ARTS WAY MANUFACTURING CO INC
Form 10QSB
April 08, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

(Mark One)

[x] Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 For the quarter ended February 28, 2005

[ ] Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 For the transition period from ______ to ______

Commission File No. 0-5131

ART'S-WAY MANUFACTURING CO., INC.
(Exact Name of Small Business Issuer as Specified in Its Charter)

DELAWARE	42-0920725
(State or Other Jurisdiction of Incorporation or Organization)	I.R.S. Employer Identification No.

Hwy 9 West, Armstrong, Iowa 50514
(Address of Principal Executive Offices)

(712) 864-3131
Issuer's Telephone Number, Including Area Code

Check whether the issuer (1) has 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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No __

Number of common shares outstanding as of April 7, 2005: 1,938,176

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

ART'S-WAY MANUFACTURING CO., INC.

Consolidated Statement of Operations
Condensed
(Unaudited)

	Three Months Ended	
	February 28, 2005	February 29, 2004
Net Sales	$ 3,591,843	$ 2,624,293
Cost of goods sold	2,336,859	1,990,469
Gross Profit	1,254,984	633,824
Expenses:		
Engineering	128,920	54,790
Selling	216,872	121,709

General and administrative	377,822	400,297
Total expenses	723,614	576,796
Income from operations	531,370	57,028
Other expenses (income):		
Interest expense	50,207	36,025
Other, net	(38,371)	(3,200)
Total other expenses	11,836	32,825
Income before income taxes	519,534	24,203
Income tax expense	176,642	0
Net income	$ 342,892	$ 24,203
Net income per share:		
Basic	$ 0.18	$ 0.01
Diluted	$ 0.17	$ 0.01
Common shares and equivalent outstanding:		
Basic	1,938,176	1,938,176
Diluted	1,964,784	1,958,196

See accompaning notes to financial statements.

ART'S-WAY MANUFACTURING CO., INC.

Consolidated Balance Sheets
Condensed
(Unaudited)

	February 28, 2005	November 30, 2004
ASSETS		
Current Assets		
Cash	$ 1,766,714	$ 116,001
Accounts receivable-customers, net of allowance for doubtful accounts of $36,522 and $30,417 in February and November, respectively	1,185,605	737,008
Inventories	6,508,948	6,298,049
Deferred taxes	539,000	539,000
Real estate loan receivable	0	165,725
Other current assets	116,441	90,224
Total current assets	10,116,708	7,946,007
Property, plant and equipment, at cost	11,612,460	11,600,548
Less accumulated depreciation	10,353,802	10,292,460
Net property, plant and equipment	1,258,658	1,308,088
Inventories, noncurrent	434,079	459,792
Deferred taxes	607,814	786,000
Other assets	76,623	146,006
Total Assets	$ 12,493,882	$ 10,645,893

LIABILITIES AND

STOCKHOLDERS' EQUITY		
Current Liabilities		
Notes payable to bank	0	870,071
Current portion of long-term debt	251,409	174,674
Accounts payable	386,505	536,929
Customer deposits	1,664,070	77,975
Accrued expenses	849,952	853,795
Landstar payable	130,000	0
Total current liabilities	3,281,936	2,513,444
Long-term liabilities	0	144,766
Long-term debt, excluding current portion	2,669,613	1,788,242
Total liabilities	5,951,549	4,446,452
Stockholders' Equity		
Common stock - $.01 par value. Authorized 5,000,000 shares; issued 1,938,176 shares in February and in November	19,382	19,382
Additional paid-in capital	1,634,954	1,634,954
Retained earnings	4,887,997	4,545,105
Total stockholders' equity	6,542,333	6,199,441
Total liabilities and stockholders' equity	$12,493,882	$ 10,645,893

See accompanying notes to financial statements.

ART'S-WAY MANUFACTURING CO., INC.

Consolidated Statements of Cash Flow
Condensed
(Unaudited)

	Three Months Ended February 28, 2005	February 29, 2004
CASH FLOW FROM OPERATIONS:		
Net income	$ 342,892	$ 24,203
Adjustment to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	74,509	64,110
Deferred income taxes	178,186	0
Changes in working capital components: (Increase) decrease in:		
Accounts receivable	(448,597)	(179,524)
Inventories	(185,186)	(446,936)
Other current assets	(26,217)	12,054
Other	165,725	0
Increase (decrease) in:		
Accounts payable	(150,424)	309,940
Customer deposits	1,586,095	1,881,893
Accrued expenses	56,157	(50,085)
Net cash provided by operating activities	1,593,140	1,615,655

CASH FLOW FROM INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(11,912)	(270,117)
CASH FLOW FROM FINANCING ACTIVITIES:		
Principal payments on line of credit	(870,071)	0
Proceeds from notes payable	1,000,000	0
Principal payments on term debt	(41,894)	(54,881)
Loan origination fees paid	(18,550)	0
Net cash used in financing activities	69,485	(54,881)
Net increase in cash	1,650,713	1,290,657
Cash at beginning of period	116,001	800,052
Cash at end of period	$ 1,766,714	$ 2,090,709
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 50,207	$ 32,835
Income taxes	14,498	13,441

See accompanying notes to financial statements.

ART'S-WAY MANUFACTURING CO., INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Statement Presentation

The financial statements are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and operating results for the interim periods. The financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company's Annual Report on Form 10-KSB for the year ended November 30, 2004. The results of operations for the first quarter ended February 28, 2005 are not necessarily indicative of the results for the fiscal year ending November 30, 2005.

Restatement

In Form 10-KSB for the year ended November 30, 2004, we restated our 2004 first and second quarter results to correct the accounting for a sales arrangement with a specific customer. The fiscal 2004 first quarter income statement presented herein reflects those corrections and has been restated from the amounts originally filed on Form 10-QSB for the quarter ended February 29, 2004. The restatement has the effect of decreasing sales by $268,000, net income by $62,000 and earnings per share by $0.03 for the quarter ended February 29, 2004 and will increase sales, net income and earnings per share by those same amounts in the quarter ended May 31, 2004.

2. INCOME PER SHARE

Basic net income per common share is computed on the basis of weighted average number of common shares outstanding. Diluted net income per share has been computed on the basis of weighted average number of common shares outstanding plus equivalent shares assuming exercise of stock options.

The Company accounts for stock options in accordance with the provisions of APB Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees, and related interpretations. As such, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. Accordingly, the Company has not recognized compensation expense for its options granted. Statement of Financial Accounting Standards No. 123 (SFAS 123), Accounting for Stock-Based Compensation, permits entities to recognize as expense over the vesting period by the fair value of all stock-based awards on the date of grant. SFAS 123 also allows entities to continue to apply the provisions of APB 25 and provide pro forma net income and income per share disclosure for employee stock option grants, as if the fair-value-based method defined in SFAS 123 had been applied. The Company has elected to continue to apply the provisions of APB 25 and provide the pro forma disclosure provisions of SFAS 123. Since the Company applies APB Opinion No. 25 in accounting for its plans, no compensation cost has been recognized for its stock options in the financial statements. Had the Company recorded compensation cost based on the fair value at the grant date for its stock options under SFAS No. 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

	February 30, 2005	February 30, 2004
Net income:		
As reported	$ 342,892	$ 24,203
Deduct:		
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,898)	(6,823)
Pro forma	340,994	17,380
Basic earnings per share:		
As reported	$ 0.18	$ 0.01
Pro forma	0.18	0.01
Diluted earnings per share:		
As reported	$ 0.17	$ 0.01
Pro forma	0.17	0.01

3. INVENTORIES

Major classes of inventory are:

	February 28, 2005	November 30, 2004
Raw material	$ 2,526,515	$ 2,867,914
Work-in-process	1,530,200	1,495,985
Finished goods	2,886,312	2,393,942
Total	$ 6,943,027	6,757,841

Less inventories classified as noncurrent	434,079	459,792
Inventories, current	$6,458,948	$6,298,049

4. ACCRUED EXPENSES

Major components of accrued expenses are:

	February 28, 2005	November 30, 2004
Salaries, wages and commissions	$ 421,055	$ 412,663
Accrued warranty expense	155,934	119,912
Other	272,963	321,220
Total	$ 849,952	$ 853,795

5. Product Warranty

The Company offers warranties of various lengths to its customers depending on the specific product and terms of the customer purchase agreement. The average length of the warranty period is one year from date of purchase. The Company's warranties require it to repair or replace defective products during the warranty period at no cost to the customer. The Company records a liability for estimated costs that may be incurred under its warranties. The costs are estimated based on historical experience and any specific warranty issues that have been identified. Although historical warranty costs have been within expectations, there can be no assurance that future warranty costs will not exceed historical amounts. The Company periodically assesses the adequacy of its recorded warranty liability and adjusts the balance as necessary. Changes in the Company's product warranty liability for the three months ended February 28, 2005 and February 29, 2004 are as follows:

	2005	2004
Balance, beginning	$ 119,912	$ 59,207
Settlements made in cash or in-kind	(23,697)	(31,791)
Warranties issued	59,719	26,527
Balance, ending	$ 155,934	$ 53,943

6. LOAN AND CREDIT AGREEMENTS

Line of Credit

The Company has financing through West Bank consisting of two loan agreements totaling $6,500,000. On March 14th, 2005, we renewed our financing agreements with West Bank. The terms below are based on this renewal.

Facility #1 is a revolving line of credit for $3,500,000 with advances funding the working capital, letter of credit and corporate credit card needs that mature on March 31, 2006. The interest rate is West Bank's prime interest rate adjusted daily. Monthly interest only payments are required and the unpaid principal is due on the maturity date. Collateral consists of a first position on assets owned by the Company including, but not limited to inventories, accounts receivable, machinery and equipment. As of February 28, 2005, the Company had no borrowings against Facility #1.

Facility #2 is long-term financing for up to $3,000,000 that is supported by a guarantee issued by the United States Department of Agriculture (USDA) for 75% of the loan amount outstanding. In 2003 the loan refinanced existing debt to UPS Capital (approximately $1,500,000), finance equipment (approximately $250,000), provide permanent working capital (approximately $500,000) and satisfy closing costs (approximately $50,000). Approximately $700,000 was reserved for future acquisitions. The variable interest rate is West Bank's prime interest rate plus 1.5%, adjusted daily. Our initial borrowing of $2,000,000 requires monthly principal and interest payments over 20 years with a final maturity date of March 31, 2023. We borrowed an additional $1,000,000 on this facility in January 2005, which is amortized over 10 years with a final maturity date of March 31, 2015. Collateral for Facility #2 is primarily real estate with a second position on assets of Facility #1. The USDA subordinates collateral rights in all assets other than real estate in an amount equal to West Bank's other credit commitments. As of February 28, 2005, the total outstanding balance on Facility #2 was $2,812,901.

Other terms and conditions include providing monthly internally prepared financial reports including accounts receivable aging schedules and borrowing base certificates and year-end audited financial statements. The borrowing bases limit advances from Facility #1 to 60% of accounts receivable less than 90 days, 60% of finished goods inventory, 50% of raw material inventory and 50% of work-in-process inventory plus 40% of appraisal value of machinery and equipment. Covenants include restrictions on debt service coverage ratio, debt/tangible net worth ratio, current ratio, limit capital expenditures and tangible net worth. We are in compliance with debt covenants.

J. Ward McConnell, Jr. is required to personally guarantee $2,500,000 on Facility #1 and all of Facility #2 on an unlimited and unconditional basis. The guarantees of Facility #1 and Facility #2 shall be reduced after the first three years to a percentage representing his ownership of the Company. Mr. McConnell's guarantees shall be removed from Facility #1 and Facility #2 in the event that his ownership interest in the Company is reduced to a level less than 20% after the first three years of the loan. The Company compensates Mr. McConnell for his personal guarantees at an annual percentage rate of 2% of the outstanding balances paid monthly. As a result of the outstanding balances on Facility #1 and Facility #2 Mr. McConnell received $9,795 and $9,618 under this compensation agreement, for the three months ended February 28, 2005 and 2004, respectively.

A summary of the Company's term debt is as follows:

	February 28, 2005	November 30, 2004
West Bank Facility #2 payable in monthly installments of $17,776 including interest at Bank's prime rate plus 1.5%	$ 1,812,901	$ 1,836,565
West Bank Facility #2 payable in monthly installments of $10,000 including interest		

at Bank's prime rate plus 1.5%	$ 1,000,000	$ 0
State of Iowa Community Development Block Grant promissory notes at zero percent interest, maturity September 2006, with quarterly principal payments of $11,111	$ 66,667	$ 77,778
State of Iowa Community Development Block Grant local participation promissory notes at 4% interest, maturity September 2006, with quarterly payments of $ 7,007	$ 41,454	$ 48,573
Total term debt	$ 2,921,022	$ 1,962,916
Less current portion of term debt	$ 251,409	$ 174,674
Term debt, excluding current portion	$ 2,669,613	$ 1,788,242

7. Income taxes

Beginning in this fiscal quarter, we have recognized income tax expense as compared to the first fiscal quarter of 2004 when the calculated income tax expense was offset by a reduction in the valuation allowance for deferred tax assets. At November 30, 2004 we eliminated all but $41,000 of our deferred tax valuation allowance and we will record income tax expense each quarter as we earn income. As of February 28, 2005, we have net operating loss carry forwards for federal tax purposes of approximately $3,120,000 and so we will not be required to make cash tax payments until we have utilized those net operating loss carry forwards.

Item 2

MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

The following discussion and analysis should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this document. Management's discussion and analysis contains forward-looking statements that involve risks and uncertainties, including but not limited to, quarterly fluctuations in results; customer demand for our products; economic conditions; the achievement of lower costs and expenses; the continued availability of financing in the amount and on the terms required to support future business; and other risks detailed from time to time in our other Securities and Exchange Commission filings. Actual results may differ materially from management's expectations.

(a) Plan of Operation

In the current fiscal year we plan to continue growth through new product development and acquisition. In December, of fiscal year 2005, we started working with an outside engineering firm to develop a new exportable sugar beet harvester. Other projects include updating our defoliator and a self propelled sugar beet harvester. We will continue to attempt to improve our efficiencies, and to battle labor demand, through the implementation of lean manufacturing processes.

(b) Management's Discussion and Analysis of Financial Condition and Results of Operations

(i) Critical Accounting Policies

The Company's critical accounting policies involving the more significant judgments and assumptions used in the preparation of the financial statements as of February 28, 2005 have remained unchanged from November 30, 2004. These policies involve revenue recognition, inventory valuation and income taxes. Disclosure of these critical accounting policies is incorporated by reference under Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operation" in our annual report on Form 10-KSB for the year ended November 30, 2004.

(ii) Results of Operations

Revenue of $3,592,000 for the first quarter of 2005 is 37% higher when compared to $2,624,000 for the same period in 2004. First quarter 2005 Art's-Way branded whole goods revenue increased by approximately $1,443,000. The two product lines that showed the greatest increase was grinder mixers and land planes. OEM sales decreased by approximately $532,000 due to a delay in the timing of the blower built in 2005 compared to last year. OEM sales are expected to be up in the second quarter of 2005 as the delayed production is completed.

Gross profit, as a percent of sales was 35% for the quarter ended February 28, 2005, as compared to 24% for the same period in 2004. The shift in the product lines from OEM to Art's-Way branded product effect the gross profit as Art's-Way branded products typically obtain a higher gross profit as compared to OEM products. Also during the first quarter of 2004 we started to experience price increases on steel and at that time we were unable to pass along those increases, thus bringing down our gross profit. We have now been able to partially pass on price increases for transportation and raw materials to our customers, while decreasing our manufacturing expenses through the consolidation of our manufacturing facilities.

Operating expenses in first quarter of 2005 increased $147,000 from 2004. As a percent of sales, operating expenses were approximately 20% and 22%, respectively, when comparing 2005 and 2004. General and administrative expenses are down $23,000 due to the consolidation of manufacturing facilities. This decrease was offset by continuing new product development, expenses of $94,000 reflected in engineering expenses which is an $84,000 increase over 2004. This increase allows us to introduce new product offerings for 2005 and beyond that will continue to improve revenue and earnings. Selling expenses also increased $95,000 over 2005 from 2004, primarily due to an increase in commission of $76,000. We also have an additional salesperson compared to a year ago. These wages along with increased travel and meal expenses also contributed to the increase. We continue to attend more farm and industry trade shows to regain visibility of Art's-Way and Cherokee Truck Bodies branded products.

We experienced an increase in interest expense in the first quarter of 39% as a result of increased borrowings and a rise in the prime interest rate. Other income increased as the result of the repayment of the real estate loans receivable.

The order backlog as of March 2005 is $4,104,000, compared to $4,060,000 one year ago. These orders primarily will be delivered in the second and third quarters of the current fiscal year.

(iii) Liquidity and Capital Resources

Our main source of funds for the quarter ended February 28, 2005 was customer deposits received for advance payments on sugar beet equipment sales to be delivered in the second and third quarters. These customer deposits are unique to our sugar beet equipment line and are seasonal in nature. The increase in account receivable results from the OEM sales in February 2005, which were sold on 30-day terms.

The positive cash flow from operations of $1,593,000, a result of customer deposits mentioned above, increased our cash balance which will be used for general operating needs.

See footnote 5 of the notes to the consolidated condensed financial statements for a discussion of the Company's credit facility.

Item 3

CONTROLS AND PROCEDURES

Senior management, including the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is (a) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure; and (b) recorded, processed, summarized and reported, within the time specified in the SEC's rules and forms. Since that evaluation process was completed there have been no significant changes in our disclosure controls or in other factors that could significantly affect these controls.

There were no changes in our internal control over financial reporting, identified in connection with this evaluation that occurred during the period covered by this report that materially affected, this reasonably likely to materially affect, our internal control over financial reporting.

Part II - Other Information

ITEM 1. LEGAL PROCEEDINGS

During the period covered by this report, we were not a party to any legal action or claim which was other than routine litigation incidental to our business.

ITEM 6. EXHIBITS

(a) Exhibits:

3.0 Certificate of Incorporation and Bylaws for Art's-Way Manufacturing, Inc. (incorporated by reference to Exhibit 3 to the Form 10-K for the year ended May 27, 1989.)

3.1 Amendments to Bylaws of Art's-Way Manufacturing, Inc. adopted as of February 27, 2004 (incorporated by reference to Exhibit 3.1 to the Form 10-QSB for the

	quarter ended May 31, 2004).
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a).
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a).
32.1	Certification of Chief Executive Officer under 18 U.S.C. Section 1350.
32.2	Certification of Chief Financial Officer under 18 U.S.C. Section 1350.