FLEXSTEEL INDUSTRIES INC
Form 10-Q
February 09, 2007

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

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended December 31, 2006

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 **0-5151**

FLEXSTEEL INDUSTRIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Incorporated in State of Minnesota	42-0442319
(State or other Jurisdiction of Incorporation or Organization)	(I.R.S. Identification No.)

P. O. BOX 877
DUBUQUE, IOWA 52004-0877
(Address of Principal Executive Offices) (Zip Code)

(563) 556-7730

(Registrant s Telephone Number, Including Area Code)

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 o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (check one).
Large accelerated filer o Accelerated filer x Non-accelerated filer 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 x

Common Stock $1.00 Par Value
Shares Outstanding as of December 31, 2006 6,566,340

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

FLEXSTEEL INDUSTRIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

ASSETS		December 31, 2006 (UNAUDITED)		June 30, 2006
CURRENT ASSETS:				
Cash and cash equivalents	$	1,108,074	$	1,985,768
Investments		922,514		817,618
Trade receivables less allowance for doubtful accounts: December 31, 2006, $2,460,000; June 30, 2006, $2,820,000		51,715,380		51,179,791
Inventories		76,952,019		84,769,972
Deferred income taxes		4,480,000		4,620,000
Other		2,036,170		2,014,121
Total current assets		137,214,157		145,387,270
NON-CURRENT ASSETS:				
Property, plant and equipment, net		24,461,527		24,158,041
Deferred income taxes		2,650,000		2,210,000
Other assets		11,539,129		11,570,393
TOTAL	$	175,864,813	$	183,325,704

LIABILITIES AND SHAREHOLDERS EQUITY				
CURRENT LIABILITIES:				
Accounts payable trade	$	16,256,418	$	15,768,435
Notes payable		2,081,957		9,466,643
Accrued liabilities:				
Payroll and related items		6,276,277		7,720,173
Insurance		7,252,131		7,651,109
Other		8,551,817		7,793,645
Total current liabilities		40,418,600		48,400,005
LONG-TERM LIABILITIES:				
Long-term debt		21,589,573		21,846,386
Deferred compensation		5,339,536		5,207,176
Other liabilities		369,812		369,812
Total liabilities		67,717,521		75,823,379
SHAREHOLDERS EQUITY:				
Cumulative preferred stock $50 par value; authorized 60,000 shares; outstanding none				
Undesignated (subordinated) stock $1 par value; authorized 700,000 shares; outstanding none				
Common stock $1 par value; authorized 15,000,000 shares; outstanding December 31, 2006, 6,566,340 shares; outstanding June 30, 2006, 6,563,750 shares		6,566,340		6,563,750
Additional paid-in capital		3,975,162		3,670,152
Retained earnings		96,767,021		96,502,311
Accumulated other comprehensive income		838,769		766,112
Total shareholders equity		108,147,292		107,502,325
TOTAL	$	175,864,813	$	183,325,704

See accompanying Notes to Consolidated Financial Statements (Unaudited).

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FLEXSTEEL INDUSTRIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

		Three Months Ended				Six Months Ended		
		December 31,				December 31,		
		2006		2005		2006		2005
NET SALES	$	105,699,659	$	106,301,259	$	207,039,215	$	203,736,422
COST OF GOODS SOLD		(85,925,703)		(86,598,189)		(168,860,032)		(164,890,157)
GROSS MARGIN		19,773,956		19,703,070		38,179,183		38,846,265

SELLING, GENERAL AND ADMINISTRATIVE	(17,326,814)	(18,610,560)	(34,607,791)	(36,097,226)
OPERATING INCOME	2,447,142	1,092,510	3,571,392	2,749,039
OTHER INCOME (EXPENSE):				
Interest and other income	173,287	137,630	331,007	306,935
Interest expense	(391,772)	(371,123)	(780,617)	(631,404)
Total	(218,485)	(233,493)	(449,610)	(324,469)
INCOME BEFORE INCOME TAXES	2,228,657	859,017	3,121,782	2,424,570
PROVISION FOR INCOME TAXES	(820,000)	(370,000)	(1,150,000)	(950,000)
NET INCOME	$ 1,408,657	$ 489,107	$ 1,971,782	$ 1,474,570
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING:				
Basic	6,566,340	6,560,190	6,565,684	6,553,776
Diluted	6,579,053	6,583,053	6,574,963	6,573,116
EARNINGS PER SHARE OF COMMON STOCK:				
Basic	$ 0.21	$ 0.07	$ 0.30	$ 0.22
Diluted	$ 0.21	$ 0.07	$ 0.30	$ 0.22
DIVIDENDS DECLARED PER COMMON SHARE	$ 0.13	$ 0.13	$ 0.26	$ 0.26

See accompanying Notes to Consolidated Financial Statements (Unaudited).

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FLEXSTEEL INDUSTRIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Six Months Ended December 31, 2006	2005
OPERATING ACTIVITIES:		
Net income	$ 1,971,782	$ 1,474,570
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,723,279	2,699,355
	274,000	427,000

Stock-based compensation expense		
Gain on disposition of capital assets	(15,732)	(24,447)
Deferred income taxes	(344,723)	(520,000)
Changes in operating assets and liabilities:		
Trade receivables	(535,589)	(1,820,281)
Inventories	7,817,953	(18,493,115)
Other current assets	(22,049)	(270,525)
Other assets	(101,305)	(275,872)
Accounts payable trade	487,983	5,265,049
Accrued liabilities	(1,085,745)	137,514
Other long-term liabilities		42,928
Deferred compensation	132,361	115,458
Net cash provided by (used in) operating activities	11,302,215	(11,242,366)
INVESTING ACTIVITIES:		
Purchases of investments	(96,853)	(168,855)
Proceeds from sales of investments	198,266	257,355
Proceeds from sale of capital assets	16,650	58,086
Capital expenditures	(2,984,043)	(3,064,688)
Net cash used in investing activities	(2,865,980)	(2,918,102)
FINANCING ACTIVITIES:		
(Repayment of) proceeds from short-term borrowings, net	(7,406,517)	14,065,353
Repayment of long-term borrowings	(234,982)	(19,708)
Proceeds from long-term borrowings		2,760,471
Dividends paid	(1,706,737)	(2,555,874)
Proceeds from issuance of common stock	34,307	59,871
Net cash (used in) provided by financing activities	(9,313,929)	14,310,113
(Decrease) increase in cash and cash equivalents	(877,694)	149,645
Cash and cash equivalents at beginning of period	1,985,768	1,706,584
Cash and cash equivalents at end of period	$ 1,108,074	$ 1,856,229

SUPPLEMENTAL CASH FLOW INFORMATION Cash paid during the period for:

Six Months Ended

	December 31, 2006	2005
Interest	$ 760,000	$ 672,000
Income taxes	$ 1,372,000	$ 1,583,000

See accompanying Notes to Consolidated Financial Statements (Unaudited).

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FLEXSTEEL INDUSTRIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

FOR THE PERIOD ENDED DECEMBER 31, 2006

1. The consolidated financial statements included herein have been prepared by Flexsteel Industries, Inc. and Subsidiaries (the Company or Flexsteel), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). The information furnished in the consolidated financial statements includes normal recurring adjustments and reflects all adjustments, which are, in the opinion of management, necessary for a fair presentation of such consolidated financial statements. Operating results for the six-month period ended December 31, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2007. Certain information and footnote disclosures normally included in the consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. It is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements for the year ended June 30, 2006, and the notes thereto, included in Flexsteel s most recent Annual Report on Form 10-K as filed with the SEC.

DESCRIPTION OF BUSINESS Flexsteel was incorporated in 1929 and is one of the oldest and largest manufacturers, importers and marketers of residential, recreational vehicle and commercial upholstered and wooden furniture products in the country. Product offerings include a wide variety of upholstered and wood furniture such as sofas, loveseats, chairs, reclining and rocker-reclining chairs, swivel rockers, sofa beds, convertible bedding units, occasional tables, desks, dining tables and chairs and bedroom furniture. The Company s products are intended for use in home, office, motor home, travel trailer, yacht, health care and hotel applications. Featured as a basic component in most of the upholstered furniture is a unique drop-in seat spring. The Company primarily distributes its products throughout the United States through the Company s sales force to furniture dealers, department stores, recreational vehicle manufacturers, and hospitality and healthcare facilities. The Company s products are also sold to several national and regional chains, some of which sell on a private label basis.

The Company has two active wholly-owned subsidiaries: (1) DMI Furniture, Inc. (DMI), which is a Louisville, Kentucky-based, vertically integrated manufacturer, importer and marketer of residential and commercial office furniture with manufacturing plants and warehouses in Indiana and manufacturing sources in Asia; DMI s divisions are WYNWOOD, Homestyles and DMI Commercial Office Furniture, and (2) Desert Dreams, Inc., which owns a commercial building that it leases to an unrelated entity. A third wholly-owned subsidiary, Four Seasons, Inc., is no longer active.

2. INVENTORIES The Company values inventory at the lower of cost or market. Raw steel, lumber and wood frame parts are valued on the last-in, first-out (LIFO) method. Other inventories are valued on the first-in, first-out (FIFO) method. Inventories valued on the LIFO method would have been approximately $3.6 million and $3.3 million higher at December 31, 2006 and June 30, 2006, respectively, if

they had been valued on the FIFO method. At December 31, 2006 and June 30, 2006 the total value of LIFO inventory was $3.0 million and $3.8 million, respectively. A comparison of inventories is as follows (in millions):

		December 31, 2006		June 30, 2006
Raw materials	$	17.2	$	19.7
Work in process and finished parts		8.6		8.7
Finished goods		51.2		56.4
Total	$	77.0	$	84.8

3. BORROWINGS AND CREDIT ARRANGEMENTS At December 31, 2006, outstanding borrowings consisted of the following (in millions):

Current:		
Current maturities of long-term debt	$	0.5
Overnight borrowing interest rate at prime minus 1%; unsecured		1.6
$20.0 million working capital line of credit through June 29, 2007; interest rate at LIBOR +0.75%; unsecured		0.0
Long-Term:		
$20.0 million revolving note; expires October 31, 2010; interest rate at LIBOR +0.75%; unsecured		20.0
$2.6 million fixed rate note; requiring payments through December 2010; interest rate at 4.99%; secured by certain delivery equipment; net of current portion		1.6
Total	$	23.7

The Company has lines of credit of $45.0 million with banks, with borrowings at differing rates based on the date and type of financing utilized.

The credit facilities provide for $41.0 million in unsecured credit and provides the Company with flexibility between long-term and short-term financing. The short-term portion of the credit facility provides working capital financing up to $20.0 million with interest selected at the option of the Company at prime (8.25% at December 31, 2006) or LIBOR (5.35% at December 31, 2006) plus 0.75%. The short-term portion also provides overnight credit at prime rate less 1% when required for operations. At December 31, 2006, $0.8 million was outstanding at prime rate less 1% (7.25%). The short-term line of credit expires June 29, 2007. The long-term portion of the credit facility provides up to $20.0 million, of which $20.0 million was outstanding at December 31, 2006, and expires October 31, 2010. Variable interest is set monthly at the option of the Company at prime or LIBOR plus 0.75%. The credit facility also provides $1.0 million to support letters of credit issued by the Company, of which $0.1 million was outstanding at December 31, 2006. All interest rates are adjusted monthly, except for the overnight portion of the short-term line of credit, which varies daily at the prime rate minus 1%. On December 31, 2006, the Company had effectively fixed the interest rates at 4.1% on approximately $11.1 million of its long-term debt through the use of interest rate swaps.

The credit agreement contains certain restrictive covenants that require the Company, among other things, to maintain an interest coverage ratio, leverage ratio, and limitations on capital disposals, all as defined in the credit agreement. At December 31, 2006, the Company was in compliance with all financial covenants contained in the credit agreement. During fiscal 2007, the Company has begun the process of obtaining an extension or refinancing their working capital line of credit that expires June 29, 2007. The Company believes that it will be able to successfully refinance or extend the terms of the current agreement prior to its expiration date; however, there can be no assurance that the Company will be successful in these endeavors or that completion of such extension or refinancing will be on terms acceptable to the Company.

The Company financed the purchase of delivery equipment through a five-year fixed rate note at 4.99%. The note requires payments through December 2010. The delivery equipment purchased with the note proceeds secures the note.

An officer of the Company is a director at one of the banks where the Company maintains a $4.0 million line of credit and where its routine daily banking transactions are processed. This line of credit is at a rate of prime minus 1.0%, is unsecured and expires November 28, 2007. The Company receives no special services or pricing on the services performed by the bank due to the directorship of this officer. A total of $0.8 million was outstanding on this line of credit at December 31, 2006.

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4. DERIVATIVE INSTRUMENTS & HEDGING ACTIVITIES Related to its variable debt, the Company has interest rate swaps utilized to hedge against adverse changes in interest rates. The notional principal amounts of the outstanding interest rate swaps totaled $11.1 million with a weighted average fixed rate of 4.1% at December 31, 2006. The interest rate swaps are not utilized to take speculative positions. The Board of Directors established the Company s policies with regard to activities involving derivative instruments. Management, along with the Board of Directors, periodically reviews those policies, along with the actual derivative related results. The Company recorded the fair market value of its interest rate swaps as cash flow hedges on its balance sheet and has marked them to fair value through other comprehensive income. The fair values of the swaps were an asset of $0.1 million and $0.4 million as of December 31, 2006 and June 30, 2006, respectively, and are reflected as other assets on the accompanying consolidated balance sheet. All of the derivatives used by the Company in its risk management are highly effective hedges because all of the critical terms of the derivative instruments match those of the hedged item.

5. ACCRUED WARRANTY COSTS The Company estimates the amount of warranty claims on sold product that may be incurred based on current and historical data. The actual warranty expense could differ from the estimates made by the Company based on product performance. The following table presents the changes in the Company s product warranty liability for the six months ended December 31, 2006 and 2005 (in millions):

	2006	2005
Accrued warranty costs at June 30	$ 1.1	$ 1.2
Payments made for warranty and related costs	(1.6)	(1.8)
Accrual for product warranty	1.6	1.7
Accrued warranty costs at December 31	$ 1.1	$ 1.1

6. STOCK-BASED COMPENSATION The Company has two stock-based compensation methods available when determining employee compensation.

(1) Management Incentive Plan This plan provides for shares of common stock to be awarded to key employees based on targeted rate of earnings to common equity as established by the Board of Directors. Shares awarded to employees are subject to the restriction of continued employment, with one-third of the stock received by the employee on the award date and the remaining shares vested after one and two years. Under the plan no shares were awarded, granted or vested during the six-months ended December 31, 2006 and 2005. As of December 31, 2006,

there were 4,745 unvested shares outstanding with a weighted average grant date fair value of $0.1 million, which will vest in the first quarter of fiscal 2008. Compensation cost related to these awards was not material during the three and six month periods ended December 31, 2006 and is not expected to be material over the weighted average remaining life of 0.5 years. The Company expects forfeitures under this plan to be nominal. A total of 50 shares and no shares were forfeited in the six months ended December 31, 2006 and 2005, respectively. At December 31, 2006, 69,407 shares were available for future grants.

(2) Stock Options Plans The stock option plans for key employees and directors that provide for the granting of incentive and nonqualified stock options. Under the plans, options are granted at an exercise price equal to the fair market value of the underlying common stock at the date of grant, and may be exercisable for up to 10 years. All options are exercisable when granted. The Company s shareholders have approved all stock option plans.

In December 2006 and 2005 the Company issued options for 135,000 and 159,500 common shares at an exercise prices of $12.63 and $14.40 (the fair market value on the date of grant), respectively. The options were immediately available for exercise and may be exercised for a period of 10 years. In accordance with the provisions of SFAS No. 123(R) the Company recorded compensation expense of $0.3 and $0.4 million during the quarter ended December 31, 2006 and 2005, respectively. The Company also recorded reductions in its income tax expense of $0.1 million related to the issuance of the options in both quarters ended December 31, 2006 and 2005. The assumptions used in determining the compensation expense and related income tax impacts are discussed below.

The fair value of each option grant is estimated on the date of grant using the Black-Sholes option-pricing model with the following weighted-average assumptions used for grants in fiscal 2006 and 2005, respectively; dividend yield of 4.1% and 3.6%; expected volatility of 21.6% and 23.3%; risk-free interest rate of 4.5% and 4.5%; and an expected life of 5 years on all options. The expected volatility is determined based on historical data. The expected life is based on the simplified method described in the SEC Staff Accounting Bulletin, Topic 14: Share-Based Payment.

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The weighted-average grant date fair value of stock options granted during the three months and six months ended December 31, 2006 and 2005 was $1.98 and $2.68, respectively. The cash proceeds, income tax benefit and aggregate intrinsic value of options (the amount by which the market price of the stock on the date of exercise exceeded the market price of stock on the date of grant) exercised during the three months and six months ended December 31, 2006 and 2005 were not material.

At December 31, 2006, 496,700 shares were available for future grants. The Company does not anticipate that additional options will be granted during fiscal 2007. It is the Company s policy to issue new shares upon exercise of stock options. The Company does not expect to repurchase any shares during fiscal year 2007 related to stock option exercises. The Company accepts shares of the Company s common stock as payment for the exercise price of options. These shares received as payment are retired upon receipt.

A summary of the status of the Company s stock option plans as of December 31, 2006, and the changes from June 30, 2005, are presented below:

	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (in millions)
Outstanding and exercisable at June 30, 2005	503,601	$ 16.50	$ 0.2
Granted	159,500	14.40	
Exercised	(2,000)	11.25	
Canceled			
Outstanding and exercisable at June 30, 2006	661,101	16.01	0.1
Granted	135,000	12.63	
Exercised			
Canceled	(7,500)	15.65	
Outstanding and exercisable at December 31, 2006	788,601	$ 15.44	$ 0.1

The following table summarizes information for options outstanding and exercisable at December 31, 2006:

Range of Prices		Options Outstanding	Weighted Average Remaining Life (Years)	Exercise Price
$ 10.30	11.44	26,200	4.0	$ 10.65
12.66	13.59	188,200	7.9	12.79
14.40	16.52	427,806	7.7	15.56
19.21	20.27	146,395	6.9	19.33
$ 10.30	20.27	788,601	7.5	$ 15.44

7. INCOME TAXES In determining our quarterly provision for income taxes, we use an estimated annual effective tax rate, which is based on our expected annual income, statutory tax rates and tax planning opportunities available to us in the various jurisdictions in which we operate. This includes recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns to the extent pervasive evidence exists that they will be realized in future periods. The deferred tax balances are adjusted to reflect tax rates by tax jurisdiction, based on currently enacted tax laws, which are expected to be in effect in the years in which the temporary differences are expected to reverse. In accordance with our income tax policy, significant or unusual items are separately recognized in the quarter in which they occur.

8. LITIGATION From time to time, the Company is subject to various legal proceedings, including lawsuits, which arise out of, and are incidental to, the conduct of the Company s business. The Company does not consider any of such proceedings that are currently pending, individually or in the aggregate, to be material to its business or likely to result in a material adverse effect on its consolidated operating results, financial condition, or cash flows.

9. CONTINGENCIES The Company has guaranteed the future lease payments of a third party ending August 2007. The annual minimum lease payments are approximately $0.2 million and the remaining minimum payments are approximately $0.2 million at December 31, 2006. The Company has not been required to make any payments and has not recorded any amount in its financial statements related to this guarantee.

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10. EARNINGS PER SHARE Basic earnings per share (EPS) is computed based upon the weighted-average number of common shares outstanding for each period. Diluted EPS is computed based on the weighted-average number of common shares and common equivalent

shares. Common equivalent shares represent the effect of stock options during each period presented, which if exercised, would dilute EPS. In computing EPS for the quarters and six months ended December 31, 2006 and 2005, net income as reported for each respective period is divided by:

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2006	2005	2006	2005
Basic shares outstanding	6,566,340	6,560,190	6,565,684	6,553,776
Dilutive effect of stock options	12,713	22,863	9,279	19,340
Diluted shares outstanding	6,579,053	6,583,053	6,574,963	6,573,116
Stock options excluded from the calculation of diluted EPS because the option exercise price was greater than the average market price of the common shares	577,201	420,201	577,201	420,201

11. COMPREHENSIVE INCOME The components of comprehensive income, net of income taxes, for the quarters and six months ended December 31, 2006 and 2005, were as follows (in thousands):

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2006	2005	2006	2005
Net income	$ 1,409	$ 489	$ 1,972	$ 1,475
Other comprehensive income (OCI):				
Change in fair value of derivatives, net of income taxes of $7, $10, $92 and $(20), respectively	(11)	(18)	(150)	34
Change in fair value of available-for-sale, securities, net of income taxes of $(77), $(6), $(137) and $(15), respectively	124	9	223	25
Total other comprehensive income (loss)	113	(9)	73	59
Total comprehensive income	$ 1,522	$ 480	$ 2,044	$ 1,534

The components of accumulated other comprehensive income, net of income taxes, are as follows (in thousands):

	December 31, 2006	June 30, 2006
Available-for-sale securities	$ 981	$ 758

Interest rate swaps	113	263
Minimum pension liability	(255)	(255)
Total accumulated other comprehensive income	$ 839	$ 766

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12. ACCOUNTING DEVELOPMENTS In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires that the Company recognize in its consolidated financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of the Company s 2008 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective as of the beginning of the Company s 2009 fiscal year. The Company is currently evaluating the impact of adopting SFAS No. 157 on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R).* SFAS No. 158 requires the recognition of the funded status of a defined benefit plan in the statement of financial position, requires that changes in the funded status be recognized through comprehensive income, changes the measurement date for defined benefit plan assets and obligations to the entity s fiscal year-end and expands disclosures. The recognition and disclosures under SFAS No. 158 are required as of the end of the fiscal year 2007 while the new measurement date is effective for fiscal year 2008. The Company is in the process of evaluating the impact of SFAS No. 158 on its consolidated financial statements.

13. On January 25, 2007 the Company received a comment letter from the staff of the Division of Corporation Finance of the SEC. These comments were received as part of the SEC s standard review from time to time of periodic reports of public companies. The SEC staff s review encompassed Flexsteel s Form 10-K for fiscal year ended June 30, 2006. The Company is in the process of responding to the SEC s comments within the timeframe provided, and does not believe that the resolution of such matters will have a significant impact on its financial statements.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

GENERAL:

The following analysis of the results of operations and financial condition of the Company should be read in conjunction with the consolidated financial statements and related notes included elsewhere in this quarterly report on Form 10-Q.

CRITICAL ACCOUNTING POLICIES:

The discussion and analysis of the Company s consolidated financial statements and results of operations are based on consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America. Preparation of these consolidated financial statements requires the use of estimates and judgments that affect the reported results. Ultimate results may differ from these estimates under different assumptions or conditions.

Use of estimates the Company uses estimates based on the best information available in recording transactions and balances resulting from business operations. Estimates are used for such items as collect ability of trade accounts receivable, inventory valuation, depreciable lives, self-insurance programs, warranty costs and income taxes.

Allowance for doubtful accounts the Company establishes an allowance for doubtful accounts through review of open accounts, and historical collection and allowances amounts. The allowance for doubtful accounts is intended to reduce trade accounts receivable to the amount that reasonably approximates their fair value due to their short-term nature. The amount ultimately realized from trade accounts receivable may differ from the amount estimated in the consolidated financial statements based on collection experience and actual returns and allowances.

Inventories the Company values inventory at the lower of cost or market. Raw steel, lumber and wood frame parts are valued on the LIFO method. Other inventories are valued on the FIFO method. Changes in the market conditions could require a write down of inventory.

Valuation of long-lived assets the Company periodically reviews the carrying value of long-lived assets and estimated depreciable or amortizable lives for continued appropriateness. This review is based upon projections of anticipated future cash

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flows and is performed whenever events or changes in circumstances indicate that asset carrying values may not be recoverable or that the estimated depreciable or amortizable lives may have changed. These evaluations could result in a change in estimated useful lives in future periods.

Self-insurance programs the Company is self-insured for health care and most workers compensation up to predetermined amounts above which third party insurance applies. The Company purchases specific stop-loss insurance for individual health care claims in excess of $150,000 per plan year, with a $1.0 million individual lifetime maximum. For workers compensation, the Company retains the first $350,000 per claim and purchases excess coverage up to the statutory limits for amounts in excess of the retention limit. The Company is contingently liable to insurance carriers under its comprehensive general, product, and vehicle liability policies, as well as some workers compensation. Losses are accrued based upon the Company s estimates of the aggregate liability of claims incurred using certain actuarial assumptions followed in the insurance industry and based on Company experience. The actual claims experience could differ from the estimates made by the Company.

Warranty the Company has warranty coverage s with respect to the original purchases of its products that range from three months to lifetime. The Company estimates the amount of warranty claims on sold product that may be incurred based on current and historical data. The actual warranty expense could differ from the estimates made by the Company based on product performance.

Income taxes the Company accounts for income taxes in accordance with the provisions of SFAS No. 109, Accounting for Income Taxes. In the preparation of the Company s consolidated financial statements, management calculates income taxes. This includes estimating the Company s current tax liability as well as assessing temporary differences resulting from different treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. These assets and liabilities are analyzed regularly and management assesses the likelihood that deferred tax assets will be realized from future taxable income.

Revenue recognition is upon delivery of product to our customer. The Company s ordering process creates persuasive evidence of the sale arrangement and the sales amount is determined. The delivery of the goods to its customer completes the earnings process. Net sales consist of product sales and related delivery charge revenue, net of adjustments for returns and allowances. Shipping and handling costs are included in cost of goods sold.

Overview

The following table has been prepared as an aid in understanding the Company s results of operations on a comparative basis for the three months and six months ended December 31, 2006 and 2005. Amounts presented are percentages of the Company s net sales.

	Three Months Ended		Six Months Ended	
	December 31,		December 31,	
	2006	2005	2006	2005
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	(81.3)	(81.5)	(81.6)	(80.9)
Gross margin	18.7	18.5	18.4	19.1
Selling, general and administrative	(16.4)	(17.5)	(16.7)	(17.7)
Operating income	2.3	1.0	1.7	1.4
Other expense, net	(0.2)	(0.3)	(0.2)	(0.2)
Income before income taxes	2.1	0.8	1.5	1.2
Income tax (expense) benefit	(0.8)	(0.3)	(0.5)	(0.5)
Net income	1.3%	0.5%	1.0%	0.7%

Results of Operations for the Quarter Ended December 31, 2006 vs. 2005

Net sales for the quarter ended December 31, 2006 were $105.7 million compared to the prior year quarter of $106.3 million, a decrease of 0.6%. Residential net sales were $67.0 million, compared to $69.6 million, a decrease of 3.7% from the prior year quarter. Residential net sales were down slightly from the prior period due to lower demand at the retail level. Recreational vehicle net sales were $14.9 million, compared to

$15.9 million, a decrease of 6.2% from the prior year quarter. The decline in recreational vehicle net sales was due primarily to a weaker wholesale market environment**.** Commercial net sales were $23.8 million, compared to $20.8 million in the prior year quarter, an increase of 14.1%. The increase in commercial net sales was primarily due to improved commercial office product offerings and improved industry performance for hospitality products.

Gross margin for the quarter ended December 31, 2006 was 18.7% compared to 18.5% in the prior year quarter.

Selling, general and administrative (SG&A) expenses were 16.4% and 17.5% of net sales for the quarters ended December 31, 2006 and 2005, respectively. The decrease in quarterly SG&A expenses was due primarily to a decrease in selling expenses of approximately $0.8 million, a decrease in collection related expenses of approximately $0.3 million and a reduction in stock-based compensation expense of approximately $0.2 million.

Operating income for the current quarter was $2.4 million compared to $1.1 million in the prior year quarter reflecting the aforementioned factors.

The effective tax rate was 36.7% and 43.1% in the current and prior year fiscal quarters, respectively. The Company anticipates its effective tax rate for the fiscal year to be approximately 37.0%. The primary difference between the federal statutory rate and the expected effective rate is the result of state taxes.

The above factors resulted in current quarter net income of $1.4 million or $0.21 per share, compared to the prior year quarter of $0.5 million or $0.07 per share.

All earnings per share amounts are on a diluted basis.

<u>Results of Operations for the Six Months Ended December 31, 2006 vs. 2005</u>

Net sales for the six months ended December 31, 2006 were $207.0 million compared to $203.7 million in the prior year six months, an increase of 1.6%. Residential net sales were $128.8 million, compared to $127.7 million, an increase of 0.9% from the prior year six months. Recreational vehicle net sales were $30.8 million, compared to $34.2 million, a decrease of 9.7% from the prior year six months. The decline in recreational vehicle net sales was due primarily to a weaker wholesale market environment**.** Commercial net sales were $47.4 million, compared to $41.9 million in the prior year quarter, an increase of 13.2%. The increase in commercial net sales was primarily due to improved commercial office product offerings and improved industry performance for hospitality products.

Gross margin declined $0.7 million to $38.2 million or 18.4% of net sales in the current period from $38.8 million or 19.1% of net sales in the prior year period. Changes in product mix and continued pricing pressures combined with continued under absorption of fixed manufacturing costs have negatively impacted gross margin during the current six-month period, as compared to the prior year six-month period.

SG&A expenses were 16.7% and 17.7% of net sales for the current and prior six-month period, respectively. The decrease in SG&A expenses was due primarily to a decrease in selling expenses of approximately $0.8 million, a decrease in collection related expenses of approximately $0.4 million and a reduction in stock-based compensation expense of approximately $0.2 million.

The effective income tax rate was 36.8% and 39.2% in the current and prior six-month period, respectively. The Company anticipates its effective income tax rate for the fiscal year to be approximately 37.0%. The primary difference between the federal statutory rate and the expected effective rate is the result of state taxes.

The above factors resulted in current fiscal year to date net income of $2.0 million or $0.30 per share compared to $1.5 million or $0.22 per share in the prior year period, an increase of $0.5 million or $0.08 per share from the prior year six-month periods.

All earnings per share amounts are on a diluted basis.

Liquidity and Capital Resources

Working capital (current assets less current liabilities) at December 31, 2006 was $96.8 million, compared to $97.0 million at June 30, 2006. Net cash provided by operating activities was $11.3 million for the six months ended December 31, 2006. Fluctuations in net cash provided by operating activities were primarily the result of a reduction in finished product and raw material inventories. The decrease of approximately $5.2 million in finished product inventory is primarily due to improved inventory turns. The decrease of approximately $2.5 million in raw material inventory is due to lower levels of domestic manufacturing.

Capital expenditures were $3.0 million and $3.1 million during the first six months of fiscal 2007 and 2006, respectively. The Company expects that capital expenditures will be approximately $9.0 million for the remainder of the fiscal year, including approximately $6.0 million for the purchase of a west coast warehouse building. The Company believes that existing credit facilities are adequate for its capital requirements for the remainder of fiscal year 2007.

Net cash used in financing activities was $9.3 million during the quarter ended December 31, 2006. Net cash provided by financing activities was $14.3 million during the quarter ended December 31, 2005. Short-term borrowings decreased by $7.4 million in the quarter ended December 31, 2006 primarily due to the decrease in accounts receivable. During the quarter ended December 31, 2005, short-term borrowings increased $14.1 million to meet cash requirements related to increases in inventory.

The Company has adequate cash and credit arrangements to meet its current operating and capital requirements. In the opinion of management, the Company s liquidity and credit resources provide it with the ability to react to opportunities as they arise, the ability to pay quarterly dividends to its shareholders, and ensures that productive capital assets that enhance safety and improve operations are purchased as needed. During fiscal 2007, the Company has begun the process of obtaining an extension or refinancing its working capital line of credit that expires June 29, 2007. The Company believes that it will be able to successfully refinance or extend the terms of the current agreement prior to its expiration date; however, there can be no assurance that the Company will be successful in these endeavors or that completion of such extension or refinancing will be on terms acceptable to the Company.

Outlook

The residential and vehicle markets continued soft through the Company s second fiscal quarter. Sales of products into commercial applications showed continued strength. The Company expects these business conditions to continue through the remainder of the 2007 fiscal year.

The Company continues to explore cost control opportunities in all facets of its business and will continue to evaluate and implement sell price increases for products, as warranted. The Company believes it has the necessary inventories and product offerings in place to take advantage of opportunities for expansion of certain markets, such as commercial office and hospitality. The Company will continue its strategy of providing furniture from a wide selection of domestically manufactured and imported products.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

General Market risk represents the risk of changes in value of a financial instrument, derivative or non-derivative, caused by fluctuations in interest rates, foreign exchange rates and equity prices. As discussed below, management of the Company does not believe that changes in these factors could cause material fluctuations in the Company s results of operations or cash flows. The ability to import furniture products can be adversely affected by political issues in the countries where suppliers are located and disruptions associated with shipping distances. Other risks related to furniture product importation include government imposition of regulations and/or quotas; duties and taxes on imports; and significant fluctuation in the value of the U. S. dollar against foreign currencies. Any of these factors could interrupt supply, increase costs and decrease earnings.

Impairment of long-lived assets Accounting rules require that long-lived assets be evaluated for impairment at least annually. We have substantial long-lived assets, consisting mainly of property, plant and equipment, which based upon the outcome of the annual evaluation could result in the write-down of all or a portion of these assets and a corresponding reduction in our earnings and net worth. At December 31, 2006, no impairment of long-lived assets has been identified.

Foreign Currency Risk During the six-months ended December 31, 2006 and 2005, the Company did not have sales, purchases, or other expenses denominated in foreign currencies, nor did it have any active subsidiaries located in foreign countries. As such, the Company is not exposed to market risk associated with currency exchange rates and prices.

Interest Rate Risk The Company s primary market risk exposure with regard to financial instruments is changes in interest rates. At December 31, 2006, a hypothetical 100 basis point increase in short-term interest rates would decrease annual pre-tax earnings by approximately $105,000, assuming no change in the volume or composition of debt. On December 31, 2006, the Company had effectively fixed the interest rates at 4.1% on approximately $11.1 million of its long-term debt through the use of interest rate swaps and fixed the interest rate on an additional $2.1 million through fixed rate equipment financing. The estimated earnings reduction takes the interest rate swaps and fixed interest financing into account. As of December 31, 2006, the cumulative fair value of the swaps is an asset of approximately $0.1 million and is included in other assets.

Tariffs The Company has exposure to actions by governments, including tariffs. Tariffs are a possibility on any imported or exported products. Tariff expense on wooden bedroom furniture imported from China, which represents less than 3% of the Company s net sales, is based on the most current rates published by the Department of Commerce. These rates are potentially subject to an administrative review process starting approximately one year after the publication date. The final amounts will depend on whether administrative reviews are performed and the outcome of those reviews, if any, on the vendors we purchase from. The Company continues to review alternate sources of product supply to minimize the impact of the tariffs.

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Item 4. Controls and Procedures

(a) *Evaluation of disclosure controls and procedures.* Based on their evaluation as of the end of the period covered by this quarterly report on Form 10-Q, the Company s Chief Executive Officer and Chief Financial Officer have concluded that the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e)) under the Securities Exchange Act of 1934, as amended) were effective as of the date of such evaluation.

(b) *Changes in internal control over financial reporting.* During the quarter ended December 31, 2006, there were no significant changes in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) that has materially affected, or is reasonably likely to materially affect the Company s internal control over financial reporting.

Cautionary Statement Relevant to Forward-Looking Information for the Purpose of Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995

The Company and its representatives may from time to time make written or oral forward-looking statements with respect to long-term goals or anticipated results of the Company, including statements contained in the Company s filings with the Securities and Exchange Commission and in its reports to stockholders.

Statements, including those in this quarterly report on Form 10-Q, which are not historical or current facts, are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. There are certain important factors that could cause our results to differ materially from those anticipated by some of the statements made herein. Investors are cautioned that all forward-looking statements involve risk and uncertainty. Some of the factors that could affect results are the cyclical nature of the furniture industry, the effectiveness of new product introductions and distribution channels, the product mix of sales, pricing pressures, the cost of raw materials and fuel, foreign currency valuations, actions by governments including taxes and tariffs, the amount of sales generated and the profit margins thereon, competition (both foreign and domestic), changes in interest rates, credit exposure with customers and general economic conditions. For further information regarding these risks and uncertainties, see the Risk Factors section in Item 1A of the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2006.

We specifically decline to undertake any obligation to publicly revise any forward-looking statements that have been made to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

PART II OTHER INFORMATION

Item 1A. Risk Factors

There has been no material change in the risk factors set forth under Part 1, Item 1A Risk Factors in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2006, except that on January 25, 2007, the Company received a comment letter from the staff of the Division of Corporation Finance of the SEC. These comments were received as part of the SEC s standard review from time to time of periodic reports of public companies. The SEC staff s review encompassed Flexsteel s Form 10-K for fiscal year ended June 30, 2006. The Company is in the process of responding to the SEC s comments within the timeframe provided, and does not believe that the resolution of such matters will have a significant impact on its financial statements.

Item 4. Submission of Matters to a Vote of Security Holders

At the annual meeting of stockholders on December 11, 2006, Proposals 1, 2 and 3 set forth in the Board of Directors definitive Proxy Statement dated November 1, 2006 were approved and adopted by the stockholders with the following votes:

Proposal 1 (Election of Directors): James R. Richardson: For 5,326,990, Withheld 311,189, Abstentions and Broker Non-votes 52,843. Patrick M. Crahan: For 5,326,980, Withheld 311,199, Abstentions and Broker Non-votes 52,843. Robert E. Deignan: For 5,629,426, Withheld 8,753, Abstentions and Broker Non-votes 52,843. Mary C. Bottie: For 5,630,279, Withheld 7,900, Abstentions and Broker Non-votes 52,843. The names of each Director whose term of office as a Director continued after the meeting are as follows: K. Bruce Lauritsen, Ronald J. Klosterman, Jeffrey T. Bertsch, Mary C. Bottie, L. Bruce Boylen, Lynn J. Davis, Thomas E. Holloran, James R. Richardson, Patrick M. Crahan, Robert E. Deignan and Eric S. Rangen.

Proposal 2 (Approval of the 2006 Stock Option Plan): For: 4,866,803, Against: 170,270, Abstentions: 11,336 and Broker Non-votes: 642,613.

Proposal 3 (Amendment of the 1983 Restated Articles of Incorporation): For: 5,241,502, Against: 407,048, and Abstentions: 42,472.

Item 6. Exhibits

31.1	Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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.

FLEXSTEEL INDUSTRIES, INC.

Date: February 9, 2007

By: */S/ Timothy E. Hall*
Timothy E. Hall
Chief Financial Officer &
Principal Financial Officer

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