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ARTS WAY MANUFACTURING CO INC
Form 10QSB
July 14, 2005

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

FORM 10-QSB

(Mark One)

Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 For the quarterly period ended May 31, 2005

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

Commission File No. 0-5131

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

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

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

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

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ___

Number of common shares outstanding as of July 14, 2005: 1,958,176

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

ART'S-WAY MANUFACTURING CO., INC.
CONDENSED STATEMENTS OF OPERATIONS
(Unaudited)

Three Months Ended		Year to Date	
May 31,	May 31,	May 31,	May 31,
2005	2004	2005	2004

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Net sales	\$ 3,799,873	\$ 3,185,125	\$ 7,391,716	\$ 5,809,417
Cost of goods sold	2,776,938	2,197,203	5,113,797	4,187,671
Gross profit	1,022,935	987,922	2,277,919	1,621,746
Operating expenses:				
Engineering	150,367	40,058	279,287	94,848
Selling	118,231	200,168	335,103	321,878
General and administrative	432,248	496,915	810,070	897,212
Total expenses	700,846	737,141	1,424,460	1,313,938
Income from operations	322,089	250,781	853,459	307,808
Other expenses:				
Interest expense	80,087	44,805	130,294	80,830
Other	(6,510)	(11,999)	(44,881)	(15,200)
Total other expenses	73,577	32,806	85,413	
Net income per share:				
Basic	\$ 0.08	\$ 0.16	\$ 0.25	\$ 0.18
Diluted	\$ 0.08	\$ 0.16	\$ 0.25	\$ 0.17
65,630				
Income before income taxes	248,512	217,975	768,046	242,178
Income tax expense (benefit)	98,754	(100,000)	275,396	(100,000)
Net income	\$ 149,758	\$ 317,975	\$ 492,650	\$ 342,178
Common shares and equivalent outstanding:				
Basic	1,944,385	1,938,176	1,941,280	1,938,176
Diluted	1,966,405	1,959,639	1,965,566	1,950,438

See accompanying notes to condensed financial statements.

ART'S-WAY MANUFACTURING CO., INC.

CONDENSED BALANCE SHEETS

(Unaudited)

	May 31, 2005	November 30, 2004
ASSETS		
Current Assets		
Cash	\$ 2,175,798	\$ 116,001
Accounts receivable-customers, net of allowance for doubtful accounts of \$46,385 and \$30,417 in May and November, respectively	859,396	737,008
Inventories	6,834,976	6,298,049
Deferred taxes	539,000	539,000
Real estate loan receivable	0	165,725
Other current assets	147,278	90,224
Total current assets	10,556,448	7,946,007
Property, plant and equipment, at cost	11,675,878	11,600,548
Less accumulated depreciation	10,415,144	10,292,460
Net property, plant and equipment	1,260,734	1,308,088

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Inventories, noncurrent	387,992	459,792
Deferred taxes	523,228	786,000
Other assets	73,705	146,006
Total assets	\$ 12,802,107	\$ 10,645,893

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities		
Notes payable to bank	\$ 0	\$ 870,071
Current portion of long-term debt	240,041	174,674
Accounts payable	518,184	536,929
Customer deposits	1,836,277	77,975
Accrued expenses	821,379	853,795
Total current liabilities	3,415,881	2,513,444
Long-term liabilities	0	144,766
Long-term debt, excluding current portion	2,637,085	1,788,242
Total liabilities	6,052,966	4,446,452

Stockholders' Equity

Common stock - \$.01 par value. Authorized 5,000,000 shares; issued 1,958,176 shares in May and 1,938,176 in November	19,582	19,382
Additional paid-in capital	1,691,804	1,634,954
Retained earnings	5,037,755	4,545,105
Total stockholders' equity	6,749,141	6,199,441

Total liabilities and stockholders' equity	\$ 12,802,107	\$ 10,645,893
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See accompanying notes to condensed financial statements.

ART'S-WAY MANUFACTURING CO., INC.

CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended	
	May 31, 2005	May 31, 2004
CASH FLOW FROM OPERATIONS:		
Net income	\$ 492,650	\$ 342,178
Adjustment to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	125,612	128,220
Deferred income tax	262,772	(100,000)
Changes in working capital components:		
(Increase) decrease in:		
Accounts receivable	(122,388)	(197,807)
Other receivables	0	0
Inventories	(465,127)	(2,371,946)
Other current assets	(57,054)	60,124
Other	108,883	64,797
Increase (decrease) in:		
Accounts payable	(18,745)	774,020
Customer deposits	1,758,302	2,051,391
Accrued expenses	(32,416)	80,787
Net cash provided by operating activities	2,052,488	831,764
CASH FLOW FROM INVESTING ACTIVITIES:		

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Purchases of property, plant and equipment	(75,330)	(427,635)
CASH FLOW FROM FINANCING ACTIVITIES:		
Principal payments on line of credit	(870,071)	0
Proceeds from notes payable	1,000,000	0
Principal payments on long term debt	(85,790)	(90,547)
Loan origination fees paid	(18,550)	0
Proceeds from the exercises of stock options	57,050	0
Net cash provided by (used in) financing activities	82,639	(90,547)
Net increase in cash	2,059,797	313,582
Cash at beginning of period	116,001	800,052
Cash at end of period	\$ 2,175,798	\$ 1,113,634
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest	\$ 104,980	\$ 80,830
Income taxes	12,624	17,321

See accompanying notes to condensed financial statements.

ART'S-WAY MANUFACTURING CO., INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Statement Presentation

The financial statements are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and operating results for the interim periods. The financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company's Annual Report on Form 10-KSB for the year ended November 30, 2004. The results of operations for the second quarter and year to date ended May 31, 2005 are not necessarily indicative of the results for the fiscal year ending November 30, 2005.

Restatement

In Form 10-KSB for the year ended November 30, 2004, we restated our 2004 first and second quarter results to correct the accounting for a sales arrangement with a specific customer. The fiscal 2004 second quarter income statement presented herein reflects those corrections and has been restated from the amounts originally filed on Form 10-QSB for the quarter ended May 31, 2004. The restatement has the effect of increasing sales by \$268,000, net income by \$62,000 and earnings per share by \$0.03 for the quarter ended May 31, 2004. This restatement has no effect on the year to date statement of operations for the six months ended May 31, 2004.

2. INCOME PER SHARE

Basic net income per common share is computed on the basis of weighted average number of common shares outstanding. Diluted net income per

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share has been computed on the basis of weighted average number of common shares outstanding plus equivalent shares assuming exercise of stock options.

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

Since the Company applies APB Opinion No. 25 in accounting for its plans, no compensation cost has been recognized for its stock options in the financial statements. The impact on net income and earnings per share is insignificant, had the Company recorded compensation cost based on the fair value at the grant date for its stock options under SFAS No. 123.

3. INVENTORIES

Major classes of inventory are:

	May 31, 2005	November 30, 2004
Raw material	\$ 2,925,584	\$ 2,867,914
Work-in-process	1,279,457	1,495,985
Finished goods	3,017,933	2,393,942
Total	\$ 7,222,968	\$ 6,757,841
Less inventories classified as noncurrent	387,992	459,792
Inventories, current	\$ 6,834,976	\$ 6,298,049

4. ACCRUED EXPENSES

Major components of accrued expenses are:

	May 31, 2005	November 30, 2004
Salaries, wages and commissions	\$ 420,245	\$ 412,663
Accrued warranty expense	115,993	119,912
Other	285,141	321,220
Total	\$ 821,379	\$ 853,795

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

Changes in the Company's product warranty liability for the three and six months ended May 31, 2005 and 2004 are as follows:

	Three Months Ended		Six Months Ended	
	May 31, 2005	May 31, 2004	May 31, 2005	May, 31 2004
Balance, beginning	\$ 155,934	\$ 53,943	\$ 119,912	\$ 59,207
Settlements made				
in cash or in-kind	(224,556)	(19,721)	(248,253)	(51,512)
Warranties issued	184,615	38,061	244,334	64,588
Balance, ending	\$ 115,993	\$ 72,283	\$ 115,993	\$ 72,283

6. LOAN AND CREDIT AGREEMENTS

Line of Credit

The Company has financing through West Bank consisting of two loan agreements totaling \$6,500,000.

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

Facility #2 is long-term financing for up to \$3,000,000 that is supported by a guarantee issued by the United States Department of Agriculture (USDA) for 75% of the loan amount outstanding. In 2003 the loan refinanced existing debt to UPS Capital (approximately \$1,500,000), finance equipment (approximately \$250,000), provide permanent working capital (approximately \$500,000) and satisfy closing costs (approximately \$50,000). Approximately \$700,000 was reserved for future acquisitions. The variable interest rate is West Bank's prime interest rate plus 1.5%, adjusted daily. The Company's initial borrowing of \$2,000,000 requires monthly principal and interest payments over 20 years with a final maturity date of March 31, 2023. The Company borrowed an additional \$1,000,000 on this facility in January 2005, which is amortized over 10 years with a final maturity date of March 31, 2015.

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Collateral for Facility #2 is primarily real estate with a second position on assets securing Facility #1. The USDA subordinates collateral rights in all assets other than real estate in an amount equal to West Bank's other credit commitments. As of May 31, 2005, the total outstanding balance on Facility #2 was \$2,787,406.

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

J. Ward McConnell, Jr. is required to personally guarantee \$2,500,000 on Facility #1 and all of Facility #2 on an unlimited and unconditional basis. The guarantees of Facility #1 and Facility #2 shall be reduced after the first three years to a percentage representing his ownership of the Company. Mr. McConnell's guarantees shall be removed from Facility #1 and Facility #2 in the event that his ownership interest in the Company is reduced to a level less than 20% after the first three years of the loan. The Company compensates Mr. McConnell for his personal guarantees at an annual percentage rate of 2% of the outstanding balances paid monthly. As a result of the outstanding balances on Facility #1 and Facility #2 Mr. McConnell received \$23,778 and \$19,103 under this compensation agreement, for the six months ended May 31, 2005 and 2004, respectively.

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

	May 31, 2005	November 30, 2004
West Bank Facility #2 payable in monthly installments of \$17,776 including interest at Bank's prime rate plus 1.5%	\$ 1,791,792	\$ 1,836,565
West Bank Facility #2 payable in monthly installments of \$10,000 including interest at Bank's prime rate plus 1.5%	\$ 995,614	\$ 0
State of Iowa Community Development Block Grant promissory notes at zero percent interest, maturity September 2006, with quarterly principal payments of \$11,111	\$ 55,556	\$ 77,778
State of Iowa Community Development Block Grant local participation promissory notes at 4% interest, maturity September 2006, with quarterly payments of \$7,007	\$ 34,164	\$ 48,573
Total term debt	\$ 2,877,126	\$ 1,962,916
Less current portion of term debt	\$ 240,041	\$ 174,674

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Term debt, excluding current portion \$ 2,637,085 \$ 1,788,242

7. Income taxes

Beginning in the first fiscal quarter of 2005, the Company began recognizing income tax expense as compared to the fiscal year 2004 when the calculated income tax expense was offset by a reduction in the valuation allowance for deferred tax assets. At November 30, 2004 the Company eliminated all but \$41,000 of our deferred tax valuation allowance and we will record income tax expense each quarter as we earn income. As of May 31, 2005, the Company has net operating loss carry forwards for federal tax purposes of approximately \$1,090,000 and accordingly the Company will not be required to make cash tax payments until it has utilized those net operating loss carry forwards.

Item 2

MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

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

(a) Plan of Operation

In the current fiscal year we plan to continue growth through new product development and when appropriate acquisition. In December, of fiscal year 2005, we started working with an outside engineering firm to develop a new exportable sugar beet harvester. We continue to look for new and better way to improve our product offerings for our end users. We persist in our attempt to improve our efficiencies, through the implementation of lean manufacturing processes.

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

(i) Critical Accounting Policies

The Company's critical accounting policies involving the more significant judgments and assumptions used in the preparation of the financial statements as of May 31, 2005 have remained unchanged from November 30, 2004. These policies involve revenue recognition, inventory valuation and income taxes. Disclosure of these critical accounting policies is incorporated by reference under Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operation" in our annual report on Form 10-KSB for the year ended November 30, 2004.

(ii) Results of Operations

The second quarter and year to date net sales were 19% and 27% respectively, higher than for the comparable periods one year ago. The first six months of 2005 revenues of \$7,392,000 included increased sales

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of grinder mixers, vegetation cutting, and OEM equipment. We credit part of the increase to changes in our sales force which increased sales in certain regions significantly.

Gross profit, as a percent of sales, was 27% for the quarter ended May 31, 2005, as compared to 31% for the same period in 2004; this was due to a product mix shift. Gross profit as a percent of sales in the first quarter was 34% as compared to 24% in first quarter 2004. In the first quarter of our fiscal year we typically bill out a high percent of OEM equipment at low margins. In 2005 a majority of those sales were pushed back into the second quarter; bringing our gross profit as a percent of sales down slightly for the quarter. Year to date gross profit as a percent of sales is 31% which is a 3% increase over last year.

Operating expenses year to date increased \$111,000 from 2004, however, as a percent of sales; operating expenses went from 23% in 2004 to only 19% in 2005. General and administrative expenses were down \$87,000 due to the consolidation of manufacturing facilities. This decrease was offset by increased engineering expenses. Engineering expenses have increased \$184,000 over the same period in 2004. This entire increase is due to new product development expenses. It is our belief that continuing to bring new products to market will enhance our growth and overall income, and improve the overall performance of the Company. Selling expenses remain relatively consistent.

We experienced an increase in interest expense in the first six months of \$49,000 as a result of increased borrowings and a rise in the prime interest rate.

The order backlog as of May 31, 2005 is \$3,042,000 compared to \$3,936,000 one year ago. In 2004 our backlog started going up significant due to the introduction of our new 6812 sugar beet harvester. The introduction of the 6812 was soon followed by our new 5165 grinder mixer and we were able to maintain the order backlog for about a year. Now we are seeing our backlog falling back into our cyclical trend. We will have two new product offerings in 2006 and expect the backlog to peak again at that time. Our current order backlog consists primarily of sugar beet equipment.

(iii) Liquidity and Capital Resources

Our main source of funds for the six months ended May 31, 2005 was customer deposits received for advance payments on sugar beet equipment sales to be delivered in the third quarter. These customer deposits are unique to our sugar beet equipment line and are seasonal in nature. They accounted for \$1,758,000 of the \$2,053,000 in cash flow from operations.

See footnote 5 of the notes to the consolidated condensed financial statements for a discussion of our credit facilities.

Item 3

CONTROLS AND PROCEDURES

Senior management, including the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is (a) accumulated and communicated to our management, including our Chief

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Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure; and (b) recorded, processed, summarized and reported, within the time specified in the SEC's rules and forms. Since that evaluation process was completed there have been no significant changes in our disclosure controls or in other factors that could significantly affect these controls.

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

Part II - Other Information

ITEM 1. LEGAL PROCEEDINGS

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

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

At our annual meeting of stockholders held April 19, 2005, the following individuals were re-elected to our Board of Directors to hold office until the next annual meeting or until their successors are elected and qualified, with the following votes in favor of election:

	FOR	WITHHELD
David R. Castle	1,738,512	140,549
George A. Cavanaugh, Jr.	1,868,812	10,249
James L. Koley	1,871,312	7,749
Douglas McClellan	1,875,812	3,249
J. Ward McConnell, Jr.	1,875,812	3,249
Marc H. McConnell	1,873,312	5,749
Thomas E. Buffamante	1,873,312	5,749

The stockholders also ratified the selection of McGladrey & Pullen, LLP as independent public accountants for the year ending November 30, 2005.

Total number of shares voted in favor: 1,877,836
Total number of shares voted against: 600
Total number of abstentions: 625
Total number of broker non-votes: 0

ITEM 6. EXHIBITS

See exhibit index on page 15.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ART'S-WAY MANUFACTURING CO., INC.

By: _____
John C. Breitung
Chief Executive Officer

By: _____
Carrie L. Majeski
Chief Financial Officer

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Date: _____

Date: _____

Exhibits Index

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