross-functional teams.

**Executive Summary**

Revenues for the third quarter were a record \$7.4 million, an increase of 11.9% compared to the \$6.6 million reported for the third quarter of fiscal 2004. The increase in sales for the quarter was driven by sales to original equipment manufacture (OEM) customers including new product line items integrated from original equipment manufacture (OEM) customers during the past twenty-one months. Gross profit for the quarter was \$1.7 million, or 23.0% of sales, an increase of 10.7% compared to the \$1.5 million, or 23.2% of sales, reported for the third quarter one year ago. Total operating expenses increased 11.6% for the third quarter to \$965,872 compared to the \$865,149 for the third quarter of last year. Operating income increased 9.6% to \$733,401 for the third quarter compared to the \$669,247 reported for the third quarter of last year. Net income increased more than 15.9% to \$436,832, or \$0.12 per basic and fully diluted share, from \$376,954, or \$0.11 per basic and fully diluted share in the third quarter of 2004. The Company utilized 3.7 million fully diluted shares in the calculation compared to 3.5 million for the same period last year.

The balance sheet remained strong, with stockholders' equity increasing 22.5% to \$8.39 million as of September 30, 2005, from \$6.85 million on December 31, 2004. The Company completed the quarter with \$1,016,058 in cash and a current ratio of 2.48 to 1.

**RESULTS OF OPERATIONS****Three and nine months ended September 30, 2005 vs.****Three and nine months ended September 30, 2004**

**Net Sales:** The Company recorded net sales of \$7,399,885 for the three months ended September 30, 2005, an increase of \$786,193, or 11.9%, from \$6,613,692 for the same period in 2004. The gross sales for original equipment manufacture (OEM) customers increased 17.5%. Revenue from engineering design services grew by 12.4% and sales of Winland proprietary products, primarily for the security/industrial markets, decreased 21.8%.

The Company recorded net sales of \$21,542,640 for the nine months ended September 30, 2005, an increase of \$3,917,492, or 22.2%, from \$17,625,148 for the same period in 2004. The gross sales for original equipment manufacture (OEM) customers increased 24.6%. Revenue from engineering design services grew by 143% from \$106,951 in 2004 to \$260,253 for the same period in 2005. Sales of Winland proprietary products, primarily for the security/industrial markets, remained consistent for the reported periods. During the three and nine months ended September 30, 2005, the Company introduced to production 24 and 56 new OEM products, respectively. This is compared to the 22 and 44 new OEM products introduced during the same periods in 2004.

**Table of Contents**

The Company's OEM customers have given the Company purchase orders having an aggregate value of \$17.5 million for delivery during the remainder of 2005 and into 2006. The Company expects to receive additional orders from current OEM customers for future production. Although the Company has purchase orders in place for many of its OEM customers scheduled to be fulfilled in 2005, these customers may terminate their relationship with the Company at any time pursuant to certain cancellation provisions.

During the third quarter, the Company received orders from Select Comfort totaling \$5.5 million dollars to be delivered within the next 6 months. The Company's master supply contract with Select Comfort, which provides Winland exclusivity for Select's EMS domestic supply, expires in August 2006. In September 2005, the Company also received notice from Select Comfort that this contract and its existing terms would not be renewed. The notice also stated we [Select Comfort] strongly value the partnership we have had with Winland Electronics over the years, and we have confidence that the relationship will continue at a re-defined level. As a result, we expect that sales volume from Select Comfort will decrease sometime in 2006. We cannot currently predict the amount or timing of such decrease or the effect on Winland's revenues or operating results.

**Cost of Sales:** Cost of sales was \$5,700,612 or 77.0% of net sales for the three months ended September 30, 2005, compared to \$5,079,296 or 76.8% of net sales for the same period in 2004. Cost of sales for nine months ended September 30, 2005 was \$16,265,235 or 75.5% of net sales compared to \$13,689,375 or 77.7% of net sales for the same period in 2004. The Company includes material and supplies, direct labor and other manufacturing expenses in its computation of cost of sales. Other manufacturing expenses, some of which are included in overhead, include, but are not limited to, indirect manufacturing labor and related benefits and expenses, depreciation and maintenance of manufacturing equipment and software, freight expense, purchasing expenses, warehousing expenses, warranty expense, inventory scrap and write-offs, an allocation for facility and information technology usage and product liability insurance.

Costs that are capitalized in work in process and finished goods inventory include all of the above, except certain expenses such as warranty expense, inventory scrap and write-offs and some freight.

**Gross Profits:** Gross profit can fluctuate from period to period due to a variety of factors, including, but not limited to, sales volume, product mix, and plant efficiency. Gross profit dollars increased 10.7% to \$1,699,273 or 23.0% of net sales for the three months ended September 30, 2005, compared to \$1,534,396 or 23.2% of net sales for the same periods in 2004. Gross profit dollars for the nine months ended September 30, 2005 increased 34% to \$5,277,405 or 24.5% of net sales compared to \$3,935,773 or 22.3% for the same period in 2004. The Company was successful introducing new line items and was able to maintain plant efficiencies and control costs. Maintenance of product costs and the increase in sales volume contributed to the gross profit dollars reported for the three and nine months ended September 30, 2005. For the three months ended September 30, 2005, the increase in gross profit was reduced in part by increased salaries and related expenses of \$74,053, increased warranty expense of \$23,635 and increased obsolescence expenses of \$15,323, offset, in part, by a decrease in depreciation expense of \$24,554 and decreased repair and maintenance expenses of \$5,741. The increase in gross profit dollars for the nine months ended September 30, 2005 was reduced in part by increased salaries and related expenses of \$453,966, increased warranty expense of \$71,912 and increased obsolescence expenses of \$50,951, offset, in part, by a decrease in depreciation expense of \$49,742, decreased interplant store (IPS) fees of \$19,414 and decreased repair and maintenance expenses of \$7,990.

**Operating Expenses:** Operating expenses were \$965,872 and \$2,999,623 or 13.0% and 13.9% of net sales for the three and nine months ended September 30, 2005, respectively compared to \$865,149 and \$2,736,798 or 13.1% and 15.5% for the same periods ended September 30, 2004. Operating expenses include: 1) general and administrative expenses such as administrative salaries and related benefits and expenses, professional and legal fees, investor relations expenses, board of directors fees, and directors

**Table of Contents**

and officers insurance and other general office supplies and expenses; 2) sales and marketing expenses including salaries and related benefits and expenses for direct outside salesmen, customer service and the senior vice president of sales and marketing, sales commissions, trade show expenses, web site development and maintenance, promotional materials, advertising expense and an allocation for facility and information technology usage; and 3) research and development expense such as salaries and related benefits and expenses, labor and material associated with new product development, depreciation and maintenance of research and development equipment and software, warranty expense associated with engineering projects and an allocation of facility and information technology usage. General and administrative expense was \$432,673 or 5.8% of net sales and \$1,390,657 or 6.5% of net sales for the three and nine months ended September 30, 2005, respectively, compared to \$397,607 or 6.0% of net sales and \$1,223,025 or 6.9% of net sales for the same periods in 2004. The increase in general and administrative expense for the three months ended September 30, 2005 is attributed to increased office supplies expense of \$12,784, increased investor relations expense of \$10,090 and board of directors expense of \$9,877, offset in part by declines in salaries and related expenses of \$14,067, professional fees of \$6,000 and directors and officers insurance of \$2,750. The increase in general and administrative expense for the nine months ended September 30, 2005 is attributed to increased salaries and related expenses of \$70,512, professional fees of \$57,667, office supplies expense of \$22,217 and board of directors expense of \$19,131, offset in part by declines in directors and officers insurance expense of \$23,238.

Sales and marketing expense (including project management) was \$321,205 or 4.3% of net sales and \$997,904 or 4.6% of net sales for the three and nine months ended September 30, 2005, compared to \$315,789 or 4.8% of net sales and \$946,287 or 5.4% of net sales for the same periods in 2004. The increase in sales and marketing expense for the three months ended September 30, 2005 is attributed to increased promotional and trade show expenses of \$14,341 and professional fees of \$2,500, offset in part by declines in salaries and related expenses of \$13,453. The increase in sales and marketing expense for the nine months ended September 30, 2005 is attributed to increased promotional and trade show expenses of \$19,754, legal fees \$11,431 and professional fees of \$10,000, offset in part by declines in salaries and related expenses of \$8,350.

Research and development expense (including the development of new Company products as well as design services and support to the OEM customer base) was \$211,994 or 2.9% of net sales and \$611,062 or 2.8% of net sales for the three and nine months ended September 30, 2005, compared to \$151,753 or 2.3% of net sales and \$567,486 or 3.2% of net sales for the same periods in 2004. The increase in expense for the three months end September 30, 2005 is attributed to new product development expenses of \$60,781, offset in part by decreased consulting expenses of \$5,657 and decreases in depreciation of \$1,974. The increase in expense for the nine months ended September 30, 2005 is due to an increase in new product development expense of \$142,855, consulting expenses of \$17,909 and travel related expenses of \$8,712, offset in part by decrease in warranty expense associated with engineering projects of \$82,122, decrease in office supplies of \$6,325 and depreciation expense of \$4,708.

**Interest Expense:** Interest expense was \$32,564 or 0.4% of net sales and \$92,537 or 0.4% of net sales for the three and nine months ended September 30, 2005, compared to \$46,413 or 0.7% of net sales and \$110,595 or 0.6% of net sales for the same periods in 2004. During the first nine months of 2005, the Company paid off its revolving line-of-credit in the amount of \$270,000 and paid down \$378,848 of long-term debt.

**Net Income:** The Company reported net income of \$436,832 or \$0.12 per basic share and diluted share and \$1,378,185 or \$0.39 per basic share and \$0.38 per diluted share for the three and nine months ended September 30, 2005, compared to net income of \$376,954 or \$0.11 per basic and diluted share and \$674,344 or \$0.20 per basic share and \$0.19 per dilutive share for the same periods in 2004.

**Table of Contents**

The Company believes inflation has not significantly affected its results of operations.

The Company uses a 39% blended federal and state income tax rate. Year-to-date pre-tax income was \$2,259,285 for 2005 and \$1,105,344 for 2004, resulting in income tax expense of \$881,100 and \$431,000, respectively.

**LIQUIDITY AND CAPITAL RESOURCES**

Cash provided by operating activities was \$1,013,132 for the nine months ended September 30, 2005, compared to cash used by operating activities of \$1,532,813 for the same period in 2004, an increase of \$2,545,945. This change was primarily due to increased net income levels and increases in accounts payable and accrued expenses, offset in part by increased inventory, accounts receivable and prepaid expense balances. Cash provided by operations was used primarily to fund current operations and to purchase \$429,148 of capital equipment.

The Company has funded its current operations with cash provided by operations.

The current ratio at September 30, 2005 was 2.48 to 1, compared to 3.19 to 1 at December 31, 2004. Working capital equaled \$6,116,889 on September 30, 2005, compared to \$4,887,402 on December 31, 2004. The increased working capital is primarily attributed to an increase in cash from operating activities, offset in part by purchases of capital equipment of \$429,148.

On June 30, 2004, the Company entered into a revolving credit agreement with the M&I Bank of Minneapolis, Minnesota. There were no advances outstanding on the revolving line-of-credit agreement at September 30, 2005. The Company had \$270,000 outstanding on December 31, 2004

We believe that our cash balance, funds available under a line of credit agreement, the \$1.5 million term loan and anticipated cash flows from operations will be adequate to fund our cash requirements for the next twelve months.

A summary of our contractual cash obligations at September 30, 2005 is as follows

**Contractual Cash Obligations at 9/30/05**

|                               | Monthly<br>Pmt   | Buy Out<br>Amount | Last Pmt | 2,005   | 2,006   | 2,007   | 2,008   | 2009+   | Total     |
|-------------------------------|------------------|-------------------|----------|---------|---------|---------|---------|---------|-----------|
| Building<br>Mortgage          | 11,373.34        | 4,439.47          | 10/01/14 | 22,747  | 136,480 | 136,480 | 136,480 | 788,578 | 1,220,765 |
| Equipment<br>Capital<br>Lease | 7,783.21         | 7,783.21          | 11/30/06 | 23,350  | 85,615  |         |         |         | 108,965   |
| Equipment<br>Capital<br>Lease | 1,929.76         | 6,750.00          | 07/01/05 |         |         |         |         |         |           |
| Equipment<br>Loan             | 20,833.33        | 20,833.33         | 04/01/08 | 70,257  | 273,328 | 260,883 | 84,203  |         | 688,671   |
| Equipment<br>Loan             | 10,416.67        | 10,416.67         | 05/01/09 | 38,610  | 149,366 | 141,128 | 132,918 | 52,939  | 514,961   |
|                               | Plus<br>Interest | Plus<br>Interest  |          | 154,963 | 644,790 | 538,491 | 353,601 | 841,517 | 2,533,361 |

There are no off balance sheet contractual cash obligations.



**Table of Contents**

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and related disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We cannot assure you that actual results will not differ from those estimates. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

**Revenue Recognition.** In most cases, the Company recognizes revenue from the sale of products and out of warranty repairs when the product is delivered to a common carrier for shipment and title transfers.

With one particular customer, the Company recognizes revenue from the sale of customized products when the product is delivered to a customer warehouse location within the Company, title is transferred and risk of loss and ownership passes to the buyer. These sales are subject to written purchase orders including a fixed schedule for delivery; the date for delivery is reasonable and consistent with the buyer's business purpose. The product cannot be used to fulfill other customers' orders, as this is a unique product for this customer only. We are the sole supplier source of this product for this customer. Because of the unique nature of this product, the customer must have stock on hand and ready to ship to their customers and, therefore, has requested that the transaction be on a bill and hold basis. Since the customer does not have its own warehouse, they rent warehouse space from the Company by paying a monthly rental charge based on the number of pallets containing their inventory. The customer's credit and payment terms are the same as all other OEM customers.

Another portion of the Company's business involves the Company shipping product to a primary customer's location where it is held in a separate warehouse. Revenue is recognized when that customer notifies the Company that the inventory has been removed from the warehouse and title to the product is transferred.

Revenue recognition occurs for engineering design services as the progress billings are made and at the conclusion of the project.

Shipping and handling charges billed to customers are included in net sales, and shipping and handling costs incurred by the Company are included in cost of goods sold. For all sales, the Company uses either a binding purchase order or customer accepted and signed engineering quote as evidence of the arrangement. The Company does not generally accept returns but does provide a limited warranty as outlined below under Allowance for Rework and Warranty Costs.

**Inventory Valuation.** Our inventories are stated at the lower of cost, using the first-in, first-out (FIFO) method, or market value. Our industry is characterized by rapid technological change, short-term customer commitments and rapid changes in demand, as well as other market considerations. The Company makes provisions for slow moving, estimated excess and obsolete inventory based on an analysis of the existing inventory, and applying probability of obsolescence percentages to the aged inventory brackets based on historical experience and specific identification of obsolete inventory. Management's estimated reserve for slow moving and obsolete inventories was valued at \$154,800 and \$200,000 for the periods ended September 30, 2005 and 2004, respectively.

In addition to the above methodology, we have developed procedures that will provide for estimated excess, slow moving and obsolete inventory reserves based on quarterly reviews for our major customers and annual reviews for lower volume customers of inventory quantities on hand and on order in conjunction with the latest forecasts of product demand and production requirements from these customers. Inventory not specific to a customer is evaluated at least annually.

**Table of Contents**

***Allowance for Doubtful Accounts.*** We evaluate our allowance for uncollectible accounts on a quarterly basis and review any significant customers with delinquent balances to determine future collectibility. We base our determinations on legal issues (such as bankruptcy status), past history, current financial and credit agency reports, and experience. We reserve accounts deemed to be uncollectible in the quarter in which we make the determination. We maintain additional reserves based on our historical bad debt experience. We believe these values are estimates and may differ from actual results. We believe that, based on past history and credit policies, the net accounts receivable are of good quality. Write offs for the three months ended September 30, 2005 and 2004 were \$0 and \$0, respectively. Write offs for the nine months ended September 30, 2005 and 2004 were \$0 and \$2,486 respectively. The Allowance for Doubtful Accounts was valued at \$20,000 and \$10,000 for the periods ended September 30, 2005 and 2004, respectively.

***Allowance for Rework and Warranty Costs.*** We have established a warranty reserve for rework, product warranties and customer refunds. We provide a limited warranty to our OEM customers that requires us to repair or replace product that is defective, due to Company workmanship issues, at no cost to the customer. In addition, we provide a limited warranty for our proprietary products for a period of one year, which requires us to repair or replace defective product at no cost to the customer or refund the purchase price. Reserves are established based on historical experience and analysis for specific known and potential warranty issues. The reserve reflecting historical experience and potential warranty issues is determined based on a percentage of sales for the prior six-month period. Any specific known warranty issues are reserved for individually. The total of these is analyzed to determine the probability and the Company's financial exposure, and the reserve is established. As of September 30, 2005 and 2004, the Allowance for Rework and Warranty Costs was valued at \$121,925 and \$116,000, respectively. The product warranty liability reflects management's best estimate of probable liability under our product warranties and may differ from actual results.

***Deferred Taxes.*** At September 30, 2005, the financial statements reflect deferred tax assets of \$197,700 and deferred tax liabilities of \$263,800. Deferred taxes are provided on an asset and liability method, whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carry-forwards, and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Realization of deferred tax assets is dependent on future taxable income during the period that deductible temporary differences and carry-forwards are to be available to reduce taxable income.

***Depreciation and Asset Impairment.*** The Company depreciates property and equipment over its estimated useful life. There were no impairment charges taken for the three months or nine months ended September 30, 2005.

**CAUTIONARY STATEMENTS**

Certain statements contained in this Quarterly Report on Form 10-QSB and other written and oral statements made from time to time by the Company do not relate strictly to historical or current facts. As such, they are considered forward-looking statements that provide current expectations or forecasts of future events. Such statements can be identified by the use of terminology such as anticipate, believe, estimate, expect, intend, may, could, project, should, will, forecast and similar words or expressions. The Company's forward-looking statements generally relate to the Company's purchase order levels, building market share in the EMS market, growth strategies,

**Table of Contents**

financial results, product development, sales efforts and sufficiency of capital. One must carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by inaccurate assumptions, including, among others, those discussed below. Consequently, no forward-looking statement can be guaranteed, and actual results may vary materially. As provided for under the Private Securities Litigation Reform Act of 1995, the Company wishes to caution investors that the following important factors, among others, in some cases have affected and in the future could affect the Company's actual results of operations and cause such results to differ materially from those anticipated in forward-looking statements made in this document and elsewhere by or on behalf of the Company.

The Company derives a significant portion of its revenues from a small number of major OEM customers that are not subject to any long-term contracts with the Company. If any major customers should for any reason decrease the volume of their business or stop doing business with the Company, the Company's business would be adversely affected. Some of the Company's customers are not large well-established companies, and the business of each customer is subject to various risks such as market acceptance of new products and continuing availability of financing. To the extent that the Company's customers encounter difficulties or the Company is unable to meet the demands of its OEM customers, the Company could be adversely affected.

The Company's ability to increase revenues and profits is dependent upon its ability to retain valued existing customers and obtain new customers that fit its customer profile. The Company competes for new customers with numerous independent contract design and manufacturing firms in the United States and abroad, many of whom have greater financial resources and more established reputations. The Company's ability to compete successfully in this industry depends, in part, upon the price at which the Company is willing to manufacture a proposed product and the quality of the Company's design and manufacturing services. There is no assurance that the Company will be able to continue to obtain contracts from existing and new customers on financially advantageous terms, and the failure to do so could prevent the Company from achieving the growth it anticipates.

The Company's ability to execute its initiatives to increase sales and expand market share depends upon its ability to develop additional value added capabilities and/or proprietary products and technologies and on the availability of sufficient financing, both equity and debt, to meet fixed and variable costs associated with such growth. In the current economic environment, banks and other sources of financing are conservative in their lending and investment policies. There is no assurance that the Company will be able to obtain the financing necessary to achieve its goals.

The Company's success in providing an improved mix of higher margin products and services depends on the effectiveness of its new product development and planning efforts as well as the timing of such and the availability and costs of any competing products or services on the market.

**Table of Contents**

**ITEM 3. CONTROLS  
AND  
PROCEDURES**

(a) Evaluation of Disclosure Controls Procedures.

The Company's Chief Executive Officer, Lorin E. Krueger, and Chief Financial Officer, Jennifer A. Thompson, have reviewed the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon this review, these officers believe that the Company's disclosure controls and procedures are effective in ensuring that information that is required to be disclosed by the Company in reports that it files under the Securities Exchange Act of 1934 is recorded, processed and summarized and reported within the time periods specified in the rules of the Securities and Exchange Commission.

(b) Changes in Internal Control.

The Company appropriately addressed and corrected the two significant deficiencies identified by the independent registered public accounting firm, McGladrey & Pullen, LLP, and disclosed in Item 8A of the 10-KSB for the year ended December 31, 2004. The first deficiency related to the methodology used to determine our inventory obsolescence reserve. The Company previously determined the reserve for slow moving and obsolete inventory by analyzing the existing inventory and applying probability of obsolescence percentages to the aged inventory brackets and included specific identification of obsolete inventory.

To address the identified deficiency, in addition to the above methodology, we have developed procedures that will provide for estimated excess, slow moving and obsolete inventory reserves based on quarterly reviews for our major customers and annual reviews for lower volume customers of inventory quantities on hand and on order in conjunction with the latest forecasts of product demand and production requirements from these customers. Inventory not specific to a customer is evaluated at least annually. All parts specifically identified as obsolete, excess with no foreseeable opportunity of usability and slow moving parts which become unusable due to solderability or date code issues are periodically discarded as part of inventory write downs.

The second deficiency related to the reporting of shipping revenue and the related expense. Previously, the Company netted the shipping revenue charged to the customer against the expense for such shipping. The net revenue or expense was previously reported as part of net sales. Beginning with the 10-KSB for the year ended December 31, 2004, and including this 10-QSB, the Company reported the shipping revenue in net sales and the related shipping expense as cost of sales. The comparative information for the three and nine months ended September 30, 2004 was restated to reflect this change. This did not affect the gross profit dollars or net income and was not material in amount or nature as to cause a material misstatement.

**Table of Contents****PART II OTHER INFORMATION****ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table sets out shares of the Company's Common Stock repurchased by the Company since February 2005.

| Period                   | (a) Total<br>Number of<br>Shares (or<br>Units)<br><br>Purchased(1) | (b) Average<br>Price<br>Paid per Share<br>(or<br><br>Unit) | (c) Total<br>Number of<br>Shares (or<br>Units)<br>Purchased as<br>Part<br><br>of Publicly<br>Announced<br>Plans<br><br>or Programs | (d) Maximum<br>Number<br><br>(or Approximate<br><br>Dollar Value) of<br>Shares (or<br>Units)<br><br>that May Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|--------------------------|--|--|--|---|
| Feb. 1 Feb. 28, 2005     | 8,662  | \$ 4.70  | N/A  | N/A   |
| March 1 March 31, 2005   | 4,972  | \$5.079  | N/A  | N/A   |
| May 1 May 31, 2005       | 6,448  | \$ 4.25  | N/A  | N/A   |
| August 1 August 31, 2005 | 3,153  | \$ 6.18  | N/A  | N/A   |
| Total                    | 23,235   |  |  |   |

(1) All of the shares were repurchased by the Company in connection with stock-for-stock option exercises by three employees, one of which is an officer, and one director.

**ITEM 6. EXHIBITS**

See Exhibit Index following the signature page.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Company has caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

WINLAND ELECTRONICS, INC.  
( Company )

Dated: November 9, 2005

/s/ Lorin E. Krueger  
Lorin E. Krueger, President and Chief  
Executive Officer (Principal Executive  
Officer)

/s/ Jennifer A. Thompson  
Jennifer A. Thompson, Chief Financial Officer  
(Principal Financial and Accounting Officer)

19

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**Table of Contents**

**SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
EXHIBIT INDEX TO FORM 10-QSB**

**For the fiscal quarter ended  
September 30, 2005**

**Commission File No. 0-18393**

**WINLAND ELECTRONICS, INC.**

**Exhibit No.    Description**

- |      |  |
|------|--|
| 31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |