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

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

FORM 10-QSB

(Mark One)

[x] Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 For the quarterly period ended August 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 Incorporation or Organization)	I.R.S. Employer Identification No.

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

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

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

Number of common shares outstanding as of October 14, 2005: 1,963,176

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	
	August 31, 2005	August 31, 2004	August 31, 2005	August 31, 2004
Net sales	$ 4,190,253	$ 3,398,683	$ 11,581,969	$ 9,208,100
Cost of goods sold	3,121,725	2,484,402	8,235,522	6,672,073

Gross profit	1,068,528	914,281	3,346,447	2,536,027
Operating expenses:				
Engineering	95,932	57,026	375,219	151,874
Selling	181,718	162,566	516,822	484,444
General and administrative	336,722	393,633	1,146,792	1,290,845
Total expenses	614,372	613,225	2,038,833	1,927,163
Income from operations	454,156	301,056	1,307,614	608,864
Other expenses:				
Interest expense	71,553	48,204	198,922	129,034
Other	(9,603)	(32,444)	(51,560)	(47,644)
Total other expenses	61,950	15,760	147,362	81,390
Income before income taxes	392,206	285,296	1,160,252	527,474
Income tax expense (benefit)	133,365	(200,000)	408,761	(300,000)
Net income	$ 258,841	$ 485,296	$ 751,491	$ 827,474
Net income per share:				
Basic	$ 0.13	$ 0.25	$ 0.39	$ 0.43
Diluted	$ 0.13	$ 0.25	$ 0.38	$ 0.42
Common shares and equivalent outstanding:				
Basic	1,958,611	1,938,176	1,947,009	1,938,176
Diluted	1,974,656	1,958,243	1,968,595	1,958,574

See accompanying notes to condensed financial statements.

ART'S-WAY MANUFACTURING CO., INC.

CONDENSED BALANCE SHEETS

(Unaudited)

	August 31, 2005	November 30, 2004
ASSETS		
Current Assets		
Cash	$ 921,869	$ 116,001
Accounts receivable-customers, net of allowance for doubtful accounts of $46,385 and $30,417 in August and November, respectively	1,064,753	737,008
Acquisitions Deposits	150,015	0
Inventories	6,066,269	6,298,049
Deferred taxes	539,000	539,000
Real estate loan receivable	0	165,725
Other current assets	46,809	90,224
Total current assets	8,788,715	7,946,007
Property, plant and equipment, at cost	11,787,748	11,600,548
Less accumulated depreciation	10,476,485	10,292,460
Net property, plant and equipment	1,311,263	1,308,088
Inventories, noncurrent	350,095	459,792
Deferred taxes	399,151	786,000

Other assets	72,964	146,006
Total assets	$ 10,922,187	$ 10,645,893
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Notes payable to bank	$ 0	$ 870,071
Current portion of long-term debt	238,766	174,674
Accounts payable	326,110	536,929
Customer deposits	46,051	77,975
Accrued expenses	701,901	853,795
Total current liabilities	1,312,828	2,513,444
Long-term liabilities	0	144,766
Long-term debt, excluding current portion	2,589,777	1,788,242
Total liabilities	3,902,605	4,446,452
Stockholders' Equity		
Common stock - $.01 par value. Authorized 5,000,000 shares; issued 1,963,176 shares in May and 1,938,176 in November	19,632	19,382
Additional paid-in capital	1,703,354	1,634,954
Retained earnings	5,296,596	4,545,105
Total stockholders' equity	7,019,582	6,199,441
Total liabilities and stockholders' equity	$ 10,922,187	$ 10,645,893

See accompanying notes to condensed financial statements.

ART'S-WAY MANUFACTURING CO., INC.

CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended	
	August 31, 2005	August 31, 2004
CASH FLOW FROM OPERATIONS:		
Net income	$ 751,491	$ 698,406
Adjustment to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	184,025	196,723
Deferred income tax	386,849	(300,000)
Changes in working capital components:		
(Increase) decrease in:		
Accounts receivable	(327,745)	(84,033)
Other receivables	0	0
Inventories	341,477	(2,811,134)
Other current assets	43,415	80,484
Other	107,302	78,333
Increase (decrease) in:		
Accounts payable	(210,818)	305,964
Customer deposits	(31,924)	732,910
Accrued expenses	(151,894)	35,998
Net cash provided by operating activities	1,092,178	(1,066,349)

CASH FLOW FROM INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(187,200)	(495,553)
CASH FLOW FROM FINANCING ACTIVITIES:		
Principal payments on line of credit	(870,071)	0
Proceeds from notes payable	1,000,000	842,285
Principal payments on long term debt	(279,139)	(126,160)
Loan origination fees paid	(18,550)	0
Proceeds from the exercises of stock options	68,650	0
Net cash provided by (used in) financing activities	(99,110)	716,125
Net increase in cash	805,868	(845,777)
Cash at beginning of period	116,001	800,052
Cash at end of period	$ 921,869	$ 800,052
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest	$ 181,869	$ 129,034
Income taxes	23,187	12,643

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 third quarter and year to date ended August 31, 2005 are not necessarily indicative of the results for the fiscal year ending November 30, 2005.

2. INCOME PER SHARE

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

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

Since the Company applies APB Opinion No. 25 in accounting for its plans, no compensation cost has been recognized for its stock options in the financial statements. 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:	August 31, 2005	November 30, 2004
Raw material	$ 2,673,761	$ 2,867,914
Work-in-process	891,932	1,495,985
Finished goods	2,850,671	2,393,942
Total	$ 6,416,364	$ 6,757,841
Less inventories classified as noncurrent	350,095	459,792
Inventories, current	$ 6,066,269	$ 6,298,049

4. ACCRUED EXPENSES

Major components of accrued expenses are:

	August 31, 2005	November 30, 2004
Salaries, wages and commissions	$ 349,853	$ 412,663
Accrued warranty expense	82,929	119,912
Other	269,119	321,220
Total	$ 701,901	$ 853,795

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

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

	Three Months Ended		Nine Months Ended	
	August 31, 2005	August 31, 2004	August 31, 2005	August, 31 2004
Balance, beginning	$ 115,993	$ 72,283	$ 119,912	$ 59,207
Settlements made in cash or in-kind	(127,684)	(12,852)	(375,937)	(64,364)
Warranties issued	94,620	53,279	338,954	117,867
Balance, ending	$ 82,929	$112,710	$ 82,929	$112,710

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 August 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. 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 August 31, 2005, the total outstanding balance on Facility #2 was $2,757,166.

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 $37,610 and $30,622 under this compensation agreement, for the nine months ended August 31, 2005 and 2004, respectively.

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

	August 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%	$ 1,772,589	$ 1,836,565
West Bank Facility #2 payable in monthly installments of $10,000 including interest at Bank's prime rate plus 1.5%	$ 984,577	$ 0
State of Iowa Community Development Block Grant promissory notes at zero percent interest, maturity September 2006, with quarterly principal payments of $11,111	$ 44,444	$ 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	$ 26,933	$ 48,573
Total term debt	$ 2,828,543	$ 1,962,916
Less current portion of term debt	$ 238,766	$ 174,674
Term debt, excluding current portion	$ 2,589,777	$ 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 August 31, 2005, the Company has net operating loss carry forwards for federal tax purposes of approximately $684,000 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 ways 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 August 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 third quarter and year to date net sales were 23% and 26% respectively, higher than for the comparable periods one year ago. For the first nine months of 2005 revenues of $11,582,000 included increased sales of grinder mixers, vegetation cutting, and OEM equipment. We credit part of the increase to changes in our sales force which increased sales in the north and central regions significantly.

Gross profit, as a percent of sales, has remained consistent with 2004. For the quarter ended August 31, 2005, gross profit as a percent of sales was 26% compared to 27% in 2004. Year to date, gross profit as a percent of sales was 29% compared to 28% for the same period in 2004.

Operating expenses year to date increased $112,000 compared to 2004. However, as a percent of sales operating expenses decreased from 21% in 2004 to 18% in 2005. General and administrative expenses were down $144,000 due to the consolidation of manufacturing facilities. This decrease was offset by increased engineering expenses, which increased $223,000 over the same period in 2004. This entire increase in engineering cost 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 our overall performance. Selling expenses were up $32,000 year to date, due to increased commission expense.

We experienced an increase in interest expense in the first nine months of $70,000 as a result of increased borrowings and a rise in the prime interest rate.

The order backlog as of September 28, 2005 is $2,629,000 compared to $3,323,000 one year ago. In 2004 our backlog started to increase 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 normal cyclical trend. We expect to have two new product offerings in 2006 and expect the backlog to peak again at that time. Our current order backlog consists primarily of OEM equipment.

(iii) Liquidity and Capital Resources

Our main source of funds for the nine months ended August 31, 2005 was 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 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 5. OTHER INFORMATION

Subsequent to the period covered by this report, on October 4, 2005, Art's-Way Manufacturing Co., Inc., acquired substantially all of the assets of Vessel Systems, Inc. of Dubuque, Iowa. The assets will be utilized through a wholly owned subsidiary, Art's-Way Vessels, Inc. Art's-Way Vessel Inc. is a manufacturer of both certified and non-certified pressure vessels or pressurized tanks, which can be certified based on the requirements of our customers needs in term of pounds per square inch. Further information on this acquisition will be provided in our filing covering the period in which the transaction occurred.

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: ______________________________	By: _________________________________
John C. Breitung	Carrie L. Majeski
Chief Executive Officer	Chief Financial Officer
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.