

WINLAND ELECTRONICS INC

Form 10KSB

March 12, 2003

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

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**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, 2002

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)

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

<u>Title of Each Class</u>	<u>Name of Exchange</u>
Common Stock, \$.01 par value	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  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, 2002: \$ 18,097,466.

The aggregate market value of the Common Stock held by non-affiliates as of February 10, 2003 was approximately \$4,501,697 based on the closing sale price of the Issuer's Common Stock on such date.

There were 2,978,160 shares of Common Stock, \$.01 par value, outstanding as of February 10, 2003.

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**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

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**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 OEM customers. Revenues from OEM customers provided 85% of the Company's total revenue in 2002. 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 Original Equipment Manufacturers (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 additional value-added services that complement the Company's contract manufacturing capabilities. The services provided may include product design, value engineering, manufacturing engineering, testing, out-of-warranty repair, shipping, and warehousing. These services differentiate the Company from the competition and increase customer satisfaction, confidence, and loyalty. Although the Company has purchase orders in place from many of its OEM customers which are scheduled to be fulfilled in 2003, these customers can 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 85% and 82% of the Company's total sales during 2002 and 2001, 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 hooked up to many burglar or fire alarm panels to monitor and report unfavorable environmental conditions. Proprietary product sales accounted for 15% and 18% of the Company's total sales for 2002 and 2001, 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 itself 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 to their manufacturing needs. The Company plans to achieve continued growth in OEM sales by providing its customers with exceptional service, application specific technical expertise, and continuing to deliver quality, cost-effective controls and assemblies to its OEM customers.

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The Company has continued to position itself as 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.

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 subsequent 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 \$12.1 million, or 66% of total net sales, in 2002 and net sales of \$10.1 million, or 67% of total net sales, in 2001.

Select Comfort Corporation has been one of the Company's most significant customers during both 2002 and 2001, with sales of 50% and 35% 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 17% and 16% of the Company's net sales during 2002 and 2001, respectively. Johnson Outdoors Inc. is a Wisconsin based manufacturer of

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recreational products. The design and manufacture services provided to PeopleNet Communications Corporation accounted for 1% and 15% of the Company's net sales during 2002 and 2001, respectively. PeopleNet Communications Corporation is a Minnesota based manufacturer of a locating and mobile communications system for the long-haul and short-haul transportation industry. Due to a re-negotiation of the manufacturing agreement with PeopleNet Communications Corporation in August 2001, the Company experienced a significant reduction of sales to PeopleNet Communications Corporation during 2002.

Sales of the Company's proprietary products accounted for 15% of total sales for 2002 and 18% for 2001. In 2002, nearly 38% 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 has been working to position itself as a full service solution 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 2002, the Company has continued to position itself as a full-service solution to its OEM customers by offering varied design technologies such as, wireless communications, and embedded software design for control systems. The Company continues to have a strong research and development department that has the ability to service most of the customers' engineering requirements, including complete new product design, value engineering, and redesign of existing products. The Company has had a reduction in its engineering staff due to attrition and reassignment of staff without replacement. The Company believes that it will be able to meet the current needs of its customer base, as well as to expand into new design projects. The Company spent \$671,930 or 3.7% of net sales for research and development expenses for the year ended December 31, 2002, compared to \$840,813 or 5.5% of net sales for 2001.

**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.

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Foreign Operations and Export Sales:

In 2002 and 2001, the Company derived less than 2% of its revenues from sales outside the United States.

Personnel:

At December 31, 2002, the Company had 85 employees (eighty-three full-time and two part-time). During 2002 and 2001, 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 that 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 are subject to mortgages securing an aggregate amount of debt, which was equal to \$1,869,866 as of December 31, 2002.

**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.

<u>Name</u>	<u>Age</u>	<u>Position</u>
Lorin E. Krueger	47	President, Chief Executive Officer, Secretary and Director
Jennifer A. Thompson, CPA	44	Chief Financial Officer
Kirk P. Hankins	41	Vice President of Sales - EMS Eastern Region
Terry E. Treanor	40	Vice President of Manufacturing
Steven W. Vogel	46	Vice President of Engineering
Dale A. Nordquist	48	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.



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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.

*Kirk P. Hankins* has served as Vice President of Sales – EMS Eastern Region since January 2002. He served as Vice President of Sales and Marketing of the Company from April 1989 to January 2002. He served as a director of the Company from 1990 until June 2001. Mr. Hankins served as Secretary of Playtronics Corporation, a manufacturer of electronic toys, from October 1985 until March 1990, when Playtronics merged into the Company, and as Vice President of Playtronics from October 1985 until April 1989. From 1984 to 1985, Mr. Hankins was the Marketing Manager of the Company.

*Terry E. Treanor* joined the Company in July 1994 and was appointed Vice President of Manufacturing on June 28, 1996, prior to which he served 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* joined the Company in May 1994 and was appointed Vice President of Engineering on September 7, 1998, prior to which he served as 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* was recently promoted to Senior Vice President of Sales and Marketing. Dale joined the Company in October 2001 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.

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The Company's Common Stock was 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.

<b>Fiscal Year Ended December 31, 2002</b>	<b>Low</b>	<b>High</b>
First Quarter	.80	1.26
Second Quarter	.80	2.89
Third Quarter	1.86	2.65
Fourth Quarter	1.20	2.84

<b>Fiscal Year Ended December 31, 2001</b>	<b>Low</b>	<b>High</b>
First Quarter	1.25	1.94
Second Quarter	1.15	1.55
Third Quarter	0.80	1.50
Fourth Quarter	0.50	1.18

On February 10, 2003, the fair market value of the Company's Common Stock was \$1.67 based on the closing sale price quoted by AMEX on that date. As of December 31, 2002, the Company had approximately 464 shareholders of record.

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.

**ITEM 6: MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION****RESULTS OF OPERATIONS- 2002 vs. 2001**

Net Sales: The Company recorded net sales of \$18,097,466 for the year ended December 31, 2002, an increase of \$2,702,712 or 17.6% from \$15,394,754 for the same period in 2001. 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 were offset, in part, by the significant reduction in sales to PeopleNet Communications. In August of 2001 the Company negotiated a release of its manufacturing agreement with PeopleNet Communications for the production of the customers base unit. The Company continues to supply manufacturing services to PeopleNet, but at a reduced level. Sales of Winland's proprietary products decreased slightly for the twelve months ended December 31, 2002, compared to 2001.

The Company's OEM customers have given the Company purchase orders and forecasts having an aggregate value of \$12.5 million to be completed over the next twelve months. The Company expects to receive additional orders from current OEM customers for 2003 and future production. Although the Company has purchase orders in place from many of its OEM customers which are scheduled to be fulfilled in 2003, these customers can 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. In addition, the Company signed a multi-year manufacturing agreement with Select Comfort Corporation, the Company's largest OEM customer. The multi-year contract names Winland as the supplier of electronic controls for Select Comfort's SLEEP NUMBER® 4000, SLEEP NUMBER® 5000 and SLEEP NUMBER® 7000 beds. The renewable contract gives Winland production rights of these electronic controls for a minimum of three years.

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The Company has continued to position itself as a full service designer and manufacturer of custom controls and assemblies for OEM customers. 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. 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 \$4,295,114 or 23.7% of net sales for the year ended December 31, 2002 compared to \$2,599,509 or 16.9% of net sales for the same period in 2001. As a percentage of net sales, gross profits increased 6.8% for the year ended December 31, 2002 compared to 2001. The increase in gross profit, as a percentage of sales, is attributed to a more profitable sales mix for the year, including improved margins on Winland proprietary products, combined with the Company's ability to lower direct and variable indirect expenses as a percentage of net sales as revenues increased for 2002, compared to 2001. Reductions in cost of good sold, as a percentage of sales, for the year ended December 31, 2002, are primarily in salaries and employee related expenses, as well as lower information technology and facility expenses, offset in part by increased warranty and obsolescence reserves, commissions expense, accrued employee incentive plan expense and the administrative expenses related to the new Arrow Electronics, Inc. In Plant Store (IPS). 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. The increase in gross profit was also offset in part by the additional accrued Paid Time Off (PTO) that was necessary when the Company modified its policy on accounting for vacation and sick leave hours into one pool.

**Operating Expenses:** General and administrative expense was \$1,268,956 or 7.0% of net sales for the year ended December 31, 2002, compared to \$1,606,663 or 10.4% of net sales for the same period in 2001. The decrease in general and administrative expenses for 2002 are attributed primarily to reductions in professional fees, information technologies, leased vehicle expenses, and executive severance expense for the former CEO of the Company, offset in part by increased employee incentive plan accruals, PTO accruals, travel expense, and directors and officers insurance premium expenses. General and administrative expenses in 2001 included more than \$277,000 of professional fees, shareholder communications and board of director expenses related to the special shareholders' meeting requested by dissident shareholder, Dyna Technology, Inc., and an annual meeting contested by Dyna Technology, Inc.

**Research and development expense** (including the development of new company products as well as design services and support to the OEM customer base) was \$671,930 or 3.7% of net sales for the year ended December 31, 2002, compared to \$840,813 or 5.5% of net sales for the same period in 2001. The decline in research and development expense for 2002, compared to 2001, is primarily attributable to employee attrition and reassignment without replacement. Accordingly, total salaries and related expenses decreased, as well as decreased facility, information technology and leased vehicle expenses, offset in part by increased employee incentive plan accruals and PTO accruals.

**Sales and marketing expense** (including project management) was \$899,539 or 5.0% of net sales for the year ended December 31, 2002, compared to \$716,821 or 4.7% of net sales for the same period in 2001. The increase in sales and marketing expense is primarily attributable to increased salaries and employee related costs due to reassignment of certain personnel and the addition of a Vice President of Sales in late 2001. In addition, the Company incurred increased expense related to employee incentive plan accruals, increased PTO accruals, offset in part by decreased leased vehicle expenses, information technology expenses and promotional expenses.

**Interest Expense:** Interest expense was \$249,515 or 1.4% of net sales for the year ended December 31, 2002, compared to \$482,634 or 3.1% of net sales for the same periods in 2001. The decrease in interest expense was due to a reduction in short-term and long-term debt as well as lower interest rates on short-term debt. During 2002, the Company paid down the entire balance of \$1,981,501 on its line-of-credit and reduced principal on long-term debt of \$482,103. The cash used to reduce debt was generated from the Company's operating activities.

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Net Earnings: The Company reported net income of \$1,077,805 or \$0.36 per basic share and \$0.35 per diluted share for 2002, compared to a net loss of \$876,729 or \$0.30 per basic and diluted share for 2001. The net income for 2002 is primarily due to increased gross profit margins based on increased sales, a more profitable sales mix, and the Company's ability to maintain lower direct and variable indirect expenses. Bottom line performance also benefited from overall reductions in operating expenses and interest expense.

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

The Company uses a 37% 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 \$2,765,275 for the year ended December 31, 2002, compared to \$3,040,357 for the same period in 2001, a decrease of \$275,082. Cash provided by operations was used to pay down \$1,981,501 of the Company's revolving line-of-credit, reduce long-term debt and to a lesser degree, for the purchase of equipment. The Company has funded its current operations with working capital provided by operations.

The current ratio at December 31, 2002 and December 31, 2001 was 2.3 to 1 and 1.4 to 1, respectively. Working capital equaled \$2,746,781 on December 31, 2002, compared to \$1,367,666 on December 31, 2001. The increase in working capital is attributed to reductions in short-term and long-term debt, offset in part by increased income taxes payable and accrued expenses, as well as, decreased inventory and income tax receivable.

The Company has a \$2,500,000 revolving line-of-credit agreement with Wells Fargo Bank, through March 31, 2003. Interest on advances is at two percentage points over the bank's reference rate and is due monthly. There were no advances outstanding on the revolving line-of-credit at December 31, 2002 and \$1,981,501 at December 31, 2001. Advances are due on demand, are secured by substantially all assets of the Company, and are subject to a defined borrowing base equal to 75% of qualified accounts receivable and 40% of eligible inventory. In addition, the line-of-credit agreement contains certain reporting and operating covenants.

In order to continue operations in the ordinary course, the Company will seek to renew or refinance its line of credit agreement, which expires March 31, 2003.

A summary of our approximate contractual cash obligations at December 31, 2002 is as follows:

Contractual Obligations	Payments due by period					
	Total	2003	2004	2005	2006	2007 and thereafter
Long-term debt including capital lease obligations, including interest	\$ 2,823,200	\$ 541,900	\$ 982,500	\$ 1,134,900	\$ 105,600	\$ 58,300
Operating leases	10,000	10,000	0	0	0	0
Total contractual cash obligations	\$ 2,833,200	\$ 551,900	\$ 982,500	\$ 1,134,900	\$ 105,600	\$ 58,300

The only off balance sheet contractual cash obligations are the operating leases noted above.

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We also have a commercial commitment as described below:

<u>Other Commercial Commitment</u>	<u>Total Amount Committed</u>	<u>Outstanding at December 31, 2002</u>	<u>Date of Expiration</u>
Line of credit	\$ 2,500,000	\$ 0	March 31, 2003

**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 \$10,000 at December 31, 2002. The Company has not experienced significant bad debt write offs the last several years, nor does a review of existing customer receivables dictate any significant potential losses. Therefore, the current allowance is believed to be adequate for any exposures to loss on December 31, 2002 accounts receivable.

The Company has established a reserve for slow moving and obsolete inventories and believes the reserve of \$185,000 at December 31, 2002 is adequate. The reserve is based on an analysis of the existing inventory, including specific identification of obsolete inventory and applying a percentage of the aged inventory 15 months old and older. We believe the obsolete and slow moving inventory allowance includes adequate reserves for any inventory related to the discontinuance of the GPS Antenna products line.

In addition, the Company has established a reserve of \$95,000 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, 2002. 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 December 31, 2002 is adequate.

At December 31, 2002, the financial statements reflect a net deferred tax asset of \$186,000. 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. During the year ended December 31, 2001, the Company recorded a valuation allowance of \$315,200, or 100% of the net deferred tax assets. Since 2001 represented the second consecutive loss year, the valuation allowance was established by management due to the difficulties in predicting when the net deferred tax assets would be utilized and the amount of future taxable income that may be generated. 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. In 2002, because income was at a record high, the Company eliminated the previously recorded valuation allowance as in the opinion of management it is more likely than not that the deferred income tax assets will be realized due to future profitability.

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The income tax expense for 2002 reflects a reduction of approximately \$315,000 over standard tax rates, due to the use of credit carryforwards and temporary book/tax differences that were reflected in the deferred tax asset valuation allowance at December 31, 2001.

The Company depreciates property and equipment over its estimated useful life. In 2001, one piece of equipment was identified as impaired and written down to its lease buy out value. There were no impairment charges taken in 2002.

## **RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In September 2001, the FASB issued Statement No. 143, *Asset Retirement Obligations*. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The statement will be effective for the Company's fiscal year ending 2003. Management does not expect the adoption of this standard to have a material impact on the Company's financial statements.

In April 2002, the FASB issued Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendments of FASB Statement No. 13, and Technical Corrections*. The Company does not believe that the adoption of this pronouncement will have a material effect on its financial statements.

In June 2002, the FASB issued Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. This statement requires the recognition of a liability for a cost associated with an exit or disposal activity when the liability is incurred versus the date the Company commits to an exit plan. In addition, this statement states the liability should be initially measured at fair value. The statement is effective for exit or disposal activities that are initiated after December 31, 2002. The Company does not believe that the adoption of this pronouncement will have a material effect on its financial statements.

In January 2003, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*. This statement provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement also amends the disclosure requirements of SFAS No. 123 to require more prominent and frequent disclosures in the financial statements about the effects of stock-based compensation. The transitional guidance and annual disclosure provisions of this statement is effective for the December 31, 2002, financial statements. The interim reporting disclosure requirements will be effective for the Company's March 31, 2003, 10-QSB. Because the Company continues to account for employee stock-based compensation under APB Opinion No. 25, the transitional guidance of SFAS No. 148 has no effect on the financial statements at this time. However, the December 31, 2002, financial statements have incorporated the enhanced disclosure requirements of SFAS No. 148, as presented above under the caption Employee Stock Plans.

## **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, possible, plan, project, should, will, forecast and similar words or expressions. The Company's forward-looking statements generally 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,

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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. In the current economic environment, banks and other sources of financing are becoming increasingly 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 proprietary products depends on the effectiveness of its new product development efforts as well as the timing of such and the availability and costs of any competing products on the market.

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**ITEM 7. FINANCIAL STATEMENTS**

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

Independent Auditors Report dated January 24, 2003 for Years Ended December 31, 2002 and 2001	14
Balance Sheets as of December 31, 2002 and 2001	15-16
Statements of Income for Years Ended December 31, 2002 and 2001	17
Statements of Changes in Stockholders Equity for Years Ended December 31, 2002 and 2001	18
Statements of Cash Flows for Years Ended December 31, 2002 and 2001	19
Notes to Financial Statements	20-30



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**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, 2002 and 2001, 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, 2002 and 2001, 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 24, 2003

McGladrey & Pullen, LLP is an independent member firm of RSM International, an affiliation of independent accounting and consulting firms

**Table of Contents****WINLAND ELECTRONICS, INC.****BALANCE SHEETS**  
**December 31, 2002 and 2001**

<b>ASSETS (Note 3)</b>	<b>2002</b>	<b>2001</b>
<b>Current Assets</b>		
Cash	\$ 692,700	\$ 399,749
Accounts receivable, less allowance for doubtful accounts of \$10,000 (Note 9)	2,091,544	1,993,983
Income tax receivable		177,000
Inventories (Note 2)	1,811,644	2,439,727
Prepaid expenses and other assets	145,035	100,191
Deferred taxes (Note 6)	186,000	
<b>Total current assets</b>	<b>4,926,923</b>	<b>5,110,650</b>
<b>Other Assets</b>		
Patents and trademarks, net of accumulated amortization of \$33,649 in 2002; \$33,212 in 2001	590	1,027
<b>Property and Equipment, at cost (Note 4)</b>		
Land and land improvements	272,901	272,901
Building	2,983,586	2,983,586
Machinery and equipment	3,735,832	3,675,897
Data processing equipment	1,265,396	1,301,598
Office furniture and equipment	352,834	353,932
<b>Total property and equipment</b>	<b>8,610,548</b>	<b>8,587,914</b>
Less accumulated depreciation	4,556,721	3,884,440
<b>Net property and equipment</b>	<b>4,053,828</b>	<b>4,703,474</b>
<b>Total assets</b>	<b>\$ 8,981,341</b>	<b>\$ 9,815,151</b>

See Notes to Financial Statements.

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<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>2002</b>	<b>2001</b>
<b>Current Liabilities</b>		
Note payable to bank (Note 3)	\$ -	\$ 1,981,501
Current maturities of long-term debt	413,546	472,325
Accounts payable	931,933	931,385
Accrued expenses:		
Compensation	524,088	289,749
Other	151,547	68,024
Income tax payable	159,028	
<b>Total current liabilities</b>	<b>2,180,143</b>	<b>3,742,984</b>
<b>Long-Term Liabilities</b>		
Deferred revenue (Note 5)	178,958	187,098
Long-term debt, less current maturities (Notes 3 and 4)	2,098,083	2,453,909
<b>Total long-term liabilities</b>	<b>2,277,041</b>	<b>2,641,007</b>
<b>Total liabilities</b>	<b>4,457,184</b>	<b>6,383,991</b>
<b>Commitments and Contingencies (Note 4)</b>		
<b>Stockholders' Equity (Notes 7 and 8)</b>		
Common stock, par value \$0.01 per share; authorized 20,000,000 shares; issued and outstanding 2,978,160 shares in 2002 and 2,959,842 shares in 2001	29,782	29,598
Additional paid-in capital	2,264,710	2,249,702
Retained earnings	2,229,665	1,151,860
<b>Total stockholders' equity</b>	<b>4,524,157</b>	<b>3,431,160</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 8,981,341</b>	<b>\$ 9,815,151</b>

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## WINLAND ELECTRONICS, INC.

## STATEMENTS OF INCOME

Years Ended December 31, 2002 and 2001

	<u>2002</u>	<u>2001</u>
Net sales (Note 9)	\$ 18,097,465	\$ 15,394,754
Cost of sales	13,802,351	12,795,245
<b>Gross profit</b>	<b>4,295,114</b>	2,599,509
Operating expenses:		
General and administrative	1,268,955	1,606,663
Research and development	671,930	840,813
Sales and marketing	899,539	716,821
	<u>2,840,424</u>	<u>3,164,297</u>
<b>Operating income (loss)</b>	<b>1,454,690</b>	(564,788)
Other income (expenses):		
Interest expense	(249,515)	(482,634)
Other, net	6,630	45,093
	<u>(242,885)</u>	<u>(437,541)</u>
<b>Income (loss) before income taxes</b>	<b>1,211,805</b>	(1,002,329)
Income tax expense (benefit) (Note 6)	134,000	(125,600)
<b>Net income (loss)</b>	<b>\$ 1,077,805</b>	\$ (876,729)