WSI INDUSTRIES INC
Form 10-Q
June 27, 2003

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended May 25, 2003

OR

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 registrant, as specified in its charter)

Minnesota	41-0691607
(State or other jurisdiction of incorporation of organization)	(I. R. S. Employer Identification No.)
Osseo, Minnesota	55369
(Address of principal executive offices)	(Zip Code)

(763) 428-4308
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant (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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No ____

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes ---------   No X -------

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.

2,451,129 Common Shares were outstanding as of June 27, 2003.

WSI INDUSTRIES, INC.

AND SUBSIDIARIES

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Part I. Financial Information

Item I. Financial Statements

WSI INDUSTRIES, INC
AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS	MAY 25, 2003 (Unaudited)
CURRENT ASSETS:	
Cash and cash equivalents	$ 1,023,081
Accounts receivable	1,224,817
Inventories	593,127
Prepaid and other current assets	53,446
Deferred tax assets	155,601
Total Current Assets	3,050,072
Property, Plant and Equipment -- Net	1,883,650
Deferred tax assets	1,863,351
Intangible assets, net	2,368,452
	$ 9,165,525
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Trade accounts payable	$ 378,204
Accrued compensation and employee withholdings	291,389
Miscellaneous accrued expenses	144,905
Current portion of long-term debt	469,013
Total Current Liabilities	1,283,511

Long term debt, less current portion	698,387
STOCKHOLDERS' EQUITY:	
Common stock, par value $.10 a share; authorized 10,000,000 shares; issued and outstanding 2,458,429 and 2,465,229 shares, respectively	245,843
Capital in excess of par value	1,633,386
Retained earnings	5,304,398
Total Stockholders' Equity	7,183,627
	$ 9,165,525

See notes to condensed consolidated financial statements

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

	13 weeks ended		39 w
	May 25, 2003	May 26, 2002	May 25, 2003
Net sales	$ 3,051,583	$ 2,144,586	$ 7,844,985
Cost of products sold	2,435,876	1,873,100	6,355,981
Gross margin	615,707	271,486	1,489,004
Selling and administrative expense	375,950	366,052	1,065,201
Loss on sale of subsidiary	-	-	-
Interest and other income	(11,441)	(5,665)	(73,790
Interest and other expense	23,164	45,809	102,848
Earnings (loss) from operations before income taxes	228,034	(134,710)	394,745
Income tax expense	82,092	-	142,227
Net earnings (loss)	$ 145,942	$ (134,710)	$ 252,518
Basic and diluted loss per share	$ .06	$ (.05)	$ .10

Weighted average number of common shares	2,462,165	2,465,229	2,464,208

See notes to condensed consolidated financial statements.

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

	39 weeks en	
	May 25, 2003	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 252,518	$ (
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Loss on sale of subsidiary	-	
Depreciation	473,986	
Deferred taxes	142,227	
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable	(70,230)	
(Increase) decrease in inventories	170,196	
(Increase) decrease in prepaid expenses	(19,456)	
Increase (decrease) in accounts payable and accrued expenses	87,748	
Net cash provided by (used in) operations	1,036,989	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of equipment	-	
Purchase of property, plant and equipment	(155,944)	
Sale of subsidiary	-	
Net cash provided by (used in) investing activities	(155,944)	
CASH FLOWS FROM FINANCING ACTIVITIES:		

Purchase of Company stock	(8,228)	
Payments of long-term debt	(965,658)	(
Net cash used in financing activities	(973,886)	(
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(92,841)	
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	1,115,922	
CASH AND CASH EQUIVALENTS AT END OF REPORTING PERIOD	$ 1,023,081	$
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$ 107,260	$
Income taxes	$ 4,300	$
Noncash investing and financing activities:		
Acquisition of machinery through capital lease	$ -	$

See notes to condensed consolidated financial statements.

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

1. CONSOLIDATED FINANCIAL STATEMENTS:

The condensed consolidated balance sheet as of May 25, 2003, the condensed consolidated statements of operations for the thirty-nine weeks ended May 25, 2003 and May 26, 2002 and the condensed consolidated statements of cash flows for the thirty-nine 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 25, 2002 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 generally accepted accounting principles 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 2002 annual report to shareholders. The results of operations for interim periods are not necessarily indicative of the operating results for the full year.

2. SALE OF SUBSIDIARY

On February 22, 2002, the Company completed the asset sale of one of its subsidiaries, Bowman Tool & Machining, Inc. ("Bowman"), to W. Bowman Consulting Company, an affiliate of the prior owner of Bowman. The Company received approximately $3.1 million in cash from the sale, with the buyer also assuming another $3.4 million in long-term debt and purchasing $1.2 million in accounts receivable and inventory. The buyer also assumed any remaining liabilities associated with amounts due on the non-compete and employment agreements that were a result of the Company's original acquisition of Bowman in 1999. The sale included substantially all of the assets of Bowman. The Company retained approximately $629,000 in Bowman-related accounts payable and accrued liabilities.

The Bowman sale was completed at the close of the last working day of the second quarter of fiscal 2002. Correspondingly, the Condensed Consolidated Statements of Operations and Condensed Consolidated Statements of Cash Flows for the thirty-nine weeks ended May 26, 2002 reflect twenty-six weeks of Bowman operations during that period.

3. DEBT AND LINE OF CREDIT:

On December 4, 2002, the Company closed on a new revolving credit agreement in the maximum amount of $1 million with a bank. Interest is at prime plus .25%. The credit agreement is secured by all assets of the Company and expires December 31, 2003. The revolver was not accessed during the current quarter and, correspondingly, no amount was owed at the end of the current quarter.

The Company issued a Subordinated Promissory Note in the original amount of $1.7 million on February 15, 1999 in connection with its acquisition of Taurus Numeric Tool, Inc. ("Taurus"). The note issued in the Taurus acquisition has been assigned in part such that there are currently two holders of the original Note. The note bears interest at 7.75% payable quarterly. Principal payments are due in three annual installments commencing February 15, 2002. The Company has made the first two scheduled annual payments. In addition to the scheduled payments, the Company reached agreement with one of the note holders to prepay that holder's portion of the 2004 payment. In exchange for the

prepayment, the note holder agreed to reduce the final payment by 10% or $27,700. The other note holder's final payment of $277,000 is scheduled to be paid February 15, 2004.

The seller was able to earn an additional amount based on the profitability of Taurus for the period February 15, 1999 to February 15, 2000. No amount was earned. The contingent payment terms were detailed in the purchase agreement and did not require continued employment of the former principal to be earned.

WSI Industries also had a Subordinated Promissory Note in connection with the original 1999 Bowman acquisition in the amount of $1.9 million. With the completion of the sale of Bowman to an affiliate of the prior owner as described in Note 2 of the Condensed Consolidated Financial Statements, the Subordinated Promissory Note was assumed by the affiliate of the prior owner, and no further amounts are due.

The Company also has capitalized lease debt of approximately $890,000, with monthly payments due of $21,000 expiring between 2005 and 2008.

4. GOODWILL AND INTANGIBLE ASSETS

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001 with early adoption permitted for companies with fiscal years beginning after March 15, 2001. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the statements. Other intangible assets will continue to be amortized over their useful lives.

The Company adopted the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of fiscal 2002. Effective with the August 27, 2001 adoption of FAS 142, goodwill is no longer amortized but is instead subject to an annual impairment test. The Company has performed its transitional impairment test in conjunction with the adoption of FAS 142 and has determined no charge is warranted.

Goodwill and other intangible assets resulting from acquisitions of business and the formation of the Company consist of the following:

	May 25, 2003	August 25, 2002
Goodwill	$ 2,428,264	$ 2,428,264
Less accumulated amortization	308,595	308,595
	$ 2,119,669	$ 2,119,669
Other identifiable intangibles:		
Organization Costs	$ 285,000	$ 285,000
Less accumulated amortization	36,217	36,217
	$ 248,783	$ 248,783

Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

and

RESULTS OF OPERATIONS

Critical Accounting Policies and Estimates

Management's Discussion and Analysis of Financial Condition and Results of Operations discusses our condensed 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 believe that the estimates, assumptions and judgments involved in the accounting policies described below have the greatest potential impact on our financial statements, so we consider these to be our critical accounting policies. Because of the uncertainty inherent in these matters, actual results could differ from the estimates we used in applying the critical accounting policies. Within the context of these critical accounting policies, we are not currently aware of any reasonably likely event that would result in materially different amounts being reported.

Allowance for 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. On a periodic basis, the Company analyzes the level of inventory on hand, its cost in relation to market value and estimated customer requirements to determine whether write-downs for excess or obsolete inventory are required. Actual customer requirements in any future periods are inherently uncertain and thus may differ from our estimates. If actual or expected requirements were significantly greater or lower than the established reserves, we would record a reduction or increase to the obsolescence allowance in the period in which we made such a determination.

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. To do this the Company determines the discounted present value of anticipated cash flows based on anticipated results of operations for the coming years. If we have 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.

Results of Operations:

As discussed in Note 2 of the Condensed Consolidated Financial Statements, the Company sold substantially all of the assets of its subsidiary, Bowman Tool & Machinery, Inc. ("Bowman"), on February 22, 2002. Correspondingly, the effects of the Bowman operation are included in the results of operations for the first two quarters of fiscal 2002, and not included in 2003.

Net sales were $3,052,000 for the quarter ending May 25, 2003, an increase of 42% or $907,000 from the same period of the prior year. The increase was due to higher sales in the Company's recreational vehicle market.

Year to date sales were $7,845,000 compared to $10,609,000 in the prior year. The drop was due to the absence of Bowman sales. Sales for the Company's remaining division, Taurus Numeric Tool, Inc. are up 28% in fiscal 2003 versus 2002 for the same reason described above.

Gross margin increased to 20% for the quarter ending May 25, 2003 versus 13% in the year ago period. The gross margin improvement was primarily related to efficiencies created from increased volume.

Year to date gross margins of 19% were an increase of 7% over the prior year. The increase in margins were again due to volume efficiencies as well as the absence of Bowman in fiscal 2003.

Selling and administrative expense of $376,000 for the quarter ending May 25, 2003 was $10,000 higher than in the prior year. Year to date selling and administrative expense of $1,065,000 was $498,000 lower than the prior year due primarily to the absence of Bowman. Current year selling and administrative expense was negatively affected by $60,000 of costs associated with a proxy contest that the Company was involved in. The proxy contest was resolved with all costs incurred by the end of the first quarter.

As described in Note 2 of the Notes to Consolidated Financial Statements, the Company completed the asset sale of Bowman Tool and Machining. The sale generated a loss of $2.5 million which was recognized in the prior year's second quarter.

Interest expense in the third quarter of fiscal 2003 was $23,000, which was $23,000 less than the fiscal 2002 amount of $46,000. The decrease is attributable to the reduced levels of debt in fiscal 2003. Year to date interest expense is also down for the same reason.

Year to date interest and other income includes a $27,700 reduction in the final payment of the subordinated promissory note as described in Note 3 of the Notes to Consolidated Financial Statements, as well as other miscellaneous income.

The Company recorded income tax expense at an effective tax rate of 36% for the quarter and nine months ended May 25, 2003.

Liquidity and Capital Resources:

On May 25, 2003, working capital was $1,767,000 compared to $1,791,000 at August 25, 2002. The ratio of current assets to current liabilities at May 25, 2003 was 2.38 to 1.0 compared to 2.23 to 1.0 at August 25, 2002. The Company generated $1,037,000 in cash from operations in the first three quarters of fiscal 2003 which is used to pay down $966,000 of its long term debt.

As discussed in the Notes to Consolidated Financial Statements, the Company has closed on a new $1,000,000 revolving credit facility with a new bank with interest at prime plus .25%. No amounts have been borrowed during the first three quarters of fiscal 2003.

As also described in the Notes, on February 15, 1999, in connection with the Company's acquisition of its Taurus subsidiary, the Company issued a subordinated promissory note to the seller in an initial amount of $1.7 million. Interest is accrued at a rate of 7.75% paid quarterly. Principal payments are due in three equal annual installments commencing on February 15, 2002. The Company

has made the first two scheduled annual payments. In addition to the scheduled payments, the Company reached an agreement with one of the note holders to prepay that holders' 2004 payment. In exchange for the payment, the note holder agreed to reduce the final payment by 10% or $27,700. The other note holder's final payment is scheduled to be paid February 15, 2004.

It is the Company's belief that its internally generated funds, as well as its line of credit, will be sufficient to enable the Company to meet its working capital requirements through the end of fiscal 2004.

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 which 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. The following important factors, among others, 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 loss of significant business from any one of its current customers could have a material adverse effect on the Company; (iii) a significant downturn in the industries in which the Company participates could have an adverse effect on the demand for Company services. 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.

ITEM 4. 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 reviewed the Company's disclosure controls and procedures within 90 days prior to the filing of this report. Based upon this review, these officers believe that the Company's disclosure controls and procedures are effective in ensuring that material information related to the Company is made known to them by others within the Company.

(b) Changes in Internal Controls.

There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls during the quarter covered by this report or from the end of the reporting period to the date of this Form 10-Q.

PART II. OTHER INFORMATION:

Item 6. Exhibits and Reports on Form 8-K:

A. The following exhibits are included herein:

Exhibit 99.1 Certificate pursuant to 18 U.S.C. Section 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: June 27, 2003 /s/ Michael J. Pudil

Michael J. Pudil, President & CEO

Date: June 27, 2003 /s/ Paul D. Sheely

Paul D. Sheely, Vice President, Finance & CFO

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CERTIFICATIONS

I, Michael J. Pudil, certify that:

1. I have reviewed this quarterly report on Form 10-Q of WSI Industries, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: June 27, 2003 /s/ Michael J. Pudil

President and Chief Executive Officer

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I, Paul D. Sheely, certify that:

1. I have reviewed this quarterly report on Form 10-Q of WSI Industries, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective

actions with regard to significant deficiencies and material weaknesses.

Date: June 27, 2003

/s/ Paul D. Sheely

Chief Financial Officer