

WINLAND ELECTRONICS INC

Form 10KSB

March 12, 2003

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

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**FORM 10-KSB**

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

For the Fiscal Year Ended December 31, 2002

Commission File No.: 0-18393

**WINLAND ELECTRONICS, INC.**  
(Name of small business issuer in its charter)

**Minnesota**  
(State or other jurisdiction of  
incorporation or organization)

**41-0992135**  
(IRS Employer  
Identification Number)

**1950 Excel Drive, Mankato, Minnesota 56001**  
(Address of principal executive offices)

**(507) 625-7231**  
(Issuer's telephone number)

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

| <u>Title of Each Class</u>    | <u>Name of Exchange</u> |
|-------------------------------|-------------------------|
| Common Stock, \$.01 par value | American Stock Exchange |

Securities registered pursuant to Section 12(g) of the Exchange Act: None

Check whether the Issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Issuer was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Check if there is no disclosure of delinquent filers pursuant to Item 405 of Regulation S-B contained in this form and no disclosure will be contained, to the best of Issuer's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Issuer's revenues for fiscal year ended December 31, 2002: \$ 18,097,466.

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

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

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**DOCUMENTS INCORPORATED BY REFERENCE**

Documents incorporated by reference pursuant to Rule 12b-23: Portions of the Company's Proxy Statement for its 2003 Annual Meeting are incorporated by reference into Items 9, 10, 11 and 12 of Part III.

Transitional Small Business Disclosure Format (check one) Yes  No

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**PART I**

**ITEM 1. DESCRIPTION OF BUSINESS**

**GENERAL**

Winland Electronics, Inc. (the Company) was incorporated as a Minnesota corporation in October 1972. The Company designs and manufactures custom electronic controls and assemblies primarily for OEM customers. Revenues from OEM customers provided 85% of the Company's total revenue in 2002. The Company provides controls and assemblies to several OEM customers who market their products to a wide variety of industries. The Company continues to maintain a presence in the security/industrial markets with the sales of its own line of proprietary environmental security products. In addition, the Company has developed a proprietary line of customizable motor controls.

**PRODUCTS**

The Company designs, produces and distributes products in two product categories defined as Electronic Manufacturing Services (EMS) for Original Equipment Manufacturers (OEM) Customers and Proprietary Products and Services, primarily for the Security/Industrial and motor control markets.

**Electronic Manufacturing Services for OEM Customers:**

The Company designs and manufactures circuit board assemblies and higher level products that incorporate them for many OEM customers. The Company is positioned to offer complete solutions to OEM customer needs by providing additional value-added services that complement the Company's contract manufacturing capabilities. The services provided may include product design, value engineering, manufacturing engineering, testing, out-of-warranty repair, shipping, and warehousing. These services differentiate the Company from the competition and increase customer satisfaction, confidence, and loyalty. Although the Company has purchase orders in place from many of its OEM customers which are scheduled to be fulfilled in 2003, these customers can terminate their relationship with the Company at any time, with certain cancellation provisions. Therefore, there is no assurance that the Company will continue to be engaged by any of these customers. Sales to OEM customers accounted for 85% and 82% of the Company's total sales during 2002 and 2001, respectively.

**Proprietary Products:**

The Company's proprietary products include an established family of environmental security products and a line of DC motor controllers that can be customized to meet customer requirements. During 2002, the company decided to discontinue promotion and development of the GPS antenna product line. The Company's security/industrial products include simple and sophisticated microprocessor and mechanically controlled sensors and alarms. These products monitor and detect environmental changes, such as changes in temperature or humidity, water leakage and power failures. The Company's ALERT series of products may be hooked up to many burglar or fire alarm panels to monitor and report unfavorable environmental conditions. Proprietary product sales accounted for 15% and 18% of the Company's total sales for 2002 and 2001, respectively.

**Marketing and Distribution:**

The Company markets its design and manufacturing services to prospective OEM customers primarily through direct sales and marketing efforts and referrals from existing customers, suppliers and electronic design firms. One of the Company's key marketing objectives is to form long-term business partnerships with OEM customers by working to develop a degree of technological interdependence between itself and the customer. With this in mind, the Company has worked to identify new OEM customers that need a broad range of services in addition to their manufacturing needs. The Company plans to achieve continued growth in OEM sales by providing its customers with exceptional service, application specific technical expertise, and continuing to deliver quality, cost-effective controls and assemblies to its OEM customers.

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The Company has continued to position itself as a full service designer and manufacturer of custom controls and assemblies for OEM customers. The Company has expanded its sales coverage in Wisconsin and Illinois, and utilizes a network of referral sources and independent sales representatives to market its contract manufacturing services.

The Company markets its proprietary products through dealers and wholesalers, in-house direct marketing and sales efforts, instrumentation catalogs, and national and regional trade expositions. Currently, the Company sells its environmental security products through a distribution network of over 900 locations in the United States, Canada, Mexico, and Europe. The Company continues to explore opportunities with its proprietary product lines, to expand into additional markets, as well as design new products.

Source of Materials:

Raw material components and some subassemblies are purchased from outside vendors, qualified through a vendor qualification process and inspected in accordance with Company inspection policies before being incorporated into products. Certain purchased components and subassemblies are manufactured to design specifications furnished by the Company, while others are standard off-the-shelf items. The Company utilizes multiple sources for the off-the-shelf components, but generally maintains only one source for the items manufactured to design specifications. If the Company loses one or more of its major components suppliers and needs to seek alternative suppliers, some delay and possible additional costs may be incurred while obtaining alternative sources.

In addition to manufacturing its own products, the Company has contracted with companies in the United States and foreign countries to provide both finished goods assemblies and component assemblies designed to the Company's specifications. Although alternative sources for such items may be found, if the Company were to lose one or more of these suppliers, some delay and additional costs may be incurred while obtaining alternative sources.

Patents, Trademarks and Licenses:

The Company holds federal trademark registrations for marks used in the Company's business as follows: WATERBUG, TEMP ALERT, ENVIRONMENTAL SECURITY and SATSOURCE.

Seasonality and Working Capital:

Due to the diversity of the Company's customer mix, the Company's business and working capital needs are not seasonal. Changes in the types of products produced for significant OEM customers could materially affect the seasonality of the Company's business in subsequent years.

Significant Customers:

The Company has worked to develop long-term relationships with its OEM customers that are mutually beneficial. Due to the nature of the Company's contract manufacturing relationships, there is a significant degree of dependence between these customers and the Company. As a group, customers whose individual revenues equaled or exceeded 10% of the Company's net sales revenues were responsible for net sales of \$12.1 million, or 66% of total net sales, in 2002 and net sales of \$10.1 million, or 67% of total net sales, in 2001.

Select Comfort Corporation has been one of the Company's most significant customers during both 2002 and 2001, with sales of 50% and 35% of the Company's net sales. Select Comfort Corporation is a Minnesota based air-sleep system manufacturer in the bedding industry. The design and manufacturing services provided to Johnson Outdoors Inc. accounted for 17% and 16% of the Company's net sales during 2002 and 2001, respectively. Johnson Outdoors Inc. is a Wisconsin based manufacturer of

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

Sales of the Company's proprietary products accounted for 15% of total sales for 2002 and 18% for 2001. In 2002, nearly 38% of all proprietary products sales were to one security/industrial distributor, the world's largest distributor.

**Competition:**

The Company's business includes the design and manufacturing of custom electronic controls and assemblies for OEM customers and the development and marketing of proprietary security/industrial products. The competition for the contract design and manufacturing services offered by the Company has increased substantially, both domestically and internationally. To enhance its ability to compete effectively, the Company has continued to invest in the development of its work force and technically advanced design production and test equipment. The Company has been working to position itself as a full service solution to its contract design and manufacture customers. Significant competitive factors in this market include development and design expertise, quality of manufacturing, price, capacity, and company reputation. The Company believes that it competes favorably with respect to development and design expertise and quality of manufacturing. The Company's foreign competitors are often more aggressive in pricing their services and many of the Company's competitors have greater capacity, and are better-known and better-financed than the Company.

Competition among the security/industrial products has increased the last several years as additional companies have introduced competing products. The Company believes, however, that its products offer desirable features at competitive prices. Significant competitive factors in the market for security/industrial products include product effectiveness and features, price, reliability and company reputation. The Company believes that it competes favorably with respect to product effectiveness, features, price and reliability. However, given the Company's size and relatively small presence in this market, many of the Company's competitors have an advantage by being larger, better-known and better-financed.

**Research and Development:**

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

**Effect on Environmental Regulations:**

The Company is not aware of any federal, state, or local provisions regulating the discharge of materials into the environment or otherwise relating to the protection of the environment with which compliance by the Company has had, or is expected to have, a material effect upon the capital expenditures, earnings, or competitive position of the Company.

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Foreign Operations and Export Sales:

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

Personnel:

At December 31, 2002, the Company had 85 employees (eighty-three full-time and two part-time). During 2002 and 2001, the Company also used temporary labor services during peak production times. The Company is not subject to a collective bargaining agreement, and it considers its relations with its employees to be good.

**ITEM 2. DESCRIPTION OF PROPERTY**

The Company owns its office and manufacturing facility located in Mankato, Minnesota. The 58,000 square foot building consists of 15,500 square feet of office space, 32,500 square feet of manufacturing space and 10,000 square feet of warehouse space, all of which is used by the Company. Management believes that the current facility adequately supports the Company's present and near future operations. Management believes its property is adequately covered by insurance. The Company's office and manufacturing facility are subject to mortgages securing an aggregate amount of debt, which was equal to \$1,869,866 as of December 31, 2002.

**ITEM 3. LEGAL PROCEEDINGS**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**EXECUTIVE OFFICERS OF THE COMPANY**

The name and ages of all of the Company's executive officers and the positions held by them are listed below.

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

*Lorin E. Krueger* has served as Chief Executive Officer of the Company since June 1, 2001, and as President of the Company since January 1999. In addition, Mr. Krueger served as Secretary of the Company since 1983. Mr. Krueger served as the Company's Chief Operating Officer from January 1999 until June 2001 and as its Senior Vice President of Operations from March 1987 until January 1999.



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Mr. Krueger has been an employee of the Company since 1976 and served as its Vice President from January 1977 to March 1987.

*Jennifer A. Thompson, CPA*, has served as Chief Financial Officer since June 2001. She joined the Company as Vice President of Financial Operations in August 2000. Ms. Thompson was a principal in Biebl, Ranweiler, Christiansen, Meyer, Thompson & Co. Chtd., a public accounting firm in New Ulm, Minnesota, from October 1996 to August 2000. Ms. Thompson practiced as a certified public accountant in the Mankato area for twenty years.

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

*Terry E. Treanor* joined the Company in July 1994 and was appointed Vice President of Manufacturing on June 28, 1996, prior to which he served in various capacities, including Quality Assurance Manager and Operations Manager. Mr. Treanor was employed by Onan Corp., a power generation company, from January 1985 until July 1994, serving most recently as Supplier Quality Engineer.

*Steven W. Vogel* joined the Company in May 1994 and was appointed Vice President of Engineering on September 7, 1998, prior to which he served as Manager of Engineering from April 1996 to September 1998 and as Design Engineer from May 1994 to April 1996. From April 1988 to May 1994, Mr. Vogel served as Design Engineer for Micro-Trak Systems, Inc., a Minnesota-based agricultural electronics company.

*Dale A. Nordquist* was recently promoted to Senior Vice President of Sales and Marketing. Dale joined the Company in October 2001 as Vice President of Sales – EMS Western Region. From May 1999 to October 2001, Mr. Nordquist served as Vice President of Sales and Marketing for Quickdraw Conveyor Systems, Inc., which filed for Chapter 7 bankruptcy in January 2001 and was acquired by MagStar Technologies, Inc. in February 2001. From 1981 to May 1999, Mr. Nordquist served as Vice President of Sales and Marketing for HEI, Inc., a Minnesota based designer and manufacturer of ultra-miniature electronic devices and high technology products incorporating these devices.

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The Company's Common Stock was listed on the American Stock Exchange ( AMEX ) under the symbol WEX. The following table sets forth the high and the low bid quotations, as reported by AMEX.

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

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

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

The Company has never paid cash dividends on its Common Stock. The Board of Directors presently intends to retain earnings for use in the Company's business and does not anticipate paying cash dividends on Common Stock in the foreseeable future. Any future determinations as to the payment of dividends will depend on the financial condition of the Company and such other factors as are deemed relevant by the Board of Directors.

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

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

The Company's OEM customers have given the Company purchase orders and forecasts having an aggregate value of \$12.5 million to be completed over the next twelve months. The Company expects to receive additional orders from current OEM customers for 2003 and future production. Although the Company has purchase orders in place from many of its OEM customers which are scheduled to be fulfilled in 2003, these customers can terminate their relationship with the Company at any time, with certain cancellation provisions. Therefore, there is no assurance that the Company will continue to be engaged by any of these customers. In addition, the Company signed a multi-year manufacturing agreement with Select Comfort Corporation, the Company's largest OEM customer. The multi-year contract names Winland as the supplier of electronic controls for Select Comfort's SLEEP NUMBER® 4000, SLEEP NUMBER® 5000 and SLEEP NUMBER® 7000 beds. The renewable contract gives Winland production rights of these electronic controls for a minimum of three years.

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The Company has continued to position itself as a full service designer and manufacturer of custom controls and assemblies for OEM customers. The Company continues to explore additional geographic regions to market its OEM services, primarily through networking with referral sources in the Chicago and Minneapolis areas. The loss of any significant OEM customer would likely have an adverse effect on the Company's short-term, and potentially long-term, results.

**Gross Profits:** Gross profit was \$4,295,114 or 23.7% of net sales for the year ended December 31, 2002 compared to \$2,599,509 or 16.9% of net sales for the same period in 2001. As a percentage of net sales, gross profits increased 6.8% for the year ended December 31, 2002 compared to 2001. The increase in gross profit, as a percentage of sales, is attributed to a more profitable sales mix for the year, including improved margins on Winland proprietary products, combined with the Company's ability to lower direct and variable indirect expenses as a percentage of net sales as revenues increased for 2002, compared to 2001. Reductions in cost of good sold, as a percentage of sales, for the year ended December 31, 2002, are primarily in salaries and employee related expenses, as well as lower information technology and facility expenses, offset in part by increased warranty and obsolescence reserves, commissions expense, accrued employee incentive plan expense and the administrative expenses related to the new Arrow Electronics, Inc. In Plant Store (IPS). Inventory in the IPS, although located on Company premises, is owned by Arrow Electronics, Inc. and is invoiced to the Company when utilized by the Company in manufacturing. The Company has seen the use of the IPS reduce shipping and carrying costs of inventory. The increase in gross profit was also offset in part by the additional accrued Paid Time Off (PTO) that was necessary when the Company modified its policy on accounting for vacation and sick leave hours into one pool.

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

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

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

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

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

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

The Company uses a 37% blended federal and state income tax rate, offset in part, by a tax benefit from the use of net operating losses and tax credits generated in previous years.

**LIQUIDITY AND CAPITAL RESOURCES**

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

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

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

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

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

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

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

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We also have a commercial commitment as described below:

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

**CRITICAL ACCOUNTING POLICIES**

Our significant accounting policies are summarized in the footnotes to our financial statements. These policies include, but are not limited to, revenue recognition, income taxes, product warranties, depreciation and long-lived assets. Some of the most critical policies are also discussed below.

The Company derives revenue from primarily two sources: (1) product and out of warranty repair revenue, which includes custom electronic controls and assemblies for original equipment manufacturers and proprietary products in the security/industrial, motor control and GPS markets and (2) engineering design services which may include programming and prototypes. The Company recognizes revenue from the sale of products and out of warranty repairs when the product is shipped by being delivered to a common carrier. Revenue recognition occurs for engineering design services as the progress billings are made and at the conclusion of the project. For all sales, the Company uses either a binding purchase order or customer accepted and signed engineering quote as evidence of the arrangement.

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

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

In addition, the Company has established a reserve of \$95,000 for rework and warranties. This reserve is based on historical experience and analysis of specific known and potential warranty issues. A portion of the reserve is based on a percentage of the sales for the six-month period ended December 31, 2002. The percentage used reflects historical experience. Specifically identified or potential warranty issues are analyzed to determine the probability and the Company's financial exposure and the reserve is established. The Company believes that the estimated reserve at December 31, 2002 is adequate.

At December 31, 2002, the financial statements reflect a net deferred tax asset of \$186,000. Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards, and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. During the year ended December 31, 2001, the Company recorded a valuation allowance of \$315,200, or 100% of the net deferred tax assets. Since 2001 represented the second consecutive loss year, the valuation allowance was established by management due to the difficulties in predicting when the net deferred tax assets would be utilized and the amount of future taxable income that may be generated. Realization of deferred tax assets is dependent on future taxable income during the period that deductible temporary differences and carryforwards are to be available to reduce taxable income. In 2002, because income was at a record high, the Company eliminated the previously recorded valuation allowance as in the opinion of management it is more likely than not that the deferred income tax assets will be realized due to future profitability.

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

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

### **RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

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

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

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

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

### **CAUTIONARY STATEMENTS**

Certain statements contained in this Annual Report on Form 10-KSB and other written and oral statements made from time to time by the Company do not relate strictly to historical or current facts. As such, they are considered forward-looking statements which provide current expectations or forecasts of future events. Such statements can be identified by the use of terminology such as anticipate, believe, estimate, expect, intend, may, could, possible, plan, project, should, will, forecast and similar words or expressions. The Company's forward-looking statements generally relate to the Company's growth strategies, financial results, product development and sales efforts. One must carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by inaccurate assumptions, including,

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among others, those discussed below. Consequently, no forward-looking statement can be guaranteed and actual results may vary materially. As provided for under the Private Securities Litigation Reform Act of 1995, the Company wishes to caution investors that the following important factors, among others, in some cases have affected and in the future could affect the Company's actual results of operations and cause such results to differ materially from those anticipated in forward-looking statements made in this document and elsewhere by or on behalf of the Company.

The Company derives a significant portion of its revenues from a small number of major OEM customers that are not subject to any long-term contracts with the Company. If any major customer should for any reason decrease the volume of their business or stop doing business with the Company, the Company's business would be adversely affected. Some of the Company's customers are not large, well-established companies, and the business of each customer is subject to various risks such as market acceptance of new products and continuing availability of financing. To the extent that the Company's customers encounter difficulties, or the Company is unable to meet the demands of its OEM customers, the Company could be adversely affected.

The Company's ability to increase revenues and profits is dependent upon its ability to retain valued existing customers and obtain new customers that fit its customer profile. The Company competes for new customers with numerous independent contract design and manufacturing firms in the United States and abroad, many of whom have greater financial resources and more established reputations. The Company's ability to compete successfully in this industry depends, in part, upon the price at which the Company is willing to manufacture a proposed product and the quality of the Company's design and manufacturing services. There is no assurance that the Company will be able to continue to obtain contracts from existing and new customers on financially advantageous terms, and the failure to do so could prevent the Company from achieving the growth it anticipates.

The Company's ability to execute its initiatives to increase sales and expand market share depends upon its ability to develop additional proprietary products and on the availability of sufficient financing, both equity and debt, to meet fixed and variable costs associated with such growth. In the current economic environment, banks and other sources of financing are becoming increasingly conservative in their lending and investment policies. There is no assurance that the Company will be able to obtain the financing necessary to achieve its goals.

The Company's success in providing an improved mix of higher margin proprietary products depends on the effectiveness of its new product development efforts as well as the timing of such and the availability and costs of any competing products on the market.

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**ITEM 7. FINANCIAL STATEMENTS**

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

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



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**INDEPENDENT AUDITOR S REPORT**

To the Board of Directors  
Winland Electronics, Inc.  
Mankato, Minnesota

We have audited the accompanying balance sheets of Winland Electronics, Inc. as of December 31, 2002 and 2001, and the related statements of income, changes in stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Winland Electronics, Inc. as of December 31, 2002 and 2001, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Minneapolis, Minnesota  
January 24, 2003

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

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

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

See Notes to Financial Statements.

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

**Table of Contents****WINLAND ELECTRONICS, INC.****STATEMENTS OF INCOME****Years Ended December 31, 2002 and 2001**

|   | <u>2002</u>         | <u>2001</u>   |
|---|---------------------|---------------|
| Net sales (Note 9)                                    | \$ 18,097,465       | \$ 15,394,754 |
| Cost of sales   | 13,802,351          | 12,795,245    |
| <b>Gross profit</b>                                   | <b>4,295,114</b>    | 2,599,509     |
| Operating expenses:                                   |                     |               |
| General and administrative                            | 1,268,955           | 1,606,663     |
| Research and development                              | 671,930             | 840,813       |
| Sales and marketing                                   | 899,539             | 716,821       |
|   | <b>2,840,424</b>    | 3,164,297     |
| <b>Operating income (loss)</b>                        | <b>1,454,690</b>    | (564,788)     |
| Other income (expenses):                              |                     |               |
| Interest expense                                      | (249,515)           | (482,634)     |
| Other, net  | 6,630               | 45,093        |
|   | <b>(242,885)</b>    | (437,541)     |
| <b>Income (loss) before income taxes</b>              | <b>1,211,805</b>    | (1,002,329)   |
| Income tax expense (benefit) (Note 6)                 | 134,000             | (125,600)     |
| <b>Net income (loss)</b>                              | <b>\$ 1,077,805</b> | \$ (876,729)  |
| Earnings (loss) per share data:                       |                     |               |
| Basic   | \$ 0.36             | \$ (0.30)     |
| Diluted   | 0.35                | (0.30)        |
| Weighted-average number of common shares outstanding: |                     |               |
| Basic   | 2,966,111           | 2,954,128     |
| Diluted   | 3,067,300           | 2,954,128     |

See Notes to Financial Statements.

**Table of Contents****WINLAND ELECTRONICS, INC.****STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY  
Years Ended December 31, 2002 and 2001**

|   | Common Stock     |                  | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Total               |
|---|------------------|------------------|----------------------------------|----------------------|---------------------|
|   | Shares           | Amount           |                                  |                      |                     |
| Balance on December 31, 2000  | 2,952,313        | \$ 29,523        | \$ 2,242,423                     | \$ 2,028,589         | \$ 4,300,535        |
| Issuance of common stock in<br>accordance with employee stock<br>purchase plan (Note 8) | 7,529            | 75               | 7,279                            |                      | 7,354               |
| Net loss  |                  |                  |                                  | (876,729)            | (876,729)           |
| Balance on December 31, 2001  | 2,959,842        | 29,598           | 2,249,702                        | 1,151,860            | 3,431,160           |
| Issuance of common stock in<br>accordance with employee stock<br>purchase plan (Note 8) | 10,894           | 110              | 11,332                           |                      | 11,442              |
| Issuance of common stock in<br>accordance with employee stock<br>option plan (Note 7)   | 7,424            | 74               | 3,676                            |                      | 3,750               |
| Net income  |                  |                  |                                  | 1,077,805            | 1,077,805           |
| Balance on December 31, 2002  | <b>2,978,160</b> | <b>\$ 29,782</b> | <b>\$ 2,264,710</b>              | <b>\$ 2,229,665</b>  | <b>\$ 4,524,157</b> |

See Notes to Financial Statements.

**Table of Contents****WINLAND ELECTRONICS, INC.****STATEMENTS OF CASH FLOWS****Years Ended December 31, 2002 and 2001**

|  | <u>2002</u>        | <u>2001</u>        |
|--|--------------------|--------------------|
| <b>Cash Flows From Operating Activities</b>  |                    |                    |
| Net income (loss)  | \$ 1,077,805       | \$ (876,729)       |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                    |                    |
| Depreciation and amortization  | 736,162            | 851,061            |
| Loss on disposal of equipment  | 5,333              | 11,003             |
| Deferred taxes   | (186,000)          | 54,800             |
| Changes in assets and liabilities:   |                    |                    |
| Accounts receivable  | (97,561)           | 1,441,047          |
| Income tax receivable  | 177,000            | (49,748)           |
| Inventories  | 628,083            | 2,830,302          |
| Prepaid expenses and other assets  | (44,844)           | (43,592)           |
| Accounts payable   | 548                | (1,175,934)        |
| Accrued expenses, including deferred revenue   | 309,723            | (1,853)            |
| Income tax payable   | 159,028            |                    |
| <b>Net cash provided by operating activities</b>   | <b>2,765,278</b>   | <b>3,040,357</b>   |
| <b>Cash Flows From Investing Activities</b>  |                    |                    |
| Proceeds from disposal of equipment  |                    | 18,150             |
| Purchases of property and equipment  | (23,912)           | (49,577)           |
| <b>Net cash used in investing activities</b>   | <b>(23,912)</b>    | <b>(31,427)</b>    |
| <b>Cash Flows From Financing Activities</b>  |                    |                    |
| Net payments on revolving credit agreement   | (1,981,501)        | (1,943,000)        |
| Principal payments on long-term borrowings, including capital lease obligations          | (482,105)          | (712,496)          |
| Proceeds from issuance of common stock   | 15,192             | 7,354              |
| <b>Net cash used in financing activities</b>   | <b>(2,448,415)</b> | <b>(2,648,142)</b> |
| <b>Net increase in cash</b>  | <b>292,951</b>     | <b>360,788</b>     |
| <b>Cash</b>  |                    |                    |
| Beginning of year  | 399,749            | 38,961             |
| End of year  | \$ 692,700         | \$ 399,749         |
| <b>Supplemental Disclosures of Cash Flow Information</b>                                 |                    |                    |
| Cash payments for (receipts of):   |                    |                    |
| Interest   | \$ 249,424         | \$ 482,818         |
| Income taxes, net  | (15,835)           | (130,815)          |
| <b>Supplemental Schedule of Noncash Investing and Financing Activities</b>               |                    |                    |
| Capital lease obligations incurred for the use of equipment                              | \$ 67,500          | \$                 |

See Notes to Financial Statements.



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**Nature of Business and Significant Accounting Policies**

**Nature of business:** The Company operates in one business segment, which includes the design and manufacture of electronic control devices. Sales are to customers located primarily in the upper Midwest, and credit is granted based upon the credit policies of the Company.

A summary of the Company's significant accounting policies follows:

**Use of estimates:** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from such estimates.

**Revenue recognition:** Revenue from product sales is recognized when shipped, FOB shipping point. Shipping and handling charges billed to customers are included in net sales, and shipping and handling costs incurred by the Company are included in cost of goods sold.

**Cash:** The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

**Trade receivables:** Trade receivables are carried at original invoice amount less an estimate made for doubtful receivables based on a review of all outstanding amounts on a monthly basis. Management determines the allowance for doubtful accounts by regularly evaluating individual customer receivables and considering a customer's financial condition and credit history, and current economic conditions. Trade receivables are written off when deemed uncollectible. Recoveries of trade receivables previously written off are recorded when received.

**Inventories:** Inventories are stated at the lower of cost (first-in, first-out method) or market.

**Patents and trademarks:** Patents and trademarks are stated at cost and are being amortized using the straight-line method over their economic useful lives. Amortization expense included in the statements of income for the years ended December 31, 2002 and 2001, was approximately \$400 and \$1,500, respectively. Approximate amortization for 2003 will be \$600.

**Depreciation:** It is the Company's policy to include depreciation expense on assets acquired under capital leases with depreciation expense on owned assets. Depreciation is computed using the straight-line method based on the estimated useful lives of the various assets or capital lease term, as follows:

|                                | <u>Years</u> |
|--------------------------------|--------------|
| Land improvements              | 17-20        |
| Building                       | 39-40        |
| Machinery and equipment        | 5-7          |
| Data processing equipment      | 3-7          |
| Office furniture and equipment | 3-7          |



**Table of Contents****Note 1. Nature of Business and Significant Accounting Policies (Continued)**

**Long-lived assets:** The Company reviews its long-lived assets and intangibles periodically to determine potential impairment by comparing the carrying value of the long-lived assets with the estimated future cash flows expected to result from the use of the assets, including cash flows from disposition. Should the sum of the expected future cash flows be less than the carrying value, the Company would recognize an impairment loss. An impairment loss would be measured by comparing the amount by which the carrying value exceeds the fair value of the long-lived assets and intangibles. In 2001, the Company recognized an impairment charge on certain equipment of approximately \$63,000. There were no impairment losses recognized in 2002.

**Product warranties:** The Company provides a limited warranty for a period of one year for its products. The Company's standard warranties require the Company to repair or replace defective products during such warranty period at no cost to the customer. The Company estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of units sold, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. The Company utilizes historical trends and actuarial analysis tools to assist in determining the appropriate loss reserve levels.

Changes in the Company's warranty liability, which is included in other accruals on the balance sheets, during the period are approximately as follows:

|   | <b>Years Ended December 31</b> |                  |
|---|--------------------------------|------------------|
|   | <b>2002</b>                    | <b>2001</b>      |
| Balance, beginning                              | \$ 25,000                      | \$ 75,000        |
| Accruals for products sold                      | 194,000                        | 50,000           |
| Payments made                                   | (118,000)                      | (70,000)         |
| Changes in accruals for pre-existing warranties | (6,000)                        | (30,000)         |
| Balance, ending                                 | <u>\$ 95,000</u>               | <u>\$ 25,000</u> |

**Income taxes:** Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards, and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Investment tax credits, research and development credits, and job credits are accounted for by the flow-through method, whereby they reduce income taxes currently payable and the provision for income taxes in the period the assets giving rise to the credits are placed in service. To the extent such credits are not currently utilized on the Company's tax return, deferred tax assets, subject to considerations about the need for a valuation allowance, are recognized for the carryforward amount.

**Table of Contents****Note 1. Nature of Business and Significant Accounting Policies (Continued)**

**Fair value of financial instruments:** Management estimates that the carrying value of long-term debt approximates fair value, estimated based on interest rates for the same or similar debt offered to the Company having the same or similar remaining maturities and collateral requirements. The carrying value of all other financial instruments approximates fair value due to the short-term nature of the instruments.

**Earnings (loss) per share:** Basic earnings (loss) per share is computed by dividing net earnings (loss) by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed by dividing net earnings by the weighted-average number of common shares outstanding during the period, including potentially dilutive shares.

The Company has granted options to purchase shares of common stock at various amounts per share (see Note 7). For 2001, these options and warrants were not included in the computation of diluted earnings per share because the Company has incurred a loss for the period. The inclusion of potential common shares in the calculation of diluted loss per share would have an antidilutive effect. Therefore, basic and diluted loss per share amounts are the same for 2001.

**Employee stock plans:** At December 31, 2002, the Company has a stock-based compensation plan, which is described more fully in Note 7. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Accordingly, no stock-based employee compensation cost has been recognized, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income (loss) and earnings (loss) per share had compensation cost for the stock-based compensation plan been determined based on the grant date fair values of awards (the method described in FASB Statement No. 123, *Accounting for Stock-Based Compensation*):

|  | <b>Years Ended December 31</b> |                     |
|--|--------------------------------|---------------------|
|  | <b>2002</b>                    | <b>2001</b>         |
| Net income (loss):   |                                |                     |
| As reported  | \$ 1,077,805                   | \$ (876,729)        |
| Deduct total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (96,209)                       | (39,153)            |
| Pro forma  | <u>\$ 981,596</u>              | <u>\$ (915,882)</u> |
| Basic earnings (loss) per share:   |                                |                     |
| As reported  | \$ 0.36                        | \$ (0.30)           |
| Pro forma  | 0.33                           | (0.31)              |
| Diluted earnings (loss) per share:   |                                |                     |
| As reported  | 0.35                           | (0.30)              |
| Pro forma  | 0.32                           | (0.31)              |

**Research and development expense:** The Company expenses research and development costs as incurred. Research and development expenses of \$672,770 and \$840,813 were charged to operations during the years ended December 31, 2002 and 2001, respectively.

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**Note 1. Nature of Business and Significant Accounting Policies (Continued)**

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

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

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

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

In January 2003, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FASB Interpretation No. 45 clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing certain guarantees. The 2002 financial statements have incorporated the enhanced disclosure requirements of Interpretation No. 45, as presented in Note 1 to the financial statements under the caption Product warranties. The Company does not expect that this interpretation will have any other effect on its financial statements.

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities*. This interpretation establishes standards for identifying a variable interest entity and for determining under what circumstances a variable interest entity should be consolidated with its primary beneficiary. Until now, a company generally has included another entity in its consolidated financial statements only if it controlled the entity through voting interests. Interpretation No. 46 changes that by requiring a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or is entitled to receive a majority of the entity's residual returns or both. The requirements of Interpretation No. 46 will apply to the Company for its quarter ending September 30, 2003. The Company does not believe that the adoption of this pronouncement will have a material effect on its financial statements.

**Table of Contents****Inventories**

The components of inventories at December 31, 2002 and 2001, are as follows:

|                      | December 31         |                     |
|----------------------|---------------------|---------------------|
|                      | 2002                | 2001                |
| Raw materials        | \$ 1,462,315        | \$ 2,006,461        |
| Work in progress     | 138,663             | 138,859             |
| Finished goods       | 395,666             | 429,407             |
| Obsolescence reserve | (185,000)           | (135,000)           |
| <b>Total</b>         | <b>\$ 1,811,644</b> | <b>\$ 2,439,727</b> |

**Financing Arrangement and Long-Term Debt**

**Financing arrangement:** The Company has a \$2,500,000 revolving line-of-credit agreement through March 31, 2003. Advances are due on demand, are secured by substantially all assets of the Company, and are subject to a defined borrowing base equal to 75 percent of qualified accounts receivable and 40 percent of eligible inventories. Interest on advances is at the prime rate plus 2.0 percent (6.25 percent at December 31, 2002) and is due monthly. Advances outstanding on the revolving line-of-credit agreement at December 31, 2001, were \$1,981,501. There were no advances outstanding on the revolving line of credit at December 31, 2002. (a)

**Long-term debt:** The following is a summary of long-term debt:

|  | December 31         |                     |
|--|---------------------|---------------------|
|  | 2002                | 2001                |
| 6.941% note payable, due in monthly installments of \$15,221, including interest, to January 1, 2005, when the remaining balance is payable, secured by property and equipment (a) | \$ 1,019,731        | \$ 1,127,505        |
| 4% note payable, due in monthly installments of \$3,698, including interest, to January 1, 2005, when the remaining balance is payable, secured by property and equipment          | 273,363             | 306,096             |
| 8.25% note payable, due in monthly installments of \$5,150, including interest, to September 2004, secured by equipment  | 464,973             | 486,890             |
| 6% note payable, due in monthly installments of \$1,665, including interest, to November 2009, secured by building   | 111,799             | 124,653             |
| Capital lease obligations, due in various monthly installments, with interest ranging from 5.44% to 9.30%, to November 2006, secured by equipment (Note 4)                         | 641,765             | 881,090             |
|  | <u>2,511,631</u>    | <u>2,926,234</u>    |
| Less current maturities  | 413,546             | 472,325             |
| <b>Total long-term debt</b>  | <b>\$ 2,098,085</b> | <b>\$ 2,453,909</b> |

These agreements contain certain reporting and operating covenants.

**Table of Contents****Note 3. Financing Arrangement and Long-Term Debt (Continued)**

Approximate maturities of long-term debt for years subsequent to December 31, 2002, are as follows:

|            |    |           |
|------------|----|-----------|
| 2003       | \$ | 414,000   |
| 2004       |    | 836,000   |
| 2005       |    | 1,112,000 |
| 2006       |    | 99,000    |
| 2007       |    | 17,000    |
| Thereafter |    | 34,000    |
|            |    | Total     |
|            | \$ | 2,512,000 |

**Commitments and Contingencies**

**Capital leases:** The Company is leasing certain equipment under capital leases. The cost and accumulated depreciation of assets acquired under capital leases at December 31, 2002 and 2001, are as follows:

|  | 2002         | 2001         |
|--|--------------|--------------|
| Cost                                     | \$ 1,417,078 | \$ 2,070,802 |
| Accumulated depreciation                 | 806,471      | 1,105,106    |
| Net leased property under capital leases | \$ 610,607   | \$ 965,696   |

The future minimum lease payments under capital leases and the aggregate present value of the net minimum lease payments at December 31, 2002, are approximately as follows:

|  |            |
|--|------------|
| 2003   | \$ 254,000 |
| 2004   | 268,000    |
| 2005   | 112,000    |
| 2006   | 85,000     |
| Total minimum lease payments   | 719,000    |
| Less amount representing interest  | 77,000     |
| Present value of net minimum lease payments (included in long-term debt) | \$ 642,000 |

**Operating leases:** The Company leases certain equipment and vehicles under noncancelable operating leases through October 2003. The Company is responsible for all repairs and maintenance, insurance and other related expenses in connection with these leases.

Rental and other related expenses for the above leases for the years ended December 31, 2002 and 2001, were approximately \$37,000 and \$68,000, respectively.

Approximate future minimum annual lease payments under these leases as of December 31, 2002, are \$10,000 for the year ending December 31, 2003.



**Table of Contents****Deferred Revenue**

During 1994, the Company and the city of Mankato entered into a tax increment financing agreement for the construction of the Company's operating facility. In connection with this agreement, the city donated land improvements with a fair value of \$270,009. The fair value of land improvements donated was accounted for as deferred revenue and is being amortized over 39 years, which is the life of the building.

**Income Taxes**

Components of the provision for (benefits of) income taxes are as follows:

|                                | <b>December 31</b> |                     |
|--------------------------------|--------------------|---------------------|
|                                | <b>2002</b>        | <b>2001</b>         |
| Currently (refundable) payable | \$ 320,000         | \$ (180,400)        |
| Deferred                       | (186,000)          | 54,800              |
|                                | <b>\$ 134,000</b>  | <b>\$ (125,600)</b> |

The statutory income tax rate reconciliation to the effective rate is as follows:

|   | <b>December 31</b> |          |             |          |
|---|--------------------|----------|-------------|----------|
|   | <b>2002</b>        |          | <b>2001</b> |          |
| Statutory U.S. income tax rate              | 35                 | %        | (35)        | %        |
| State taxes, net of federal tax effect      | 2                  | %        | (1)         | %        |
| Tax benefit of NOL and credit carryforwards | (18)               | %        | (7)         | %        |
| Research and development tax credit         |                    | %        | (7)         | %        |
| Utilization of federal NOL carryback        |                    | %        | 6           | %        |
| Valuation allowance                         | (8)                | %        | 31          | %        |
| Effective income tax rate                   | <b>11</b>          | <b>%</b> | <b>(13)</b> | <b>%</b> |

**Table of Contents****Note 6. Income Taxes (Continued)**

Net deferred tax assets (liabilities) consist of the following components as of December 31, 2002 and 2001:

|                                   | December 31       |                |
|-----------------------------------|-------------------|----------------|
|                                   | 2002              | 2001           |
| Deferred tax assets:              |                   |                |
| Inventory                         | \$ 91,100         | \$ 79,800      |
| Allowance for doubtful accounts   | 3,700             | 3,700          |
| NOL carryforwards and tax credits | 91,900            | 313,000        |
| Other                             | 109,600           | 72,300         |
|                                   | <u>296,300</u>    | <u>468,800</u> |
| Deferred tax liabilities:         |                   |                |
| Property and equipment            | 110,300           | 153,600        |
|                                   | <u>186,000</u>    | <u>315,200</u> |
| Valuation allowance               |                   | (315,200)      |
| Net deferred tax assets           | <u>\$ 186,000</u> | <u>\$</u>      |

During the year ended December 31, 2001, the Company recorded a valuation allowance of \$315,200. The valuation allowance was established by management due to the difficulties in predicting when the net deferred tax assets would be utilized and the amount of future taxable income that may be generated. Realization of deferred tax assets is dependent on future taxable income during the period that deductible temporary differences and carryforwards are to be available to reduce taxable income. In 2002, the Company eliminated the previously recorded valuation allowance, as in the opinion of management it is more likely than not that the deferred income tax assets will be realized due to future profitability.

The components giving rise to the net deferred tax assets and liabilities described above have been included in the accompanying balance sheets as current assets.

At December 31, 2002, the Company has approximately \$87,000 of tax credits with no expiration dates and another \$5,000 of tax credits that expire in 2021.

**Stock-Based Compensation Plans**

**Stock option plan:** The Company has reserved 750,000 common shares for issuance under qualified and nonqualified stock options for its key employees and directors. Option prices are the respective market values of the stock at the time the options were granted. Options become exercisable as determined at the date of grant by a committee of the Board of Directors. Options generally expire five years after the date of grant, unless an earlier expiration date is set at the time of grant.



**Table of Contents****Note 7. Stock-Based Compensation Plans (Continued)**

As noted in Note 1, the Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*. Accordingly, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 2002 and 2001:

|                                 | December 31 |         |
|---------------------------------|-------------|---------|
|                                 | 2002        | 2001    |
| Expected life of options        | 5 years     | 3 years |
| Expected dividend yield         | 0.0%        | 0.0%    |
| Expected stock price volatility | 68.5%       | 61.6%   |
| Risk-free interest rate         | 3.0%        | 6.5%    |

The pro forma effect on earnings in 2002 and 2001 is not representative of the pro forma effect in future years because it does not take into consideration pro forma compensation expense related to grants made prior to 1995.

Additional information relating to all outstanding options as of December 31, 2002 and 2001, is as follows:

|   | 2002     |                                 | 2001      |                                 |
|---|----------|---------------------------------|-----------|---------------------------------|
|   | Shares   | Weighted-Average Exercise Price | Shares    | Weighted-Average Exercise Price |
| Options outstanding, beginning of year  | 375,600  | \$ 1.80                         | 405,000   | \$ 2.10                         |
| Exercised   | (17,000) | 1.55                            |           |                                 |
| Expired   | (97,600) | 1.91                            | (103,400) | 2.13                            |
| Granted   | 128,000  | 1.74                            | 74,000    | 0.72                            |
| Options outstanding, end of year  | 389,000  | \$ 1.76                         | 375,600   | \$ 1.80                         |
| Weighted-average fair value of options granted during the year, computed using the Black-Scholes option pricing model |          | \$ 0.66                         |           | \$ 0.42                         |

The following table summarizes information about stock options outstanding at December 31, 2002:

| Range of Exercise Prices | Options Outstanding |   |                                 | Options Exercisable |                                 |
|--------------------------|---------------------|---|---------------------------------|---------------------|---------------------------------|
|                          | Number of Shares    | Weighted-Average Remaining Contractual Life (Years) | Weighted-Average Exercise Price | Number of Shares    | Weighted-Average Exercise Price |
| \$0.53 to \$0.95         | 79,000              | 4.3   | \$ 0.75                         | 35,800              | \$ 0.83                         |
| \$1.25 to \$1.75         | 131,000             | 3.2   | 1.57                            | 95,400              | 1.61                            |
| \$1.88 to \$2.00         | 48,000              | 2.9   | 1.98                            | 24,000              | 1.98                            |
| \$2.34 to \$2.94         | 131,000             | 2.2   | 2.48                            | 108,200             | 2.48                            |

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|                |                |                |                |
|----------------|----------------|----------------|----------------|
| <u>389,000</u> | <u>\$ 1.76</u> | <u>263,400</u> | <u>\$ 1.89</u> |
|----------------|----------------|----------------|----------------|

At December 31, 2001, there were 237,900 options exercisable at a weighted-average exercise price of \$1.94.

**Table of Contents****Employee Benefit Plans**

**Pension plan:** The Company has a qualified defined contribution 401(k) profit-sharing plan for its employees who meet certain age and service requirements. Employees are allowed to make contributions up to 15 percent of their eligible compensation. The plan also provides for a company-sponsored match to be determined each year by the Board of Directors. The Company contributed approximately \$65,200 and \$71,200 to the plan for the years ended December 31, 2002 and 2001, respectively. In addition, the Company may make additional discretionary contributions to the plan to the extent authorized by the Board of Directors. There were no discretionary contributions to the plan for the years ended December 31, 2002 and 2001.

**Stock purchase plan:** The Company has adopted an employee stock purchase plan to provide substantially all employees an opportunity to purchase shares of its common stock through payroll deductions of up to 15 percent of eligible compensation. The plan provides for two annual six-month phases beginning January 1 and July 1, the grant dates. On June 30 and December 31, the exercise dates, participant account balances are used to purchase shares of stock at the lesser of 85 percent of the fair value of shares on the grant date or the exercise date. The employee stock purchase plan expires December 31, 2002. A total of 100,000 shares were originally available for purchase under the plan. There were 10,894 and 7,529 shares purchased under the plan for the years ended December 31, 2002 and 2001, respectively.

**Major Customers, International Sales and Enterprisewide Disclosures**

**Major customers:** The Company has customers which accounted for more than 10 percent of net sales for the years ended December 31, 2002 and 2001, as follows:

|  | <u>2002</u> | <u>2001</u> |
|--|-------------|-------------|
| Sales percentage:                              |             |             |
| Customer A                                     | 50%         | 35%         |
| Customer B                                     | 17%         | 16%         |
| Customer C                                     | *           | 15%         |
| Accounts receivable percentage at December 31: |             |             |
| Customer A                                     | 34%         | 38%         |
| Customer B                                     | 17%         | 19%         |
| Customer C                                     | *           | 2%          |

\* Customer accounted for less than 10 percent of net sales in 2002.

**International sales:** Export sales to international customers for 2002 and 2001 were approximately \$434,000 and \$290,000, respectively. Accounts receivable from international customers were approximately \$8,000 and \$27,000 at December 31, 2002 and 2001, respectively.

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**Note 9. Major Customers, International Sales and Enterprisewide Disclosures (Continued)**

**Enterprisewide disclosures:** The following table presents revenue from external customers for each of the Company's groups of products and services:

|  | <u>Years Ended December 31</u> |                      |
|--|--------------------------------|----------------------|
|  | <u>2002</u>                    | <u>2001</u>          |
| Proprietary products and services, primarily for the security/industrial, motor control and GPS market | \$ 2,709,200                   | \$ 2,777,400         |
| Electronic controls and assemblies for OEM customers   | 15,388,300                     | 12,617,300           |
|  | <u>\$ 18,097,500</u>           | <u>\$ 15,394,700</u> |

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**ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**PART III**

**ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT**

The information required by Item 9 is either set forth under Executive Officers of the Company at the end of Part I of this Form 10-KSB or is incorporated by reference to the Company's definitive proxy statement for its 2003 Annual Meeting of Shareholders under the captions Election of Directors and Compliance with Section 16(a) of the Exchange Act.

The Company's audit committee has named S. Robert Dessalet, CPA, as the audit committee financial expert as defined by Item 401(e) of Regulation S-B under the Securities Act of 1933. Mr. Dessalet is a Certified Public Accountant, whose experience includes positions as Vice President of Finance and Administration, Chief Financial Officer and business and management consultant. The Company acknowledges that the designation of Mr. Dessalet as the audit committee financial expert does not impose on Mr. Dessalet any duties, obligations or liability that are greater than the duties, obligations and liability imposed on Mr. Dessalet as a member of the audit committee and the Board of Directors in the absence of such designation or identification.

The Company, primarily through the efforts of its Nominating and Governance Committee and Director of Quality Assurance, is in the process of preparing a Code of Ethics and Business Conduct which will be applicable at a minimum to the Company's principal executive officer, principal financial officer and principal accounting officer or controller. Upon completion and adoption of the Code by the Board of Directors, the Company will make the Code available to shareholders as required by Item 406 of Regulation S-B under the Securities Act of 1933.

**ITEM 10. EXECUTIVE COMPENSATION**

The information required by Item 10 is incorporated by reference to the Company's definitive proxy statement for its 2003 Annual Meeting of Shareholders under the caption Executive Compensation.

**ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information required by Item 11 relating to security ownership of certain holders is incorporated by reference to the Company's definitive proxy statement for its 2003 Annual Meeting of Shareholders under the caption Principal Shareholders and Management Shareholdings.

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The following table provides information concerning the Company's equity compensation plans as of December 31, 2002.

|  | Number of<br>securities to<br>be<br>issued upon<br>exercise of<br>outstanding<br>options,<br>warrants<br>and rights | Weighted<br>average<br>exercise price<br>of<br>outstanding<br>options,<br>warrants<br>and rights | Number of<br>securities<br>remaining<br>available<br>for future<br>issuance<br>under equity<br>compensation<br>plans<br>(excluding<br>securities<br>reflected in<br>column<br>(a)) |
|--|---|--|--|
|  | (a)   | (b)  | (c)  |
| Equity compensation plans approved by security holders     | 389,000   | \$1.76   | 240,842  |
| Equity compensation plans not approved by security holders | 0   | N/A  | 0  |

**ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information required by Item 12 is incorporated by reference to the Company's definitive proxy statement for its 2003 Annual Meeting of Shareholders under the caption "Certain Transactions."

**ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K****EXHIBITS.**

The following Exhibits are included in this report: See "Exhibit Index to Form 10-KSB" following the signature page of this Form 10-KSB.

**REPORTS ON FORM 8-K.**

No reports on Form 8-K were filed by the Company during the quarter ended December 31, 2002.

**ITEM 14. CONTROLS AND PROCEDURES**

## (a) Evaluation of Disclosure Controls Procedures.

The Company's Chief Executive Officer, Lorin E. Krueger, and Chief Financial Officer, Jennifer A. Thompson, have reviewed the Company's disclosure controls and procedures within 90 days prior to filing 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 that is required to be disclosed is made known to them.

## (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 subsequent to the date the Company carried out its evaluations, including any corrective actions with regard to significant deficiencies and material weaknesses.

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**SIGNATURES**

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Company has caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

WINLAND ELECTRONICS, INC.

Dated: March 7, 2003

/s/ Lorin E. Krueger  
Lorin E. Krueger, President and  
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed by the following persons on behalf of the Company, in the capacities, and on the dates, indicated.

(Power of Attorney)

Each person whose signature appears below constitutes and appoints Lorin E. Krueger and Jennifer A. Thompson as his true and lawful attorneys-in-fact and agents, each acting alone, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any or all amendments to this Annual Report on Form 10-KSB and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, each acting alone, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all said attorneys-in-fact and agents, each acting alone, or his substitute or substitutes, may lawfully do or cause to be done by virtue thereof.

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| <b>Signature and Title</b>  | <b>Date</b>       |
|---|-------------------|
| /s/ Lorin E Krueger, Chief Executive Officer, President and Director<br>(Principal Executive Officer)               | February 19, 2003 |
| /s/ Jennifer A. Thompson, Chief Financial Officer (Principal<br>Financial Officer and Principal Accounting Officer) | February 19, 2003 |
| /s/ S. Robert Dessalet, Chairman of the Board of Directors  | February 19, 2003 |
| /s/ Thomas J. de Petra, Director  | February 19, 2003 |
| /s/ Richard T. Speckmann, Director  | February 19, 2003 |
| /s/ James L. Reissner, Director   | February 19, 2003 |



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**SARBANES-OXLEY SECTION 302 CERTIFICATION**

I, Lorin E. Krueger, certify that:

1. I have reviewed this annual report on Form 10-KSB of Winland Electronics, Inc.;
2. Based on my knowledge, this annual 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 annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual report;
4. The registrant's other certifying officer 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 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 annual 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 annual report (the "Evaluation Date"); and
  - c) presented in this annual 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 officer 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 (or persons performing the equivalent functions):
  - 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 officer and I have indicated in this annual 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: March 7, 2003

/s/ Lorin E. Krueger  
Lorin E. Krueger  
Chief Executive Officer

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**SARBANES-OXLEY SECTION 302 CERTIFICATION**

I, Jennifer A. Thompson, certify that:

1. I have reviewed this annual report on Form 10-KSB of Winland Electronics, Inc.;
2. Based on my knowledge, this annual 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 annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual report;
4. The registrant's other certifying officer 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 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 annual 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 annual report (the "Evaluation Date"); and
  - c) presented in this annual 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 officer 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 (or persons performing the equivalent functions):
  - 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 officer and I have indicated in this annual 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: March 7, 2003

/s/ Jennifer A. Thompson  
Jennifer A. Thompson  
Chief Financial Officer

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

EXHIBIT INDEX TO FORM 10-KSB

For the fiscal year ended  
December 31, 2002

Commission File No. 0-18393

WINLAND ELECTRONICS, INC.

| <b>Exhibit<br/>Number</b> | <b>Item</b>  |
|---------------------------|--|
| 3.1                       | Restated Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 to Form 10-KSB for the fiscal year ended December 31, 1994)   |
| 3.2                       | Restated Bylaws (Incorporated by reference to Exhibit 3.2 to Current Report on Form 8-K dated March 5, 2001)   |
| 4.1                       | Specimen of Common Stock certificate (Incorporated by reference to Exhibit 4 to Registration Statement on Form S-4, SEC File No. 33-31246)   |
| 10.1                      | Winland Electronics, Inc. 1989 Stock Option Plan (Incorporated by reference to Exhibit 10.6 to Registration Statement on Form S-4, SEC File No. 33-31246)**  |
| 10.2                      | Amendment to Winland Electronics, Inc. 1989 Stock Option Plan (Incorporated by reference to Exhibit 10.4 to Form 10-KSB for the fiscal year ended December 31, 1993)**   |
| 10.3                      | Form of Incentive Stock Option Agreement for use under the 1989 Stock Option Plan (Incorporated by reference to Exhibit 10.7 to Registration Statement on Form S-4, SEC File No. 33-31246)**   |
| 10.4                      | Amendment to Winland Electronics, Inc. 1989 Stock Option Plan dated December 22, 1994 (Incorporated by reference to Exhibit 10.4 to Form 10-KSB for the fiscal year ended December 31, 1994)**   |
| 10.5                      | Form of Nonqualified Stock Option Agreement for use under the 1989 Stock Option Plan (Incorporated by reference to Exhibit 10.8 to Registration Statement on Form S-4, SEC File No. 33-31246)**  |
| 10.6                      | Promissory Note of the Company in the principal amount of \$500,000 dated October 6, 1994 in favor of The City of Mankato, Minnesota (Incorporated by reference to Exhibit 10.14 to Form 10-KSB for the fiscal year ended December 31, 1994) |
| 10.7                      | Employment Agreement dated January 1, 1999 between the Company and Lorin E. Krueger (Incorporated by reference to Exhibit 10.14 to Form 10-KSB for the fiscal year ended December 31, 1998)**  |

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| Exhibit<br>Number | Item  |
|-------------------|---|
| 10.8              | Employment Agreement dated January 1, 1999 between the Company and Kirk P. Hankins (Incorporated by reference to Exhibit 10.15 to Form 10-KSB for the fiscal year ended December 31, 1998)**  |
| 10.9              | Winland Electronics, Inc. 1997 Employee Stock Purchase Plan (Incorporated by reference to Exhibit 10.1 to Form 10-QSB for the quarter ended June 30, 1997)**  |
| 10.10             | Winland Electronics, Inc. 1997 Stock Option Plan (Incorporated by reference to Exhibit 10.2 to Form 10-QSB for the quarter ended June 30, 1997)**   |
| 10.11             | Form of Incentive Stock Option Plan under 1997 Stock Option Plan (Incorporated by reference to Exhibit 10.3 to Form 10-QSB for the quarter ended June 30, 1997)**   |
| 10.12             | Form of Nonqualified Stock Option Plan under 1997 Stock Option Plan (Incorporated by reference to Exhibit 10.4 to Form 10-QSB for the quarter ended June 30, 1997)**  |
| 10.13             | Term Loan and Credit Agreement dated as of July 31, 1998 between the Company and Wells Fargo Bank Minnesota, National Association (formerly Norwest Bank Minnesota South), First amendment dated October 23, 1998 and Second Amendment dated September 29, 1999 (Incorporated by reference to Exhibit 10.16 to Form 10-KSB for the fiscal year ended December 31, 1999)                                     |
| 10.14             | Term Note dated September 29, 1999 in the principal amount of \$530,052.64 in favor of Wells Fargo Bank Minnesota, National Association (formerly Norwest Bank Minnesota South)-(Incorporated by reference to Exhibit 10.18 to Form 10-KSB for the fiscal year ended December 31, 1999)   |
| 10.15             | Mortgage in the amount of \$57,725 dated May 7, 1996 between the Company and Wells Fargo Bank Minnesota, National Association (formerly Norwest Bank Minnesota South) and Note and Mortgage Modification Agreement dated July 31, 1998 and Mortgage Modification Agreement dated September 29, 1999 (Incorporated by reference to Exhibit 10.19 to Form 10-KSB for the fiscal year ended December 31, 1999) |
| 10.16             | Mortgage Loan Agreement dated October 6, 1999 between the Company and the City of Mankato (Incorporated by reference to Exhibit 10.20 to Form 10-KSB for the fiscal year ended December 31, 1999)   |
| 10.17             | Promissory Note dated October 6, 1999 in the principal amount of \$150,000 in favor of the City of Mankato (Incorporated by reference to Exhibit 10.21 to Form 10-KSB for the fiscal year ended December 31, 1999)  |
| 10.18             | Agreement for Loan of Minnesota Investment Fund dated October 6, 1999 between the Company and the City of Mankato (Incorporated by reference to Exhibit 10.22 to Form 10-KSB for the fiscal year ended December 31, 1999)   |

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| Exhibit<br>Number | Item   |
|-------------------|--|
| 10.19             | Agreement for Loan of Small Cities Development Program Funds dated December 14, 1999 between the Company and the City of Mankato (Incorporated by reference to Exhibit 10.23 to Form 10-KSB for the fiscal year ended December 31, 1999)   |
| 10.20             | Promissory Note dated December 14, 1999 in the principal amount of \$1,321,913.59 in favor of the City of Mankato (Incorporated by reference to Exhibit 10.24 to Form 10-KSB for the fiscal year ended December 31, 1999)  |
| 10.21             | Revolving Note dated September 26, 2000 in the principal amount of \$3,500,000 in favor of Wells Fargo Bank Minnesota, National Association (formerly Norwest Bank Minnesota South) (Incorporated by reference to Exhibit 10.25 to Form 10-KSB for the fiscal year ended December 31, 2000)  |
| 10.22             | Third Amendment dated September 26, 2000 to Credit Agreement dated July 31, 1998 between the Company and Wells Fargo Bank Minnesota, National Association (formerly Norwest Bank Minnesota South) (Incorporated by reference to Exhibit 10.26 to Form 10-KSB for the fiscal year ended December 31, 2000)  |
| 10.23             | Fourth Amendment dated November 27, 2000 to Credit Agreement dated July 31, 1998 between the Company and Wells Fargo Bank Minnesota, National Association (formerly Norwest Bank Minnesota South) (Incorporated by reference to Exhibit 10.28 to Form 10-KSB for the fiscal year ended December 31, 2000)  |
| 10.24             | Fifth Amendment dated October 10, 2001 to Credit Agreement dated July 31, 1998 between the Company and Wells Fargo Bank Minnesota, National Association and Revolving Note dated October 10, 2001 in the principal amount of \$3,500,000 (Incorporated by reference to Exhibit 10.28 to Form 10-KSB for the fiscal year ended December 31, 2001) |
| 10.25             | Security Agreement dated December 19, 2001 between the Company and Wells Fargo Bank Minnesota, National Association (Incorporated by reference to Exhibit 10.29 to Form 10-KSB for the fiscal year ended December 31, 2001)  |
| 10.26             | Fifth Amendment dated December 28, 2001 to Credit Agreement dated July 31, 1998 between the Company and Wells Fargo bank Minnesota, National Association (Incorporated by reference to Exhibit 10.30 to Form 10-KSB for the fiscal year ended December 31, 2001)   |
| 10.27             | Sixth Amendment dated March 19, 2002 to Credit Agreement dated July 31, 1998 between the Company and Wells Fargo Bank Minnesota, National Association (Incorporated by reference to Exhibit 10.1 to Form 10-KSB for the quarter ended June 30, 2001)   |
| 10.28             | Separation agreement and release dated May 12, 2001 between the Company and W. Kirk Hankins (Incorporated by reference to Exhibit 10.31 to Form 10-KSB for the fiscal year ended December 31, 2001)**  |

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| Exhibit<br>Number | Item  |
|-------------------|---|
| 10.29             | Amendment to Employment Agreement dated March 25, 2002 between the Company and Kirk P. Hankins (Incorporated by reference to Exhibit 10.1 to Form 10-QSB for quarter ended June 30, 2002)**   |
| 10.30             | Employment Agreement dated April 8, 2002 between the Company and Dale Nordquist (Incorporated by reference to Exhibit 10.1 to Form 10-QSB for quarter ended June 30, 2002)**  |
| 10.31             | Seventh Amendment dated September 15, 2002 to Credit Agreement dated July 31, 1998 between the Company and Wells Fargo Bank Minnesota, National Association (Incorporated by reference to Exhibit 10.1 to Form 10-QSB for quarter ended September 30, 2002) |
| 10.32             | Note Modification Agreement dated September 15, 2002 between the Company and Wells Fargo Bank Minnesota, National Association (Incorporated by reference to Exhibit 10.1 to Form 10-QSB for quarter ended September 30, 2002)                               |
| 23.1*             | Consent of McGladrey & Pullen, LLP  |
| 24.1*             | Power of Attorney for Lorin E. Krueger, Jennifer A. Thompson, S. Robert Dessalet Thomas J. de Petra, Richard T. Speckmann, James L. Reissner (included on signature page of this Form 10-KSB)   |
| 99.1*             | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 99.2*             | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

\* Filed herewith.

\*\* Management agreement or compensatory plan or arrangement.