WSI INDUSTRIES, INC.
Form 10QSB
January 09, 2008

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549
FORM 10-QSB

(Mark One)

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

For the quarterly period ended November 25, 2007

OR

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

For the transition period from __________ to __________

Commission File Number 0-619

WSI Industries, Inc.

(Exact Name of Small Business Issuer, as Specified in Its Charter)

Minnesota	41-0691607
(State or other jurisdiction of incorporation of organization)	(I. R. S. Employer Identification No.)
213 Chelsea Road Monticello, Minnesota	55362
(Address of principal executive offices)	(Zip Code)

(763) 295-9202

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

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

Yes o No þ

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 2,754,087 shares of common stock were outstanding as of December 31, 2007.

WSI INDUSTRIES, INC.
AND SUBSIDIARIES
INDEX

Table of Contents

Part I. Financial Information

Item I. Financial Statements

WSI INDUSTRIES, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	November 25, 2007	August 26, 2007
Assets		
Current Assets:		
Cash and cash equivalents	$ 1,850,182	$ 1,626,801
Accounts receivable	3,026,160	3,054,050
Inventories	1,557,265	1,899,299
Prepaid and other current assets	234,380	154,793
Deferred tax assets	213,759	162,535
Total Current Assets	6,881,746	6,897,478
Property, Plant and Equipment Net	5,565,155	4,520,382
Deferred tax assets	701,259	954,162
Goodwill and other assets, net	2,377,820	2,379,473
	$ 15,525,980	$ 14,751,495
Liabilities and Stockholders Equity		
Current Liabilities:		
Trade accounts payable	$ 1,823,512	$ 2,200,544
Accrued compensation and employee withholdings	531,164	680,419
Other accrued expenses	80,516	125,038
Current portion of long-term debt	643,006	518,718
Total Current Liabilities	3,078,198	3,524,719
Long-term debt, less current portion	4,243,335	3,328,694
Stockholders Equity:		
	274,808	273,117

Common stock, par value $.10 a share; authorized 10,000,000 shares; issued and outstanding 2,748,087 and 2,731,165 shares, respectively		
Deferred compensation	(143,294)	(26,577)
Capital in excess of par value	2,351,734	2,214,922
Retained earnings	5,721,199	5,436,620
Total Stockholders Equity	8,204,447	7,898,082
	$ 15,525,980	$ 14,751,495

See notes to condensed consolidated financial statements

3

Table of Contents

WSI INDUSTRIES, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	13 weeks ended	
	November 25, 2007	November 26, 2006
Net sales	$ 5,974,584	$ 4,129,379
Cost of products sold	4,855,541	3,418,115
Gross margin	1,119,043	711,264
Selling and administrative expense	576,998	462,244
Gain on sale of equipment	(97,861)	
Interest and other income	(22,105)	(16,215)
Interest and other expense	67,067	44,932
Earnings from operations before income taxes	594,944	220,303
Income taxes	208,231	83,715
Net income	$ 386,713	$ 136,588
Basic earnings per share	$ .14	$ .05
Diluted earnings per share	$ .14	$ .05
Cash dividend per share	$ .0375	$ .0375
Weighted average number of common shares outstanding, basic	2,723,559	2,680,630
Weighted average number of common Shares outstanding, diluted	2,804,071	2,715,376

See notes to condensed consolidated financial statements.

4

Table of Contents

WSI INDUSTRIES, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	13 weeks ended	
	November 25, 2007	November 26, 2006
Cash Flows From Operating Activities:		
Net earnings	$ 386,713	$ 136,588
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	187,249	113,158
Amortization of deferred finance cost	1,653	1,653
Gain on sale of equipment	(97,861)	
Deferred taxes	201,679	80,215
Stock option compensation expense	21,786	16,509
Changes in assets and liabilities:		
Decrease in accounts receivable	27,890	414,304
(Increase) decrease in inventories	342,034	(99,560)
(Increase) decrease in prepaid expenses	(79,587)	22,217
Decrease in accounts payable and accrued expenses	(570,809)	(29,983)
Net cash provided by operations	420,747	655,101
Cash Flows From Investing Activities:		
Purchase of property, plant and equipment	(36,102)	(3,656)
Proceeds from sale of equipment	97,861	
Net cash provided by (used in) investing activities	61,759	(3,656)
Cash Flows From Financing Activities:		
Payments of long-term debt	(156,991)	(91,486)
Dividends paid	(102,134)	(100,525)
Net cash used in financing activities	(259,125)	(192,011)
Net Increase In Cash And Cash Equivalents	223,381	459,434
Cash And Cash Equivalents At Beginning Of Year	1,626,801	1,282,717
Cash And Cash Equivalents At End Of Reporting Period	$ 1,850,182	$ 1,742,151

Supplemental cash flow information:		
Cash paid during the period for:		
Interest	$ 67,284	$ 45,154
Income taxes	$ 6,552	$ 3,500
Non-cash investing and financing activities:		
Acquisition of equipment through capital lease	$ 1,195,920	$

See notes to condensed consolidated financial statements.

5

Table of Contents

WSI INDUSTRIES, INC.
AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS:

The condensed consolidated balance sheet as of November 25, 2007, the condensed consolidated statements of income for the thirteen weeks ended November 25, 2007 and November 26, 2006 and the condensed consolidated statements of cash flows for the thirteen weeks then ended, respectively, have been prepared by the Company without audit. In the opinion of management, all adjustments (which include normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made.

The condensed consolidated balance sheet at August 26, 2007 is derived from the audited consolidated balance sheet as of that date. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. Therefore, these condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s 2007 annual report to shareholders. The results of operations for interim periods are not necessarily indicative of the operating results for the full year.

2. INVENTORIES

Inventories consist primarily of raw material, work-in-progress (WIP) and finished goods and are valued at the lower of cost or market value:

	November 25, 2007	August 26, 2007
Raw material	$ 338,658	$ 537,033
WIP	773,141	963,702
Finished goods	445,466	398,564
	$ 1,557,265	$ 1,899,299

3. GOODWILL AND INTANGIBLE ASSETS

Goodwill and other intangible assets consist of costs resulting from business acquisitions which total $2,368,452 (net of accumulated amortization of $344,812 recorded prior to the adoption of SFAS No. 142 Goodwill and Other Intangible Assets). The Company assesses the valuation or potential impairment of its goodwill by utilizing a present value technique to measure fair value by estimating future cash flows. The Company constructs a discounted cash flow analysis based on various sales and cost assumptions to estimate the fair value of the Company (which is the only reporting unit). The result of the analysis performed in the fiscal 2007 fourth quarter did not indicate an impairment of goodwill. The Company will analyze goodwill more frequently should changes in events or circumstances, including reductions in anticipated cash flows generated by our operations, occur.

The Company recorded $33,063 of deferred financing costs incurred in connection with mortgages entered into in order to purchase the Company s facility in Monticello, Minnesota. The costs are being amortized over five years on a straight-line basis with the Company incurring $1,653 of amortization expense for the quarters ended November 25, 2007 and November 26, 2006, respectively.

Table of Contents

4. DEBT:
During the quarter ended November 25, 2007, the Company entered into capitalized leases of approximately $1.2 million in connection with the acquisition of machinery and equipment. The leases carry interest rates that range from 6.3% to 6.9% and mature in 2014.

5. EARNINGS PER SHARE:
The following table sets forth the computation of basic and diluted earnings per share:

	Thirteen weeks ended	
	November 25, 2007	November 26, 2006
Numerator for earnings per share:		
Net income	$ 386,713	$ 136,588
Denominator:		
Denominator for basic earnings per share weighted average shares	2,723,559	2,680,630
Effect of dilutive securities:		
Employee and non-employee options	80,512	34,746
Dilutive common shares		
Denominator for diluted earnings per share	2,804,071	2,715,376
Basic earnings per share	$ .14	$ .05
Diluted earnings per share	$ .14	$ .05

Table of Contents

Item 2.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
or
PLAN OF OPERATION

Critical Accounting Policies and Estimates:

Management s Discussion and Analysis of Financial Condition and Results of Operations discuss our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities.

We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the result of which forms the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Results may differ from these estimates due to actual outcomes being different from those on which we based our assumptions. The estimates and judgments utilized are reviewed by management on an ongoing basis and by the audit committee of our board of directors at the end of each quarter prior to the public release of our financial results. We made no changes to our critical accounting policies during fiscal 2007 or in the first quarter of fiscal 2008.

Application of Critical Accounting Policies:

Excess and Obsolete Inventory:

Inventories, which are composed of raw materials, work in process and finished goods, are valued at the lower of cost or market by comparing the cost of each item in inventory to its most recent sales price or sales order price. Inventory cost is adjusted down for any excess cost over net realizable value of inventory components.

In addition, the Company determines whether its inventory is excess and obsolete by analyzing the sales history of its inventory, sales orders on hand and indications from the Company s customers as to the future of various parts or programs. If, in the Company s determination, the inventory value has become impaired, the Company adjusts the inventory value to the amount the Company estimates as the ultimate net realizable value for that inventory. Actual customer requirements in any future periods are inherently uncertain and thus may differ from our estimates. If actual or expected customer requirements were significantly lower than the established reserves, the Company would adjust inventory value down in the period in which the Company made such a determination. The Company performs its lower of cost or market testing, as well as its excess or obsolete inventory analyses, quarterly.

The Company has no specific timeline to dispose of its remaining obsolete inventory and intends to sell this obsolete inventory from time to time, as market conditions allow.

Goodwill Impairment:

The Company evaluates the valuation of its goodwill according to the provisions of SFAS 142 to determine if the current value of goodwill has been impaired. The Company believes that its stock price is not necessarily an indicator of the Company s value given its limited trading volume and its wide price fluctuations. The Company follows the guidance provided by SFAS 142 and utilizes a present value technique to measure fair value by estimating future cash flows. The major assumptions in this analysis include: (a) sales estimates for the Company in part provided with guidance from the Company s customers; and (b) material and labor costs of the Company s major programs. The Company constructs a discounted cash flow analysis based on these assumptions to estimate the fair value of the Company (which is the only reporting unit). The result of the analysis performed in the fiscal 2007 fourth quarter did not indicate an impairment of goodwill. If the Company has changes in events or circumstances, including reductions in anticipated cash flows generated by our operations, goodwill could become impaired which would result in a charge to earnings.

Deferred Taxes:

The Company accounts for income taxes using the liability method. Deferred income taxes are provided for temporary difference between the financial reporting and tax bases of assets and liabilities. A valuation allowance would be set up should the realization of any deferred taxes become less likely than not to occur. The valuation allowance is analyzed periodically by the Company and may result in income tax expense different than statutory rates. The Company has not established a valuation allowance as it believes it is more likely than not that it will fully realize the benefit of its tax assets. Currently, the Company s deferred tax assets have two major components which relate to the Company s NOL and the Company s AMT tax credit carryforwards. The Company s AMT tax credit carryforward does not expire. The Company s NOL carryforward has $2.9 million expiring in fiscal 2021 and after. The Company believes that its current rate of growth will be sufficient to fully utilize its NOL carryforwards before they expire. However, a significant loss of a customer or a change in the Company s business could affect the realization of the deferred tax assets. If a major program were discontinued, the Company would immediately assess the impact of the loss of the program on the realization of the deferred tax assets.

Revenue Recognition:

The Company considers its revenue recognition policy to fall under the guidance of FASB s conceptual framework for revenue recognition. The Company recognizes revenue only after: (a) The Company has received a purchase order identifying price and delivery terms or services to be rendered; (b) shipment has occurred, or in the case of services, after the service has been completed; (c) the Company s price is fixed as evidenced by the purchase order; and (d) collectibility is reasonably assured. The Company continually monitors its accounts receivable for any delinquent or slow paying accounts. The Company believes that based upon its past history with minimal bad debt write-offs, that all accounts are collectible upon shipment or delivery of services. Credit losses from customers have been minimal and within management s expectations. Based on management s evaluation of uncollected accounts receivable, bad debts are provided for on the allowance method. Accounts are considered delinquent if they are 120 days past due. If an uncollectible account should arise during the year, it would be written-off at the point it was determined to be uncollectible. The Company mitigates its credit risk by performing periodic credit checks and actively pursuing past due accounts. The Company refers to net sales in its consolidated statements of operations as the Company s sales are sometimes reduced by product returned by its customers.

<u>Results of Operations:</u>

Net sales were $5,975,000 for the quarter ending November 25, 2007, an increase of 45% from the same period of the prior year. The increase in sales came primarily from increases in the Company s energy business as well as its all terrain vehicle (ATV) market.

Sales from the Company s ATV and motorcycle markets were $3,757,000 and $3,341,000 for the quarters ended November 25, 2007 and November 26, 2006, respectively. The 12% increase in sales in the quarter ended November 25, 2007 as compared to November 26, 2006 came primarily from higher volume in the ATV market.

The Company entered the energy field in the spring of 2007 with the addition of three new programs. In the summer of 2007, the Company added a fourth program. Sales from the energy field in the first quarter of fiscal 2008 amounted to approximately $1.4 million.

Table of Contents

Sales from the Company s aerospace and defense markets totaled $531,000 and $481,000 for the quarters ended November 25, 2007 and November 26, 2006, respectively. The Company believes that these increases are not a result of significant change in a customer or product requirement, but rather a result of a general increase in the level of business with the Company s customers in these markets. The addition of two new customers occurred late in fiscal 2007 and did not have a significant impact in fiscal 2008 first quarter sales.

Sales from the Company s biosciences market totaled $146,000 for the quarter ended November 25, 2007, as compared to the prior year quarter s amount of $239,000. The Company scaled back its involvement in this market during fiscal 2007 as gross margins were not acceptable. Due to this, the Company expects fiscal 2008 biosciences sales to be less than fiscal 2007 as the Company pares unprofitable programs.

Gross margin for the quarters ended November 25, 2007 and November 26, 2006 were 19% and 17%, respectively. The gross margin increase for the quarter ended November 25, 2007 is attributable to higher efficiencies obtained from increased levels of manufacturing volume and the Company s emphasis on making its various programs profitable.

Selling and administrative expense of $570,000 for the quarter ending November 25, 2007 was $107,000 higher than in the prior year quarter due primarily to higher payroll and compensation expense as well as higher professional service cost.

During the quarter ended November 25, 2007, and as part of its program to maintain its capital equipment at the highest technical level, the Company sold some fully-depreciated equipment which generated a gain on sale of equipment of $98,000.

Interest expense in the first quarter of fiscal 2008 was $67,000 compared to $45,000 in first quarter of fiscal 2007 reflecting the investment in new equipment of approximately $2.7 million made by the Company over the past five quarters.

The Company recorded income tax expense at an effective tax rate of 35% for the quarter ended November 25, 2007 and 38% for quarter ended November 26, 2006.

Liquidity and Capital Resources:

On November 25, 2007, working capital was $3,804,000 compared to $3,373,000 at August 26, 2007. The ratio of current assets to current liabilities at November 25, 2007 was 2.24 to 1.0 compared to 1.96 to 1.0 at August 26, 2007. The improvement in both measurements is attributable to the generation of cash from operations in the Company s fiscal 2008 first quarter. The Company s cash balance increased $223,000 during the first quarter of fiscal 2008 which was derived primarily from a lower level of inventory.

It is the Company s belief that its current cash balance, plus future internally generated funds and its line of credit, will be sufficient to enable the Company to meet its working capital requirements through the end of calendar year 2008. The Company s line of credit expires January 31, 2008; however, it expects that it will renew the line at that point. No amounts have been borrowed under the line of credit which carries an interest rate at prime.

Cautionary Statement:

Statements included in this Management s Discussion and Analysis of Financial Condition and Results of Operations, in future filings by the Company with the Securities and Exchange Commission, in the Company s press releases and in oral statements made with the approval of an authorized executive officer that are not historical or current facts are forward-looking statements. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made and are not predictions of actual future results.

The following risks and uncertainties, as well as others not now anticipated, in some cases have affected, and in the future could affect, the Company s actual results and could cause the Company s actual financial performance to differ materially from that expressed in any forward-looking statement: (i) the Company s ability to obtain additional manufacturing programs and retain current programs; (ii) the Company s ability to timely and cost effectively ramp up new programs; (iii) the loss of significant business from any one of its current customers could have a material adverse effect on the Company; (iv) the Company was dependent upon one customer for 75% of its revenues in fiscal year 2007 and expects that a significant portion of its future revenue will be derived from this customer; (v) a significant downturn in the industries in which the Company participates could have an adverse effect on the demand for Company services; (vi) our sales are concentrated in a limited number of highly competitive industries, each with a limited number of customers; (vii) the prices of our products are subject to a downward pressure from customers and market pressure from competitors; (viii) the Company s ability to curtail its costs and expenses for new manufacturing programs, commensurate with expected revenues; (ix) the Company s ability to comply with covenants of its credit facility; (x) fluctuations in operating results due to, among other things, changes in customer demand for our product in our manufacturing costs and efficiencies of our operations; and (xi) a trend among our customers toward outsourcing manufacturing to foreign operations.

The foregoing list should not be construed as exhaustive and the Company disclaims any obligation subsequently to revise any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

Table of Contents

ITEM 3. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures.

The Company s Chief Executive Officer, Michael J. Pudil, and Chief Financial Officer, Paul D. Sheely, have evaluated the Company s disclosure controls and procedures as of the end of the period covered by this report. Based upon this review, they have concluded that these controls and procedures are effective.

(b) Changes in Internal Controls over Financial Reporting.

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

PART II. OTHER INFORMATION:

ITEM 6. EXHIBITS

A. The following exhibits are included herein:

Exhibit 31.1	Certification of Chief Executive Officer pursuant to Rules 13a-14 and 15d-14 of the Exchange Act.
Exhibit 31.2	Certification of Chief Financial Officer pursuant to Rules 13a-14 and 15d-14 of the Exchange Act.
Exhibit 32	Certificate pursuant to 18 U.S.C. §1350.

SIGNATURES

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

	WSI INDUSTRIES, INC.
Date: January 9, 2008	/s/ Michael J. Pudil Michael J. Pudil, President & CEO
Date: January 9, 2008	/s/ Paul D. Sheely Paul D. Sheely, Vice President, Finance & CFO