WINLAND ELECTRONICS INC
Form 10KSB
March 18, 2004

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF
THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended December 31, 2003 Commission File No.: 0-18393

WINLAND ELECTRONICS, INC.

(Name of small business issuer in its charter)

Minnesota
(State or other jurisdiction of incorporation or organization)

41-0992135
(IRS Employer Identification Number)

1950 Excel Drive, Mankato, Minnesota 56001
(Address of principal executive offices)

(507) 625-7231
(Issuer s telephone number)

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

Title of Each Class	Name of Exchange
Common Stock, $.01 par value	American Stock Exchange
Preferred Stock Purchase Rights	American Stock Exchange

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

Check whether the Issuer (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 Issuer was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Check if there is no disclosure of delinquent filers pursuant to Item 405 of Regulation S-B contained in this form and no disclosure will be contained, to the best of Issuer s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [ ]

Issuer s revenues for fiscal year ended December 31, 2003: $ 19,464,121.

The aggregate market value of the Common Stock held by non-affiliates as of March 9, 2004 was approximately $13,206,108 based on the closing sale price of the Issuer s Common Stock on such date.

There were 3,356,955 shares of Common Stock, $.01 par value, outstanding as of March 9, 2004.

DOCUMENTS INCORPORATED BY REFERENCE

Documents incorporated by reference pursuant to Rule 12b-23: Portions of the Company s Proxy Statement for its 2003 Annual Meeting are incorporated by reference into Items 9, 10, 11 and 12 of Part III.

Transitional Small Business Disclosure Format (check one) Yes [ ] No [X]

TABLE OF CONTENTS

Table of Contents

PART I

ITEM 1. DESCRIPTION OF BUSINESS

GENERAL

Winland Electronics, Inc. (the Company) was incorporated as a Minnesota corporation in October 1972. The Company designs and manufactures custom electronic controls and assemblies primarily for original equipment manufacturer (OEM) customers, from early concept through product realization. Revenues from OEM customers provided 87% of the Company s total revenue in 2003. The Company provides controls and assemblies to several OEM customers who market their products to a wide variety of industries. The Company continues to maintain a presence in the security/industrial markets with the sales of its own line of proprietary environmental security products. In addition, the Company has developed a proprietary line of customizable motor controls.

PRODUCTS

The Company designs, produces and distributes products in two product categories defined as Electronic Manufacturing Services (EMS) for OEM Customers and Proprietary Products and Services, primarily for the security/industrial and motor control markets.

Electronic Manufacturing Services for OEM Customers:

The Company designs and manufactures circuit board assemblies and higher level products that incorporate them for many OEM customers. The Company is positioned to offer complete solutions to OEM customer needs by providing value-added services that complement the Company s contract manufacturing capabilities. The services provided may include product concept studies, product design, printed circuit board design, design for manufacturing, higher level assembly and box build, and legacy support. These services differentiate the Company from the competition and increase customer satisfaction, confidence, and loyalty. The Company views EMS customers as strategic partners and works to provide these partners with high level customer care and technical services. Although the Company has purchase orders in place from many of its OEM customers that are scheduled to be fulfilled in 2004, these customers may terminate their relationship with the Company at any time, with certain cancellation provisions. Therefore, there is no assurance that the Company will continue to be engaged by any of these customers. Sales to OEM customers accounted for 87% and 85% of the Company s total sales during 2003 and 2002, respectively.

Proprietary Products:

The Company s proprietary products include an established family of environmental security products and a line of DC motor controllers that can be customized to meet customer requirements. During 2002, the Company decided to discontinue promotion and development of the GPS antenna product line. The Company s security/industrial products include simple and sophisticated microprocessor and mechanically controlled sensors and alarms. These products monitor and detect environmental changes, such as changes in temperature or humidity, water leakage and power failures. The Company s ALERT series of products may be connected to many burglar or fire alarm panels to monitor and report unfavorable environmental conditions. Proprietary product sales accounted for 13% and 15% of the Company s total sales for 2003 and 2002, respectively.

Marketing and Distribution:

The Company markets its design and manufacturing services to prospective OEM customers primarily through direct sales and marketing efforts and referrals from existing customers, suppliers and electronic design firms. One of the Company s key marketing objectives is to form long-term business partnerships with OEM customers by working to develop a degree of technological interdependence between the Company and the customer. With this in mind, the Company has worked to identify new OEM customers that need a broad range of services in addition

2

Table of Contents

to their manufacturing needs. The Company plans to achieve continued growth in OEM sales by providing its customers added value with a customer intimate strategy that is centered in exceptional service, application specific technical expertise, and exceptional quality.

The Company is a full service designer and manufacturer of custom controls and assemblies for OEM customers. The Company has expanded its sales coverage in Wisconsin and Illinois, and utilizes a network of referral sources and independent sales representatives to market its contract manufacturing services. In an effort to expand sales coverage within the Midwest, the Company has signed representative agreements with two independent sales representative firms in Chicago and Kansas City.

The Company markets its proprietary products through dealers and wholesalers, in-house direct marketing and sales efforts, instrumentation catalogs, and national and regional trade expositions. Currently, the Company sells its environmental security products through a distribution network of over 900 locations in the United States, Canada, Mexico, and Europe. The Company continues to explore opportunities with its proprietary product lines, to expand into additional markets, as well as design new products.

Source of Materials:

Raw material components and some subassemblies are purchased from outside vendors, qualified through a vendor qualification process and inspected in accordance with Company inspection policies before being incorporated into products. Certain purchased components and subassemblies are manufactured to design specifications furnished by the Company, while others are standard off-the-shelf items. The Company utilizes multiple sources for the off-the-shelf components, but generally maintains only one source for the items manufactured to design specifications. If the Company loses one or more of its major components suppliers, and needs to seek alternative suppliers, some delay and possible additional costs may be incurred while obtaining alternative sources.

In addition to manufacturing its own products, the Company has contracted with companies in the United States and foreign countries to provide both finished goods assemblies and component assemblies designed to the Company s specifications. Although alternative sources for such items may be found, if the Company were to lose one or more of these suppliers, some delay and additional costs may be incurred while obtaining alternative sources.

Patents, Trademarks and Licenses:

The Company holds federal trademark registrations for marks used in the Company s business as follows: WATERBUG, TEMP ALERT, ENVIRONMENTAL SECURITY and SATSOURCE.

Seasonality and Working Capital:

Due to the diversity of the Company s customer mix, the Company s business and working capital needs are not seasonal. Changes in the types of products produced for significant OEM customers could materially affect the seasonality of the Company s business in future years.

Significant Customers:

The Company has worked to develop long-term relationships with its OEM customers that are mutually beneficial. Due to the nature of the Company s contract manufacturing relationships, there is a significant degree of dependence between these customers and the Company. As a group, customers whose individual revenues equaled or exceeded 10% of the Company s net sales revenues were responsible for net sales of $13.3 million, or 68% of total net sales, in 2003 and net sales of $12.1 million, or 67% of total net sales, in 2002.

Select Comfort Corporation has been one of the Company s most significant customers during both 2003 and 2002, with sales of 55% and 50% of the Company s net sales. Select Comfort Corporation is a Minnesota based air-sleep system manufacturer in the bedding industry. The design and manufacturing services provided to Johnson Outdoors Inc. accounted for 13% and 17% of the Company s net sales during 2003 and 2002, respectively. Johnson Outdoors Inc.

Table of Contents

(JOI) is a Wisconsin based manufacturer of recreational products. In June 2003, the Company announced that orders to JOI would be reduced in the coming years. The Company will continue to provide assemblies to JOI, but with significant reductions expected in 2004 and into the future.

Sales of the Company s proprietary products accounted for 13% of total sales for 2003 and 15% for 2002. In 2003, nearly 43% of all proprietary products sales were to one security/industrial distributor, the world s largest distributor.

Competition:

The Company s business includes the design and manufacturing of custom electronic controls and assemblies for OEM customers and the development and marketing of proprietary security/industrial products. The competition for the contract design and manufacturing services offered by the Company has increased substantially, both domestically and internationally. To enhance its ability to compete effectively, the Company has continued to invest in the development of its work force and technically advanced design production and test equipment. The Company distinguishes itself from may competitors by offering full service solutions to its contract design and manufacture customers. Significant competitive factors in this market include development and design expertise, quality of manufacturing, price, capacity, and company reputation. The Company believes that it competes favorably with respect to development and design expertise and quality of manufacturing. The Company s foreign competitors are often more aggressive in pricing their services and many of the Company s competitors have greater capacity and are better-known and better-financed than the Company.

Competition among the security/industrial products has increased the last several years as additional companies have introduced competing products. The Company believes, however, that its products offer desirable features at competitive prices. Significant competitive factors in the market for security/industrial products include product effectiveness and features, price, reliability and company reputation. The Company believes that it competes favorably with respect to product effectiveness, features, price and reliability. However, given the Company s size and relatively small presence in this market, many of the Company s competitors have an advantage by being larger, better-known and better-financed.

Research and Development:

Throughout 2003, the Company has worked to provide full-service solutions to its OEM customers by offering varied design technologies such as wireless communications and embedded software design for control systems. The Company s engineering department is staffed with experienced electrical and software engineers that provide a wide range of customer services, including: conceptual design; custom enclosures and 3D modeling; board level, subsystem, and high-level assembly; PCB layout; analog and digital design, embedded systems and software; sensors, power and motor controls, and low power radio frequency design. The Company believes that with its internal engineering department and approved outside engineering consultants it will be able to meet the current needs of its customer base. The Company spent $718,650 or 3.7% of net sales for research and development expenses for the year ended December 31, 2003, compared to $671,930 or 3.7% of net sales for 2002.

Effect on Environmental Regulations:

The Company is not aware of any federal, state, or local provisions regulating the discharge of materials into the environment or otherwise relating to the protection of the environment with which compliance by the Company has had, or is expected to have, a material effect upon the capital expenditures, earnings, or competitive position of the Company.

Foreign Operations and Export Sales:

In 2003, the Company derived less than 2% of its revenues from sales outside the United States, which number was just over 2% for 2002.

Table of Contents

Personnel:

At December 31, 2003, the Company had 76 employees (75 full-time and one part-time). During 2003 and 2002, the Company also used temporary labor services during peak production times. The Company is not subject to a collective bargaining agreement, and it considers its relations with its employees to be good.

ITEM 2. DESCRIPTION OF PROPERTY

The Company owns its office and manufacturing facility located in Mankato, Minnesota. The 58,000 square foot building consists of 15,500 square feet of office space, 32,500 square feet of manufacturing space and 10,000 square feet of warehouse space, all of which is used by the Company. Management believes the current facility adequately supports the Company s present and near future operations. Management believes its property is adequately covered by insurance. The Company s office and manufacturing facility is subject to mortgages securing an aggregate amount of debt equal to $1,241,681 as of December 31, 2003.

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

EXECUTIVE OFFICERS OF THE COMPANY

The name and ages of all of the Company s executive officers and the positions held by them are listed below.

Name	Age	Position
Lorin E. Krueger	48	President, Chief Executive Officer, Secretary and Director
Jennifer A. Thompson, CPA	45	Chief Financial Officer
Terry E. Treanor	41	Vice President of Manufacturing
Steven W. Vogel	47	Vice President of Engineering
Dale A. Nordquist	49	Senior Vice President of Sales and Marketing

Lorin E. Krueger has served as Chief Executive Officer of the Company since June 1, 2001, and as President of the Company since January 1999. In addition, Mr. Krueger served as Secretary of the Company since 1983. Mr. Krueger served as the Company s Chief Operating Officer from January 1999 until June 2001 and as its Senior Vice President of Operations from March 1987 until January 1999. Mr. Krueger has been an employee of the Company since 1976 and served as its Vice President from January 1977 to March 1987.

Jennifer A. Thompson, CPA, has served as Chief Financial Officer since June 2001. She joined the Company as Vice President of Financial Operations in August 2000. Ms. Thompson was a principal in Biebl, Ranweiler, Christiansen, Meyer, Thompson & Co. Chtd., a public accounting firm in New Ulm, Minnesota, from October 1996 to August 2000. Ms. Thompson practiced as a certified public accountant in the Mankato area for twenty years.

Table of Contents

Terry E. Treanor has served as Vice President of Manufacturing since June 1996. He joined the Company in 1994 serving in various capacities, including Quality Assurance Manager and Operations Manager. Mr. Treanor was employed by Onan Corp., a power generation company, from January 1985 until July 1994, serving most recently as Supplier Quality Engineer.

Steven W. Vogel has served as Vice President of Engineering since September 1998. He served as the Company s Manager of Engineering from April 1996 to September 1998 and as Design Engineer from May 1994 to April 1996. From April 1988 to May 1994, Mr. Vogel served as Design Engineer for Micro-Trak Systems, Inc., a Minnesota-based agricultural electronics company.

Dale A. Nordquist has served as Senior Vice President of Sales and Marketing since December 2002. From October 2001 to December 2002 as Vice President of Sales EMS Western Region. From May 1999 to October 2001, Mr. Nordquist served as Vice President of Sales and Marketing for Quickdraw Conveyor Systems, Inc., which filed for Chapter 7 bankruptcy in January 2001 and was acquired by MagStar Technologies, Inc. in February 2001. From 1981 to May 1999, Mr. Nordquist served as Vice President of Sales and Marketing for HEI, Inc., a Minnesota based designer and manufacturer of ultra-miniature electronic devices and high technology products incorporating these devices.

PART II

ITEM 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS PURCHASES OF EQUITY SECURITIES

The Company s Common Stock is listed on the American Stock Exchange (AMEX) under the symbol WEX. The following table sets forth the high and the low bid quotations, as reported by AMEX adjusted for the December 31, 2003 stock split.

Fiscal Year Ended December 31, 2002	Low	High
First Quarter	0.73	1.15
Second Quarter	0.73	2.63
Third Quarter	1.69	2.41
Fourth Quarter	1.09	2.58

Fiscal Year Ended December 31, 2003	Low	High
First Quarter	1.18	2.27
Second Quarter	1.82	3.14
Third Quarter	1.82	2.54
Fourth Quarter	2.41	5.45

On March 9, 2004, the fair market value of the Company s Common Stock was $4.35 based on the closing sale price quoted by AMEX on that date. As of December 31, 2003, the Company had approximately 441 shareholders of record.

On December 9, 2003, the Board of Directors authorized a 1.1-for-1 split of the Company s Common Stock payable as a 10% stock dividend, effective December 31, 2003, payable to stockholders of record as of December 19, 2003.

The Company has never paid cash dividends on its Common Stock. The Board of Directors presently intends to retain earnings for use in the Company s business and does not anticipate paying cash dividends on Common Stock in the foreseeable future. Any future determinations as to the payment of dividends will depend on the financial condition of the Company and such other factors as are deemed relevant by the Board of Directors.

Table of Contents

ITEM 6: MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

RESULTS OF OPERATIONS- 2003 vs. 2002

Net Sales: The Company recorded net sales of $19,464,121 for the year ended December 31, 2003, an increase of $1,366,656 or 7.6% from $18,097,465 for the same period in 2002. The increase in net sales is attributable to OEM customers, mainly the additional supply of electronic controls sold to Select Comfort Corporation. The increase in net sales to OEM customers was offset, in part, by a reduction in sales to Johnson Outdoors Incorporated (JOI). In June of 2003, the Company announced that orders to JOI would be reduced in the coming years due to JOI s decision to begin purchasing more high-volume assemblies from a vendor that provides assembly in China. Sales to JOI represented 13.2% of total sales for 2003. The Company will continue to provide assemblies to JOI but with significant reductions expected in 2004 and into the future. As a percentage of total sales, proprietary product sales were 13.4% and 15% for the twelve months ended December 31, 2003 and 2002, respectively.

The Company s Original Equipment Manufacture (OEM) customers have given the Company purchase orders and forecasts having an aggregate value of $8.9 million to be completed during 2004 and subsequent periods. The Company expects to receive additional orders from current OEM customers for 2004 and future production. Although the Company has purchase orders in place from many of its OEM customers which are scheduled to be fulfilled in 2004, these customers may terminate their relationship with the Company at any time, with certain cancellation provisions. Therefore, there is no assurance that the Company will continue to be engaged by any of these customers.

The Company has continued to provide a full range of Electronic Manufacturing Services (EMS) to OEM customers, delivering product needs from early concept through product realization. The Company continues to explore additional geographic regions to market its OEM services, primarily through networking with referral sources in the Chicago and Minneapolis areas. In addition to the networking and referral sources, the Company has signed representative agreements with two manufactures representative firms in the Illinois and Kansas areas. The loss of any significant OEM customer would likely have an adverse effect on the Company s short-term, and potentially long-term, results.

Gross Profits: Gross profit was $5,064,331 or 26.0% of net sales for the year ended December 31, 2003 compared to $4,295,114 or 23.7% of net sales for the same period in 2002. Gross profits increased 17.9% for the year ended December 31, 2003 compared to 2002. The increase in gross profit, as a percentage of sales, is attributed to an increase in sales, as well as a more profitable sales mix for the year. For the year ended December 31, 2003, the Company saw increases in salaries and related expenses, employee incentive plan expenses, and product liability insurance premiums, as well as increased manufacturing variances caused by the increase in volume of new product designs, offset in part by a reduction in obsolescence and warranty reserves. For 2003, the Company also experienced increases in the administrative expenses related to the Arrow Electronics, Inc. In Plant Store (IPS), which started in April of 2002. Inventory in the IPS, although located on Company premises, is owned by Arrow Electronics, Inc. and is invoiced to the Company when utilized by the Company in manufacturing. The Company has seen the use of the IPS reduce shipping and carrying costs of inventory.

Operating Expenses: General and administrative expense was $1,515,200 or 7.8% of net sales for the year ended December 31, 2003, compared to $1,268,955 or 7.0% of net sales for the same period in 2002. The increase in general and administrative expenses for 2003 is attributed primarily to increased salaries and employee incentive plan accruals and related expenses, employee training, increased expenses connected with corporate governance and investor relations, and increases in bad debt reserves related to specific customer accounts, offset in part by decreased telephone expense due to renegotiating of rates.

Research and development expense (including the development of new company products as well as design services and support to the OEM customer base) was $718,650 or 3.7% of net sales for the year ended December 31, 2003, compared to $671,930 or 3.7% of net sales for the same period in 2002. The increase in research and development expense for 2003, compared to 2002, is primarily attributed to increased salaries and related employee expenses as well as warranty expense associated with designs for customers, offset in part by a reduction in product development costs not directly associated with billable projects.

Table of Contents

Sales and marketing expense (including project management) was $992,361 or 5.1% of net sales for the year ended December 31, 2003, compared to $899,539 or 5.0% of net sales for the same period in 2002. The increases in sales and marketing expenses are directly associated with the development of the sales and marketing efforts of the organization. The increases result from increased salaries and related expenses, commissions expense, employee training and travel expense, offset in part by a reduction in leased vehicle expense.

Winland s sales and marketing efforts are focused on building long-term relationships with targeted OEM strategic accounts in the markets that it serves. The Company relies on direct sales people along with an extensive referral network to promote its services and uncover new opportunities. Management believes that augmenting its direct sales force with a referral network and utilizing independent sales representatives on a limited basis will effectively provide Winland an opportunity to build market share in the EMS (Electronic Manufacturing Services) market. In 2003 the Company added the new sales position of EMS business development manager to focus exclusively on strategic account development at select targeted accounts that best align with the products and services offered by the Company. In an effort to expand sales coverage within the Midwest, the Company has signed representative agreements with two independent sales representative firms headquartered in Chicago, and Kansas City.

Winland s proprietary products in the Environmental Sensors and Security Retail sectors are marketed through a network of dealers and distributors and supported by internal staff. In an effort to develop the Environmental and Security Retail portion of the business, the Company added the position of Manager for Environmental Security Products and initiated strategic planning for its proprietary products in late 2003.

Interest Expense: Interest expense was $136,944 or 0.7% of net sales for the year ended December 31, 2003, compared to $249,515 or 1.4% of net sales for the same periods in 2002. The decrease in interest expense was due to a reduction in short-term and long-term debt. During 2003, the Company has not borrowed from its revolving line-of-credit and has paid down $854,125 of long term debt. All of the cash used to reduce debt was generated from the Company s operating activities.

Net Earnings: The Company reported net income of $1,048,263 or $0.32 per basic share and $0.30 per diluted share for 2003, compared to net income of $1,077,805 or $0.33 per basic share and $0.32 per diluted share for 2002. The reduction in net income for 2003 is due to a significantly increased income tax expense. During 2002 the Company had tax loss carryforwards and tax credits available that significantly reduced the tax liabilities for 2002. The income tax expense for 2003 includes a reduction of $87,000 for a tax credit carryforwards utilized in 2003; however, the tax expense more closely represents the Company s effective income tax rate. The earnings per share were also impacted by the increase in the number of shares outstanding due to the fact that a significant number of shares in the option program were converted to common stock during the latter part of 2003.

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

The Company uses a 39% blended federal and state income tax rate, offset in part, by a tax benefit from the use of net operating losses and tax credits generated in previous years.

LIQUIDITY AND CAPITAL RESOURCES

Cash provided by operating activities was $1,785,562 for the year ended December 31, 2003, compared to $2,765,278 for the same period in 2002, a decline of $979,715. Cash provided by operations was used to pay down $854,125 of the Company s long-term debt and purchases of capital equipment of $275,501. The Company has funded its current operations with working capital provided by operations.

The current ratio at December 31, 2003 and December 31, 2002 was 2.5 to 1 and 2.3 to 1, respectively. Working capital equaled $3,581,629 on December 31, 2003, compared to $2,857,080 on December 31, 2002. The increase in working capital is attributed to increases in cash and accounts receivable balances, offset in part by increased accounts payable balances, compensation payable and other accrued expenses.

Table of Contents

On June 30, 2003 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 December 31, 2003 or December 31, 2002. The agreement with M&I Bank is also subject to certain restrictive requirements.

Management believes that our cash balance, availability of funds under the line of credit agreement with M&I Bank, 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 December 31, 2003 is as follows:

	Payments due by period					
Contractual Obligations	**Total**	**2004**	**2005**	**2006**	**2007**	**2008 and thereafter**
Long-term debt, including interest	$1,805,200	$515,200	1,127,700	$105,600	$20,000	$36,700
Total contractual cash obligations	$1,805,200	$515,200	$1,127,700	$105,600	$20,000	$36,700

We also have a commercial commitment as described below:

Other Commercial Commitment	Total Amount Committed	Outstanding at December 31, 2003	Date of Expiration
Line of credit	$2,500,000	$ 0	June 28, 2004

CRITICAL ACCOUNTING POLICIES

Our significant accounting policies are summarized in the footnotes to our financial statements. These policies include, but are not limited to, revenue recognition, income taxes, product warranties, depreciation and long-lived assets. Some of the most critical policies are also discussed below.

The Company derives revenue from primarily two sources: (1) product and out of warranty repair revenue, which includes custom electronic controls and assemblies for original equipment manufacturers and proprietary products in the security/industrial, motor control and GPS markets and (2) engineering design services which may include programming and prototypes. The Company recognizes revenue from the sale of products and out of warranty repairs when the product is shipped by being delivered to a common carrier. Revenue recognition occurs for engineering design services as the progress billings are made and at the conclusion of the project. For all sales, the Company uses either a binding purchase order or customer accepted and signed engineering quote as evidence of the arrangement.

The allowance for doubtful accounts is estimated at $20,000 at December 31, 2003. During 2003, the Company increased the allowance $56,000 based on current expectations with regard to specific customers and wrote off $46,000, resulting in a net increase of $10,000. The Company has not experienced significant bad debt write-offs the last several years, therefore, the current allowance is believed to be adequate for any exposures to loss on December 31, 2003 accounts receivable.

The Company has established a reserve for slow moving and obsolete inventories and believes the reserve of $163,000 at December 31, 2003 is adequate. The reserve is based on an analysis of the existing inventory, including applying probability of obsolescence percentages to the aged inventory brackets and specific identification of obsolete inventory in connection with decisions to exit certain markets.

In addition, the Company has established a reserve of $131,000 for rework and warranties. This reserve is based on historical experience and analysis of specific known and potential warranty issues. A portion of the reserve is based on a percentage of the sales for the six-month period ended December 31, 2003. The percentage used reflects historical experience. Specifically identified or potential warranty issues are analyzed to determine the probability and the Company s financial exposure, and the reserve is established.

Table of Contents

At December 31, 2003, the financial statements reflect a net deferred tax asset of $142,700. 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 carryforwards, 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 carryforwards are to be available to reduce taxable income.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities. This interpretation establishes standards for identifying a variable interest entity and for determining under what circumstances a variable interest entity should be consolidated with its primary beneficiary. Until now, a company generally has included another entity in its consolidated financial statements only if it controlled the entity through voting interests. Interpretation No. 46 changes that by requiring a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity s activities or is entitled to receive a majority of the entity s residual returns or both. As of September 30, 2003 the requirements of Interpretation No. 46 do not apply to the Company.

In May 2003, the Financial Accounting Standards Board (FASB) issued Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*, which requires the issuer to classify certain freestanding financial instruments as liabilities. Under the provisions of Statement No. 150, common stock issued with mandatory redemption features that require the Company to repurchase the shares upon an event that is certain to occur, such as termination of employment or death of the stockholder, is no longer classified as equity; instead, these shares will be reported as *shares subject to mandatory redemption* and classified as a liability in the balance sheet. In such circumstances, disclosure of the components of this liability will be included in the notes to the financial statements. The requirements of Statement No. 150 will apply to the Company for its quarter ending September 30, 2004. The effect of the adoption of this standard will be reported as a cumulative effect of a change in accounting principle in the year of adoption, and restatement of previously issued financial statements is not permitted. The Company does not believe that the adoption of this pronouncement will have a material effect on its financial statements.

CAUTIONARY STATEMENTS

Certain statements contained in this Annual Report on Form 10-KSB 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 which 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, pos project, should, will, forecast and similar words or expressions. The Company s forward-looking statements gener relate to the Company s growth strategies, financial results, product development and sales efforts. 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 customer 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 proprietary products and on the availability of sufficient financing, both equity and debt, to meet fixed and variable costs associated with such growth. 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 proprietary products depends on the effectiveness and timing of its new product development efforts as well as the availability and price of any competing products on the market. There is no assurance that the Company will be able to develop or acquire additional proprietary products that will be accepted in the marketplace and contribute to the Company s operating profits.

Table of Contents

ITEM 7.FINANCIAL STATEMENTS

The following financial statements are at the pages set forth below:

Table of Contents

Independent Auditor s Report

To the Board of Directors
Winland Electronics, Inc.
Mankato, Minnesota

We have audited the accompanying balance sheets of Winland Electronics, Inc. as of December 31, 2003 and 2002, and the related statements of income, changes in stockholders equity and cash flows for the years then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Winland Electronics, Inc. as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Minneapolis, Minnesota
January 23, 2004

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Table of Contents

Winland Electronics, Inc.

Balance Sheets
December 31, 2003 and 2002

Assets (Note 3)	2003	2002
Current Assets		
Cash	**$1,412,058**	$ 692,700
Accounts receivable, less allowance for doubtful accounts of $20,000 in 2003; $10,000 in 2002 (Note 9)	**2,255,003**	2,091,544
Income tax receivable	**138,234**	
Inventories (Note 2)	**1,861,135**	1,811,644
Prepaid expenses and other assets	**195,278**	145,035
Deferred taxes (Note 6)	**179,500**	296,300
Total current assets	**6,041,208**	5,037,223
Other Assets		
Patents and trademarks, net of accumulated amortization of $34,065 in 2003; $33,649 in 2002	**174**	590
Property and Equipment, at cost (Note 4)		
Land and land improvements	**272,901**	272,901
Building	**2,983,586**	2,983,586
Machinery and equipment	**3,905,882**	3,735,832
Data processing equipment	**1,323,660**	1,265,396
Office furniture and equipment	**364,715**	352,834
Total property and equipment	**8,850,744**	8,610,549
Less accumulated depreciation	**5,258,004**	4,556,721
Net property and equipment	**3,592,740**	4,053,828
Total assets	**$9,634,122**	$9,091,641

See Notes to Financial Statements.

14

Table of Contents

Liabilities and Stockholders Equity	2003	2002
Current Liabilities		
Current maturities of long-term debt	**$ 408,833**	$ 413,546
Accounts payable	**1,192,391**	931,933
Accrued expenses:		
Compensation	**612,590**	524,088
Other	**245,765**	151,548
Income tax payable		159,028
Total current liabilities	**2,459,579**	2,180,143
Long-Term Liabilities		
Deferred taxes (Note 6)	**94,300**	110,300
Deferred revenue (Note 5)	**170,818**	178,958
Long-term debt, less current maturities (Notes 3 and 4)	**1,248,671**	2,098,083
Total long-term liabilities	**1,513,789**	2,387,341
Total liabilities	**3,973,368**	4,567,484
Commitments and Contingencies (Note 4 and 10)		
Stockholders Equity (Notes 7, 8 and 10)		
Common stock, par value $0.01 per share; authorized 20,000,000 shares; issued and outstanding 3,356,955 shares in 2003 and 2,978,160 shares in 2002	**33,570**	29,782
Additional paid-in capital (Note 7)	**3,886,717**	2,264,710
Retained earnings	**1,740,467**	2,229,665
Total stockholders equity	**5,660,754**	4,524,157
Total liabilities and stockholders equity	**$9,634,122**	$9,091,641

Table of Contents

Winland Electronics, Inc.

Statements of Income
Years Ended December 31, 2003 and 2002

	2003	2002
Net sales (Note 9)	**$19,464,121**	$18,097,465
Cost of sales	**14,399,790**	13,802,351
Gross profit	**5,064,331**	4,295,114
Operating expenses:		
General and administrative	**1,515,200**	1,268,955
Research and development	**718,650**	671,930
Sales and marketing	**992,361**	899,539
	3,226,211	2,840,424
Operating income	**1,838,120**	1,454,690
Other income (expenses):		
Interest expense	**(136,944)**	(249,515)
Other, net	**19,087**	6,630
	(117,857)	(242,885)
Income before income taxes	**1,720,263**	1,211,805
Income tax expense (Note 6)	**672,000**	134,000
Net income	**$ 1,048,263**	$ 1,077,805
Earnings per share data:		
Basic	**$ 0.32**	$ 0.33
Diluted	**0.30**	0.32
Weighted-average number of common shares outstanding:		
Basic	**3,302,476**	3,262,720

Diluted	**3,484,841**	3,374,030

See Notes to Financial Statements.

Table of Contents

Winland Electronics, Inc.

Statements of Changes in Stockholders Equity
Years Ended December 31, 2003 and 2002

	Common Stock		Additional Paid-In Capital	Retained Earnings	Total
	Shares	Amount			
Balance on December 31, 2001	2,959,842	$29,598	$2,249,702	$ 1,151,860	$3,431,160
Issuance of common stock in accordance with employee stock purchase plan (Note 8)	10,894	110	11,332		11,442
Issuance of common stock in accordance with employee stock option plan (Note 7)	7,424	74	3,676		3,750
Net income				1,077,805	1,077,805
Balance on December 31, 2002	2,978,160	29,782	2,264,710	2,229,665	4,524,157
Issuance of common stock in accordance with employee stock purchase plan (Note 8)	11,946	119	18,006		18,125
Issuance of common stock in accordance with employee stock option plan (Note 7)	62,454	625	26,672		27,297
Warrants issued for services (Note 7)			43,178		43,178
Stock dividend (Note 1)	304,395	3,044	1,534,151	(1,537,195)	
Cash dividend on fractional shares				(266)	(266)
Net income				1,048,263	1,048,263
Balance on December 31, 2003	**3,356,955**	**$33,570**	**$3,886,717**	**$ 1,740,467**	**$5,660,754**

See Notes to Financial Statements.

Winland Electronics, Inc.

Statements of Cash Flows
Years Ended December 31, 2003 and 2002

	2003	2002
Cash Flows From Operating Activities		
Net income	**$1,048,263**	$1,077,805
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**717,866**	736,162
Loss on disposal of equipment	**1,139**	5,333
Investor relations expense, warrants issued	**18,617**	
Deferred taxes	**100,800**	(186,000)
Changes in assets and liabilities:		
Accounts receivable	**(163,459)**	(97,561)
Income tax receivable	**(138,234)**	177,000