WINLAND ELECTRONICS INC
Form 10QSB
August 16, 2004

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 June 30, 2004 | Commission File Number: 001-15637

WINLAND ELECTRONICS, INC.

(Name of small business issuer in its charter)

Minnesota	**41-0992135**
(state or other jurisdiction of incorporation or organization)	(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 [X] No [ ]

There were 3,365,046 shares of Common Stock, $.01 par value, outstanding as of July 30, 2004.

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

TABLE OF CONTENTS

Table of Contents

PART I-FINANCIAL INFORMATION

ITEM 1: FINANCIAL STATEMENTS

WINLAND ELECTRONICS, INC.
BALANCE SHEETS

	June 30, 2004	December 31, 2003
	(UNAUDITED)	
ASSETS		
Current Assets		
Cash	**$ 205,892**	$ 1,412,058
Accounts receivable, net	**2,979,301**	2,255,003
Income tax receivable	**20,607**	138,234
Inventories	**3,719,086**	1,861,135
Prepaid expenses	**262,294**	195,278
Deferred taxes	**186,300**	179,500
Total current assets	**7,373,480**	6,041,208
Other Assets	**97**	174
Total other assets	**97**	**174**
Property and Equipment, at cost:		
Land and land improvements	**272,901**	272,901
Building	**2,983,586**	2,983,586
Machinery and equipment	**4,715,272**	3,905,882
Data processing equipment	**1,383,789**	1,323,660
Office furniture and equipment	**366,915**	364,715
Total property and equipment	**9,722,463**	8,850,744
Less accumulated depreciation	**(5,263,687)**	(5,258,004)
Net property and equipment	**4,458,776**	3,592,740

Total assets	**$11,832,353**	$ 9,634,122

See Notes to the Interim Financial Statements

2

Table of Contents

WINLAND ELECTRONICS, INC.
BALANCE SHEETS

	June 30, 2004	December 31, 2003
	(UNAUDITED)	
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities		
Note payable to bank	$ **470,000**	$
Current maturities of long-term debt	**1,509,016**	408,833
Accounts payable	**2,163,059**	1,192,391
Accrued expenses:		
Compensation	**617,046**	612,590
Other	**35,194**	245,765
Total current liabilities	**4,794,315**	2,459,579
Long Term Liabilities		
Deferred taxes	**87,100**	94,300
Deferred revenue	**166,748**	170,818
Long-term debt, less current maturities	**811,799**	1,248,671
Total long-term liabilities	**1,065,647**	1,513,789
Total liabilities	**5,859,962**	3,973,368
Stockholders Equity		
Common stock	**33,623**	33,570
Additional paid-in capital	**3,900,910**	3,886,717
Retained earnings	**2,037,858**	1,740,467
Total stockholders equity	**5,972,391**	5,660,754
Total liabilities and stockholders equity	**$11,832,353**	$9,634,122

See Notes to the Interim Financial Statements

Table of Contents

WINLAND ELECTRONICS, INC.
STATEMENTS OF INCOME
For the Three Months Ended June 30, 2004 and 2003
(UNAUDITED)

	2004	2003
Net sales	**$5,775,879**	$4,347,028
Cost of sales	**4,786,771**	3,360,629
Gross profit	**989,108**	986,399
Operating expenses:		
General and administrative	**357,831**	337,567
Sales and marketing	**313,961**	224,127
Research and development	**160,033**	180,089
	831,825	741,783
Operating income	**157,283**	244,616
Other income (expenses):		
Interest expense	**(34,152)**	(35,661)
Other, net	**13,735**	3,994
	(20,417)	(31,667)
Income before income taxes	**136,866**	212,949
Income tax expense	**(58,000)**	(79,000)
Net income	**$ 78,866**	$ 133,949
Earnings per share data:		
Basic	**$ 0.02**	$ 0.04
Diluted	**0.02**	0.04
Weighted-average number of common shares outstanding:		
Basic	**3,358,788**	3,284,109
Diluted	**3,538,104**	3,419,748

See Notes to the Interim Financial Statements

Table of Contents

WINLAND ELECTRONICS, INC.
STATEMENTS OF INCOME
For the Six Months Ended June 30, 2004 and 2003
(UNAUDITED)

	2004	2003
Net sales	**$10,935,439**	$9,790,181
Cost of sales	**8,534,061**	7,389,540
Gross profit	**2,401,378**	2,400,641
Operating expenses:		
General and administrative	**825,418**	716,660
Sales and marketing	**630,499**	456,045
Research and development	**415,733**	376,527
	1,871,650	1,549,232
Operating income	**529,728**	851,409
Other income (expenses):		
Interest expense	**(64,182)**	(78,991)
Other, net	**21,844**	4,222
	(42,338)	(74,769)
Income before income taxes	**487,390**	776,640
Income tax expense	**(190,000)**	(284,000)
Net income	**$ 297,390**	$ 492,640
Earnings per share data:		
Basic	**$ 0.09**	$ 0.15
Diluted	**0.08**	0.14
Weighted-average number of common shares outstanding:		
Basic	**3,358,169**	3,280,066
Diluted	**3,563,973**	3,420,329

See Notes to the Interim Financial Statements

Table of Contents

WINLAND ELECTRONICS, INC.
STATEMENTS OF CASH FLOWS
For the Six Months Ended June 30, 2004 and 2003
(UNAUDITED)

	2004	2003
Cash Flows From Operating Activities		
Net income	**$ 297,390**	$ 492,640
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	**322,432**	344,209
(Gain) loss on disposal of equipment	**(6,142)**	711
Investor relations expense, warrants issued	**10,794**	7,822
Deferred taxes	**(14,000)**	
Changes in assets and liabilities:		
Accounts receivable	**(724,298)**	58,851
Income tax receivable	**117,627**	
Inventories	**(1,857,951)**	149,861
Prepaid expenses	**(77,810)**	(135,339)
Accounts payable	**970,668**	(99,139)
Accrued expenses, including deferred revenue and income taxes payable	**(210,185)**	(12,613)
Net cash provided by (used in) operating activities	**(1,171,475)**	807,003
Cash Flows From Investing Activities		
Purchases of property and equipment	**(1,189,249)**	(81,625)
Proceeds from the sale of equipment	**7,000**	
Net cash used in investing activities	**(1,182,249)**	(81,625)
Cash flows From Financing Activities		
Net borrowings on revolving line of credit	**470,000**	
Proceeds from note payable to bank	**1,000,000**	
Payments on long-term borrowings, including capital lease obligations	**(336,689)**	(676,846)
Proceeds from issuance of common stock	**14,246**	10,013
Net cash provided by (used in) financing activities	**1,147,557**	(666,833)

Net increase (decrease) in cash	**(1,206,167)**	58,545
Cash		
Beginning	**1,412,058**	692,700
End	**$ 205,891**	$ 751,245
Supplemental Disclosures of Cash Flow Information Cash payments for:		
Interest	**$ 64,106**	$ 78,405
Income tax	**173,750**	412,830
Supplemental Schedule of Noncash Financing Activities Warrants Issued in Connection with Investors Relations Services to be Provided	**$**	$ 43,178

See Notes to the Interim Financial Statements

6

Table of Contents

Note 1. Basis of Presentation

The accompanying unaudited financial statements have been prepared by the Company in accordance with generally accepted accounting principles in the United States of America, pursuant to the rules and regulations of the Securities and Exchange Commission. In management s opinion all adjustments necessary for a fair presentation of the results for the interim period have been reflected in the interim financial statements. The results of operations for any interim period are not necessarily indicative of the results for a full year. All adjustments to the financial statements are of a normal recurring nature. Certain information and footnote disclosures normally included in financial statements have been condensed or omitted. Such disclosures are those that would substantially duplicate information contained in the most recent audited financial statements of the Company, such as significant accounting policies, lease and license commitments and stock options. Management presumes that users of the interim statements have read or have access to the audited financial statements included in the Company s most recent annual report on Form 10-KSB.

Note 2. Inventories

Major components of inventory at June 30, 2004 and December 31, 2003 as follows:

	June 30, 2004	December 31, 2003
Raw Materials	$2,121,030	$1,091,213
Work In Process	864,919	146,307
Finished Goods	933,137	786,615
Obsolescence reserve	(200,000)	(163,000)
Total	$3,719,086	$1,861,135

Note 3. Financing Arrangement

The Company has a $2,500,000 annual revolving line-of-credit agreement with M&I Bank of Minneapolis, Minnesota through June 28, 2005. Advances are due on demand, secured by substantially all assets of the Company, and are subject to a defined borrowing base equal to 75 percent of qualified accounts receivable, and 50 percent of qualified inventory. The total unused availability on the line of credit was $2,030,000 at June 30, 2004. Interest on advances accrues at the bank s reference rate (4 1/4 % at June 30, 2004), is due monthly and is subject to certain restrictive covenants. There were advances of $470,000 outstanding on the revolving line of credit agreement at June 30, 2004, and there were no advances outstanding at December 31, 2003.

On April 15, 2004, the Company signed an amendment to the original credit agreement that will provide the Company with a $1.5 million term loan for the purpose of purchasing capital equipment. As of April 15, 2004, the Company had drawn $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. This agreement is subject to the same restrictive covenants as the revolving line of credit agreement.

Table of Contents

Note 4. Major Customers and Enterprisewide Disclosures

Major Customers: The Company has customers that accounted for more than 10 percent of net sales for The three and six months ended June 30, 2004 and 2003, as follows:

	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003
Sales percentage:		
Customer A	58%	58%
Customer B	11%	0%
Customer C	4%	17%

	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Sales percentage:		
Customer A	60%	55%
Customer B	8%	0%
Customer C	5%	19%

The above customers had net receivables at June 30, 2004 and December 31, 2003 as follows:

	June 30, 2004	December 31, 2003
Accounts receivable percentage:		
Customer A	47%	55%
Customer B	15%	0%
Customer C	4%	13%

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

	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003
Proprietary microprocessors and mechanically controlled sensors and alarms	$ 588,658	$ 545,765
Electronic controls and assemblies for OEM customers	5,187,221	3,801,263
	$5,775,879	$ 4,347,028

	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Proprietary microprocessors and mechanically controlled sensors and alarms	$ 1,310,510	$1,219,378
Electronic controls and assemblies for OEM customers	9,624,929	8,570,803
	$10,935,439	$9,790,181

Table of Contents

Note 5. Earnings Per Share

Basic earnings per share is computed by dividing net earnings by the weighted-average number of common shares outstanding during the period. Diluted earnings per 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 the options and warrants to purchase shares of common stock at various amounts per share. The dilutive effect of the additional shares for the three and six months ended June 30, 2004 and 2003 increased the weighted-average shares outstanding by 179,316 and 205,804 compared to 135,639 and 140,263, respectively.

Note 6. Stock Options, 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. The warrants term will extend three years from the date of full 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, 2004, warrants to purchase 39,697 shares of common stock were outstanding, of which 26,464 shares were exercisable. The exercise price of such outstanding warrants is $1.85 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 life of the contract. In addition, the total value of the outstanding warrants, $43,178, is reflected in the stockholders equity section at June 30, 2004.

Stock-Based Compensation Plans: The Company has a stock-based compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Accordingly, no stock-based employee compensation cost has been recognized, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. There were 43,000 options to purchase shares issued to employees and directors during the three months ended June 30, 2004, representing gross compensation expense of $76,320. The effect on net income and earnings per share for the compensation cost for the stock-based compensation plan has been determined based on the grant date fair values of awards (the method described in FASB Statement No. 123, Accounting for Stock Based Compensation) and is reflected in the table below.

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2004	**2003**	**2004**	**2003**
Net Income:				
As reported	$ 78,866	$133,949	$297,390	$492,640
Deduct total stock-based employee compensation expense determined under the fair value-based method for all awards net of related tax effects	(25,189)	(25,980)	(36,838)	(35,311)
Pro forma	$ 53,677	$107,969	$260,552	$457,329

Basic Earnings per share								
As reported	$	0.02	$	0.04	$	0.09	$	0.15
Pro forma	$	0.02	$	0.03	$	0.08	$	0.14
Diluted Earnings per share								
As reported	$	0.02	$	0.04	$	0.08	$	0.14
Pro forma	$	0.02	$	0.03	$	0.07	$	0.13

Table of Contents

Note 7. Product Warranties:

The Company provides a limited warranty for a period of one year for its products. The Company s standard warranties require the Company to repair or replace defective products during such warranty period at no cost to the customer. The Company estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company s warranty liability include the number of units sold, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. The Company utilizes historical trends and actuarial analysis tools to assist in determining the appropriate loss reserve levels.

Changes in the Company s warranty liability, which is included in other accruals on the balance sheets, during the period are approximately as follows:

	Six Months Ended June 30,	
	2004	**2003**
Balance, Beginning	$131,000	$ 95,000
Accruals for products Sold	54,633	100,400
Charges in accruals for pre-existing warranties	(69,633)	(68,400)
Balance, Ending	$116,000	$127,000

Note 8. New Accounting Standards

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 June 30, 2004, 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. As of June 30, 2004, the requirements of FASB No. 150 do not apply to the Company.

Table of Contents

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

RESULTS OF OPERATIONS
Three and six months ended June 30, 2004 v.
Three and six months ended June 30, 2003

Net Sales: The Company recorded net sales of $5,775,879 and $10,935,439 for the three and six months ended June 30, 2004, an increase of 33% and 12% from $4,347,028 and $9,790,181 for the same periods in 2003, respectively. The increase in sales for the three and six months ended June 30, 2004 is primarily attributed to increased sales to original equipment manufacture (OEM) customers, offset in part by the decline in sales to Johnson Outdoors, Inc for the current quarter and the first six months of 2004. Sales of Winland s proprietary products primarily for the security/industrial sector, motor controls and utility controls, increased 8% for the three months ended June 30, 2004 and 7% for the first six months of 2004, compared to 2003.

The Company has received from its OEM customers purchase orders having an aggregate value of $10.8 million for delivery during the remainder of 2004 and into 2005. 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 that are scheduled to be fulfilled in 2004, these customers may terminate their relationship with the Company at any time pursuant to certain cancellation provisions. Therefore, there is no assurance that the Company will continue to be engaged by any of these customers. In June of 2003 the Company announced that orders from Johnson Outdoors, Inc. (JOI) would be reduced in the coming years. Sales to JOI represented 4.6% of total sales for first six months of 2004 compared to 19.4% for the same period in 2003.

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 manufacturers 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 dollars increased slightly to $989,108 or 17.1% of net sales for the three months ended June 30, 2004, compared to $986,399 or 22.7% of net sales for the same period in 2003. Gross profit dollars remained relatively consistent at $2,401,378 for the six months ended June 30, 2004, compared to $2,400,641 for the same period in 2003. Gross profit decreased as a percentage of net sales from 24.5% in 2003 to 22.0% in 2004. The decline in gross profit as a percentage of net sales for the quarter and the six months ended June 30, 2004 is attributed to additional production costs, including component preparation, manual component placements and manual testing associated with 23 new product introductions for the quarter and 44 new products in the first six months of 2004. During the second quarter and the six months ended June 30, 2004, additional labor costs due to overtime and the increased use of a temporary labor force, as well as increased costs associated with billable engineering projects and increased freight, offset in part by reduced warranty and obsolescence expenses and a reduction in employee incentive plan accruals when compared to the same period in 2003 also contributed to the increased manufacturing variances that resulted from the higher volume of new product design.

Operating Expenses: General and administrative expense was $357,831 or 6.2% of net sales and $825,418 or 7.5% of net sales for the three and six months ended June 30, 2004, compared to $337,567 or 7.8% of net sales and $716,660 or 7.3% of net sales for the same periods in 2003.

The increase in general and administrative expense for the three and six months ended June 30, 2004 is attributed to increased salaries and related expenses, board of directors expense, directors and officers insurance expense, legal and professional fees as well as donations expense, offset in part by a decline in bad debt and a reduction in employee incentive plan accruals when compared to the same period in 2003. Investor relations expense declined slightly for the quarter but was up for the first six months of 2004.

Table of Contents

Sales and marketing expense (including project management) was $313,961 or 5.4% of net sales and $630,499 or 5.8% of net sales for the three and six months ended June 30, 2004, compared to $224,127 or 5.2% of net sales and $456,045 or 4.7% of net sales for the same periods in 2003, respectively. The increase in sales and marketing expense for the three and six months ended June 30, 2004 are directly associated with increased salaries and related expenses, commissions expense and travel expense, offset in part by a reduction in leased vehicle expense and employee training 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 a 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.

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.

Research and development expense (primarily design services and support to the OEM customer base) was $160,033 or 2.8% of net sales for the three months ended June 30, 2004 and $415,733 or 3.8% of net sales for the first six months of 2004, compared to $180,089 or 4.1% of net sales and $376,527 or 3.8% of net sales for the same periods in 2003. The increase in research and development expense for the first six months of 2004 compared to the same period in 2003 is primarily attributed to increased design failure guarantee expense associated with designs for customers, offset in part by amounts allocated to billable engineering projects and a reduction in employee incentive plan accruals when compared to the same period in 2003. Expenses were down slightly for the second quarter of 2004 due to amounts allocated to billable engineering projects and a reduction in employee incentive plan accruals when compared to the same period in 2003.

Interest Expense: Interest expense was $34,152 and $64,182 or 0.6% of net sales for the three and six months ended June 30, 2004, compared to $35,661 and 78,991 or 0.8% of net sales for the same periods in 2003, respectively. The decline in interest expense for the second quarter and first six months of 2004 was due to the timing of new borrowings. With the increase in short-term and long-term borrowings the Company expects to see an increase in interest expense for subsequent periods.

Net Earnings: The Company reported net income of $78,866 or $0.02 per basic and diluted share for the three months ended June 30, 2004 and $297,390 or $0.09 per basic and $0.08 per diluted shared for the first six months of 2004, compared to net income of $133,949 or $0.04 per basic and diluted share and $492,640 or $0.15 per basic shared and $0.14 per diluted share for the same periods in 2003, respectively. The decline in net income for the quarter and first six months of 2004 is primarily attributed to a decline in gross profits, increased operating expenses, offset in part by a reduction in interest expense and income tax expense.

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 net income was $487,390 for 2004 and $776,640 for 2003, resulting in income tax expense of $190,000 and $284,000, respectively.

Table of Contents

LIQUIDITY AND CAPITAL RESOURCES

Cash used in operating activities was $1,171,475 for the six months ended June 30, 2004, compared to cash provided by operating activities of $807,003 for the same period in 2003, a decline of $1,978,478. This change was primarily due to decreased net income levels and increases in inventory levels, accounts receivable, prepaid expenses as well as a decline in accrued expenses, offset in part by increased accounts payable balances and a reduction in income tax receivable. Cash used in operations resulted in a decrease in reserves partially offset by borrowings on the bank line-of-credit and proceeds from long term debt.

The current ratio at June 30, 2004 was 1.54 to 1, compared to 2.46 to 1 at December 31, 2003. Working capital equaled $2,579,165 on June 30, 2004, compared to $3,581,629 on December 31, 2003. The decline in working capital is primarily attributed to a decrease in cash, used to fund current operating activities and increased current maturities of long term debt associated with the maturity date on the mortgages with the City of Mankato in January of 2005 as well as increased short-term borrowings, offset in part by increased inventory levels, accounts receivable and increased prepaid expenses.

On June 25, 2004 the Company extended its revolving credit agreement with the M&I Bank of Minneapolis, Minnesota with a renewal date of June 28, 2005. There was $470,000 of advances outstanding on the revolving line-of-credit agreement at June 30, 2004, with no advances outstanding at December 31, 2003. The interest rate on the revolving line-of-credit is at the banks reference rate, 4.25% at June 30, 2004. The agreement with M&I Bank is also subject to certain restrictive covenants. On April 15, 2004 the Company signed an amendment to the original credit agreement that will provide the Company with a $1.5 million dollar term loan for the financing of its capital equipment purchases. M&I Bank has advanced $1,000,000 to the Company as of April 15, 2004, the stated interest rate is fixed at 4.91% on this advance. The loan will be amortized in full over 48 months.

Management believes that our cash balance, availability of funds under the line of credit agreement, the amendment adding the $1.5 million dollar 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 June 30, 2004 is as follows:

	Payments due by period				
Contractual Obligations	**Total**	**Remainder Of 2004**	**2005**	**2006**	**2007 and Thereafter**
Long-term debt, including interest	$2,479,600	$380,100	$1,395,400	$359,000	$345,100

Other commercial commitments as described below:

Other Commercial Commitment	**Total Amount Committed**	**Outstanding Balance 06/30/04**	**Date of Expiration**
Line of Credit	$2,500,000.00	$470,000.00	June 28, 2005

There are no off balance sheet contractual cash obligations.

Table of Contents

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The critical accounting policies and estimates to follow include, but are not limited to, revenue recognition, income taxes, product warranties, depreciation and long-lived assets. Some of the most critical policies and estimates are also discussed below.

The Company derives revenue from primarily two sources: (1) product sales and out of warranty repair revenue, which includes custom electronic controls and assemblies for original equipment manufacturers and proprietary products in the security/industrial and motor control markets and (2) engineering design services that may include programming and prototypes. 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 to a customer. A portion of the Company s business involves the Company shipping product to a primary customers location where it is held in a separate warehouse. Revenue is recognized when the customer notifies the Company that the inventory has been removed from that 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. 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 $10,000 at June 30, 2004. 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 June 2004 accounts receivable. Factors considered in establishing the reserves include economic conditions and customer financial strength.

The Company has established a reserve for slow moving and obsolete inventories and believes the reserve of $200,000 at June 30, 2004 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 $116,000 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 June 30, 2004. 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. The Company believes that the estimated reserve at June 30, 2004 is adequate.

At June 30, 2004, the financial statements reflect deferred tax assets of $186,300 and deferred tax liabilities of $87,100. 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.

The Company depreciates property and equipment over its estimated useful life. There were no impairment charges taken for the three and six month periods ended June 30, 2004.

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, pos project, should, will,

Table of Contents

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, 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.

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.

15

Table of Contents

(b) Changes in Internal Controls.

There were no changes in the Company s internal controls over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

(a) The Company has been named a party in a suit in the Commonwealth of Massachusetts dated April 12, 2004. The parties to the suit are: The Charter Oak Insurance Co., Travelers Property Casualty Co of America (Plaintiffs) v. Joseph Carista d/b/a Prestige Alarm and Service, Winland Electronics Inc., ADD Inc., and Panitsas Engineering Associates, Inc. (Defendants). The suit claims that on January 12, 2004 the fire protection system sprinkler head located in an unheated area of the 6th floor of 210 Commercial Street Boston, Massachusetts froze and caused catastrophic water loss damages. The Plaintiffs are seeking $1 million dollars in damages collectively from the Defendants. The Company denies any liability for the loss because of the alleged improper installation of the TA-40 Fixed Temp Atert sold by the Company. Management does not believe that the resolution of this suit will have a material financial impact on the Company.

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

The Company held its Annual Meeting on May 11, 2005.

Proxies for the annual meeting were solicited pursuant Regulation 14A under the Securities and Exchange Act of 1394. There was no solicitation in opposition to management s nominees as listed in the proxy statement, and all nominees were elected.

The number of directors was set at five by eliciting the following persons to serve as directors of the Company until the next annual meeting of shareholders with the following votes:

Nominee	Number of Votes For	Number of Votes Withheld
Thomas J. de Petra	2,878,330	263,956
S. Robert Dessalet	3,093,735	48,551
Lorin E. Krueger	3,094,210	48,076
James L. Reissner	3,094,430	47,856
Richard T. Speckman	3,094,430	47,856

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) **Exhibits**. See Exhibit Index following the signature page.

(b) **Reports on Form 8-K.** The Company filed (i) a Form 8-K dated April 4, 2004 announcing first quarter earnings for 2004 and (ii) a Form 8-K dated May 21, 2004 to provide the first quarter 2004 letter to shareholders.

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: August 16, 2004

/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)

18

Table of Contents

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

EXHIBIT INDEX TO FORM 10-QSB

For the fiscal quarter ended June 30, 2004

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