WSI INDUSTRIES, INC.
Form 10-Q
December 22, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended November 26, 2017

OR

[ ] **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _______ to _______

Commission file number 0-619

WSI Industries, Inc.

(Exact name of registrant as specified in its charter)

Minnesota	**41-0691607**

(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

213 Chelsea Road, Monticello, Minnesota	**55362**
(Address of principal executive offices)	**(Zip Code)**

(763) 295-9202

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed

since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [X] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "larger accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer [ ]	Accelerated filer [ ]
Non-accelerated filer [ ]	Smaller reporting company [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

Indicate by check mark whether the registrant is an emerging growth company as defined in Rule 405 of the Securities Act of 1933 (§230.405 of this chapter) or Rule 12b-2 of the Securities Exchange Act of 1934 (§240.12b-2 of this chapter).

Emerging growth company [ ]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 2,951,676 shares of common stock were outstanding as of December 22, 2017.

WSI INDUSTRIES, INC.

AND SUBSIDIARIES

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Part I. Financial Information

Item I. Financial Statements

WSI INDUSTRIES, INC.

AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	November 26, 2017	August 27, 2017
Assets		
Current Assets:		
Cash and cash equivalents	$5,987,078	$5,846,933
Accounts receivable	2,319,250	2,739,087
Inventories	4,755,795	3,131,679
Prepaid and other current assets	54,690	78,409
Total Current Assets	13,116,813	11,796,108
Property, Plant and Equipment – Net	10,856,286	10,320,808
Goodwill and other assets, net	2,368,452	2,368,452
Total Assets	$26,341,551	$24,485,368
Liabilities and Stockholders’ Equity		
Current Liabilities:		
Trade accounts payable	$2,703,568	$2,058,992
Accrued compensation and employee withholdings	736,577	664,277
Other accrued expenses	786,167	530,552
Current portion of long-term debt	1,384,585	1,438,057
Total Current Liabilities	5,610,897	4,691,878
Long-term debt, less current portion	6,208,942	5,441,848
Deferred tax liabilities	1,128,851	915,068

Stockholders' Equity:		
Common stock, par value $.10 a share; authorized 10,000,000 shares; issued and outstanding 2,951,676 and 2,959,940 shares, respectively	295,168	295,994
Capital in excess of par value	3,987,470	4,192,578
Deferred compensation	-	(76,500)
Retained earnings	9,110,223	9,024,502
Total Stockholders' Equity	13,392,861	13,436,574
Total Liabilities and Stockholders' Equity	$26,341,551	$24,485,368

See notes to condensed consolidated financial statements.

WSI INDUSTRIES, INC.

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CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	13 weeks ended	
	November 26, 2017	November 27, 2016
Net sales	$7,528,800	$6,329,941
Cost of products sold	6,629,932	6,022,057
Gross margin	898,868	307,884
Selling and administrative expense	691,113	761,178
Interest and other income	(8,504)	(2,090)
Interest and other expense	77,755	67,670
Earnings (loss) from operations before income taxes	138,504	(518,874)
Income tax expense (benefit)	52,783	(196,511)
Net income (loss)	$85,721	$(322,363)
Basic earnings (loss) per share	$.03	$(.11)
Diluted earnings (loss) per share	$.03	$(.11)
Weighted average number of common shares outstanding, basic	2,936,227	2,919,500
Weighted average number of common shares outstanding, diluted	2,938,888	2,919,500

See notes to condensed consolidated financial statements.

WSI INDUSTRIES, INC.

AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	13 weeks ended	
	November 26, 2017	November 27, 2016
Cash Flows From Operating Activities:		
Net income (loss)	$85,721	$(322,363)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	437,617	452,978
Amortization	983	1,002
Deferred taxes	52,783	(196,511)
Stock option compensation expense	57,762	26,052
Changes in assets and liabilities:		
Decrease in accounts receivable	419,837	2,773,513
Increase in inventories	(1,624,116)	(478,475)
Decrease in prepaid expenses	23,719	18,231
Decrease (increase) in accounts payable and accrued expenses	946,295	(396,512)
Net cash provided by operations	400,601	1,877,915
Cash Flows From Investing Activities:		
Purchase of property, plant and equipment	(973,095)	(15,093)
Equipment advance payments exchanged with debt	1,091,722	-
Net cash provided by (used in) investing activities	118,627	(15,093)
Cash Flows From Financing Activities:		
Payments of long-term debt	(379,083)	(383,799)
Net cash used in financing activities	(379,083)	(383,799)
Net Increase In Cash And Cash Equivalents	140,145	1,479,023
Cash And Cash Equivalents At Beginning Of Year	5,846,933	3,739,324
Cash And Cash Equivalents At End Of Reporting Period	$5,987,078	$5,218,347
Supplemental cash flow information:		
Cash paid during the period for:		
Interest	$77,425	$68,603
Income taxes	$-	$2,500
Payroll withholding taxes in cashless stock option exercise	$26,196	$-

Noncash investing and financing activities:		
Acquisition of machinery through debt	$1,091,722	$-

See notes to condensed consolidated financial statements.

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WSI INDUSTRIES, INC.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS:

The condensed consolidated balance sheet as of November 26, 2017, the condensed consolidated statements of income for the thirteen weeks ended November 26, 2017 and November 27, 2016 and the condensed consolidated statements of cash flows for the thirteen weeks then ended, respectively, have been prepared by the Company without audit. In the opinion of management, all adjustments (which include normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made.

The condensed consolidated balance sheet at August 27, 2017 is derived from the audited consolidated balance sheet as of that date. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. Therefore, these condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended August 27, 2017. The results of operations for interim periods are not necessarily indicative of the operating results for the full year.

2. INVENTORIES

Inventories consist primarily of raw material, work-in-progress (WIP) and finished goods and are valued at the lower of cost or market value:

	November 26, 2017	August 27, 2017
Raw material	$1,706,248	$1,047,931
WIP	2,021,703	1,448,282
Finished goods	1,027,844	635,466
	$4,755,795	$3,131,679

3. GOODWILL AND OTHER ASSETS

Goodwill and other assets consist of costs resulting from business acquisitions which total $2,368,452 at November 26, 2017 (net of accumulated amortization of $344,812 recorded prior to the adoption of ASC 350 *Goodwill and Other Intangible Assets*).

4. DEBT AND LINE OF CREDIT:

During fiscal 2017, the Company placed purchase orders for two new pieces of equipment for approximately $2,055,000 that will be delivered and put into service during fiscal 2018. The Company also made advance deposits on that equipment totaling $687,000 which has been classified as machinery and equipment on the balance sheet at August 27, 2017. During the first quarter of fiscal 2018, the Company made additional deposits of $807,000 which have also been classified as machinery and equipment.

In addition, during fiscal 2017, the Company entered into a debt agreement related to one of the pieces of equipment. During the fiscal 2018 first quarter, the Company entered into a debt agreement on the second piece of equipment. Also during the fiscal 2018 first quarter, the Company received loan advances on the two debt agreements totaling $1,092,000 which was also the amount outstanding at November 26, 2017. Until the commencement of the loan agreements upon final installation and approval of the equipment, the Company will pay interest only on the amounts loaned. There were no amounts outstanding related to either debt agreement at August 27, 2017. Upon commencement, both agreements will be for five years. The interest rate on one debt agreement is fixed at 4.25% while the interest rate on the second agreement will be fixed at commencement and will be based on a spread over a base reference rate.

5. INCOME TAXES:

The Company's effective tax rate for its quarter ended November 26, 2017 was 38.1% as compared to a negative (37.9)% for the quarter ended November 27, 2016. In March 2016, the FASB issued ASU No. 2016-09, *Compensation – Stock Compensation* which applied to the Company beginning with its fiscal year 2018. With ASU No. 2016-09, the Company is required to recognize as income tax expense the tax effect of options that have been cancelled or forfeited. This change could lead to variations in the effective tax rate in any particular quarter. The Company recognized $22,500 of income tax expense related to cancelled stock options during the quarter ended November 26, 2017. Prior to the implementation of ASU No. 2016-09, the tax effect would have been recognized as a reduction to paid-in-capital to the extent that a sufficient paid-in-capital pool existed and therefore not flow through income tax expense. The Company has also determined that certain of its activities the Company performs qualify for the Research & Development tax credit (R&D credit) as defined by Internal Revenue Code Section 41 which reduces the effective tax rate from the statutory rates.

6. EARNINGS PER SHARE:

The following table sets forth the computation of basic and diluted earnings per share:

	Thirteen weeks ended	
	November 26, 2017	November 27, 2016
Numerator for earnings per share:		
Net income (loss)	$85,721	$(322,363)
Denominator:		
Denominator for basic earnings per share - weighted average shares	2,936,227	2,919,500
Effect of dilutive securities:		
Employee and non-employee options	2,661	-
Dilutive common shares		
Denominator for diluted earnings per share	2,938,888	2,919,500
Basic earnings (loss) per share	$.03	$(.11)
Diluted earnings (loss) per share	$.03	$(.11)

7. CLAIMS AND CONTINGENCIES:

The Company is exposed to a number of asserted and unasserted claims encountered in the ordinary course of business. Although the outcome of any such claim cannot be predicted, management believes that there are no pending legal proceedings or claims against or involving the Company for which the outcome is likely to have a material adverse effect upon its financial position or results of operations.

8. RECENT ACCOUNTING PRONOUNCEMENTS:

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, "*Revenue from Contracts with Customers*". This guidance defines how companies report revenues from contracts with customers and also requires enhanced disclosures. In July 2015, the Financial Accounting Standards Board voted to defer the effective date by one year, with early adoption on the original effective date permitted. ASU 2014-09 was to be effective for annual reporting periods beginning after December 15, 2016, including interim periods within the annual reporting period. In August 2015, FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606), Deferral of the Effective Date (“ASU 2015-14”). The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 for all entities by one year. The Company is currently evaluating the potential effects of the adoption of this update on the consolidated financial statements.

In March 2016, FASB issued ASU No. 2016-02, *“Leases (Topic 842)*”. ASU 2016-02 requires lessees to recognize the assets and liabilities that arise from most leases. The main difference between previous U.S. GAAP and ASU 2016-02 is the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous U.S. GAAP. For lessors, the guidance included in ASU 2016-02 modifies the classification criteria and the accounting for sales-type and direct financing leases. ASU 2016-02 provides specific guidance for determining whether a contractual arrangement contains a lease, lease classification by lessees and lessors, initial and subsequent measurement of leases by lessees and lessors, sale and leaseback transactions, transition, and financial statement disclosures. ASU 2016-02 requires entities to use a modified retrospective approach to apply its guidance, and includes a number of optional practical expedients that entities may elect to apply. For public entities, the amendments included in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the potential effects of the adoption of this guidance on the consolidated financial statements.

Item 2.

MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

And

RESULTS OF OPERATIONS

Critical Accounting Policies and Estimates:

Management’s Discussion and Analysis of Financial Condition and Results of Operations discuss our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities.

We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the result of which forms the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Results may differ from these estimates due to actual outcomes being different from those on which we based our assumptions. The estimates and judgments utilized are reviewed by management on an ongoing basis and by the audit committee of our board of directors at the end of each quarter prior to the public release of our financial results.

The critical accounting policies and estimates followed in the preparation of the financial information contained in this Quarterly Report on Form 10-Q are the same as those described in the Company’s Annual Report on Form 10-K for the year ended August 27, 2017. Refer to the Annual Report on Form 10-K for detailed information on accounting policies.

Results of Operations:

Net sales were $7,529,000 for the first quarter of fiscal year 2018 ending November 26, 2017 as compared to $6,330,000 in the same period of the prior year. Sales by product line for the quarter and year-to-date periods are as below:

	Fiscal First Quarter Thirteen Weeks Ended							
	November 26, 2017	Percent of Total Sales		November 27, 2016	Percent of Total Sales		Dollar Percent Change	
ATV & Motorcycle	$6,002,000	80	%	$5,596,000	88	%	7	%
Energy	463,000	6	%	74,000	1	%	526	%
Aerospace, Defense & Other	1,064,000	14	%	660,000	11	%	61	%
Total Sales	$7,529,000	100	%	$6,330,000	100	%	19	%

Sales from the Company's ATV and motorcycle markets increased 7% in the fiscal 2018 first quarter as compared to the prior year's first quarter. The Company experienced an increase in demand during the fiscal 2018 first quarter for all of its product lines except for one line that was discontinued by the Company's customer during the fiscal 2017 second quarter and had no sales in the fiscal 2018 first quarter.

Sales from the Company's energy business for the fiscal first quarter of 2018 continued to accelerate with an increase of 526% versus the prior year's first quarter. The increase is due to an increase in demand from an existing customer as well as sales to a new customer in the energy industry. The Company's sales to the energy industry can vary widely as all of the Company's customers in the energy market have their own internal machining capabilities. The Company's sales are generated primarily when their customers have limited machining capacity and therefore need to outsource. Circumstances such as a low price for oil will tend to drive machining in house and therefore lower the Company's sales.

Sales from the Company's aerospace, defense and other markets increased 61% in the fiscal 2018 first quarter with the increase coming from an overall increase in demand from existing customers as well as sales generated from new programs.

Gross margin increased to 11.9% of net sales for the quarter ending November 26, 2017 as compared to 4.9% of net sales for the quarter ending November 27, 2016. The increase in fiscal 2018 was attributable to a higher overall level of business which absorbed capacity as well as improved manufacturing efficiencies.

Selling and administrative expense was $691,000 in the fiscal 2018 first quarter as compared to $761,000 in the prior year first quarter. The decrease was due primarily to lower payroll costs in the fiscal 2018 fiscal first quarter.

Interest expense in the first quarter of fiscal 2017 was $78,000 as compared to $68,000 in first quarter of fiscal 2016. The increase was due to a higher overall level of debt.

The Company's effective tax rate for its quarter ended November 26, 2017 was 38.1% as compared to a negative (37.9)% for the quarter ended November 27, 2016. In March 2016, the FASB issued ASU No. 2016-09, *Compensation – Stock Compensation* which applied to the Company beginning with its fiscal year 2018. With ASU No. 2016-09, the Company is required to recognize as income tax expense the tax effect of options that have been cancelled or forfeited. This change could lead to variations in the effective tax rate in any particular quarter. The Company recognized $22,500 of income tax expense related to cancelled stock options during the quarter ended November 26, 2017. Prior to the implementation of ASU No. 2016-09, the tax effect would have been recognized as a reduction to paid-in-capital to the extent that a sufficient paid-in-capital pool existed and therefore not flow through income tax expense. The Company has also determined that certain of its activities the Company performs qualify for the Research & Development tax credit (R&D credit) as defined by Internal Revenue Code Section 41 which reduces the effective tax rate from the statutory rates.

Liquidity and Capital Resources:

At November 26, 2017, working capital was $7,506,000 which was a $402,000 increase as compared to $7,104,000 at August 27, 2017. The increase was due to offsetting factors including an increase in inventories partially offset by an increase in accounts payable. The ratio of current assets to current liabilities was 2.34 to 1.0 at November 26, 2017 as compared to 2.51 to 1.0 at August 27, 2017 with the overall increase in both current assets and current liabilities causing the reduction during the quarter.

It is the Company's belief that its current cash balance, plus future internally generated funds and its line of credit, will be sufficient to enable the Company to meet its working capital requirements through the next 12 months.

Cautionary Statement:

Statements included in this Management's Discussion and Analysis of Financial Condition and Results of Operations, in future filings by the Company with the Securities and Exchange Commission, in the Company's press releases and in oral statements made with the approval of an authorized executive officer that are not historical or current facts are "forward-looking statements." These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. These risks and uncertainties are described in the Company's Annual Report on Form 10-K for the year ended August 27, 2017, as well as other filings the Company makes with the Securities and Exchange Commission. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made and are not predictions of actual future results. The Company disclaims any obligation subsequently to revise any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures.

As of the end of the period covered by this Quarterly Report on Form 10-Q, an evaluation was performed under the supervision and with the participation of our management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)). Based on that evaluation, the CEO and CFO have concluded that as of November 26, 2017 our disclosure controls and procedures were effective.

(b) Changes in Internal Controls over Financial Reporting.

There have been no changes in internal control over financial reporting that occurred during the fiscal period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION:

ITEM 6. EXHIBITS

A. The following exhibits are included herein:

Exhibit 31.1	Certification of Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) of the Exchange Act.
Exhibit 31.2	Certification of Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) of the Exchange Act.
Exhibit 32	Certification pursuant to 18 U.S.C. §1350.
101.INS**	XBRL Instance
101.SCH**	XBRL Taxonomy Extension Schema
101.CAL**	XBRL Taxonomy Extension Calculation
101.DEF**	XBRL Taxonomy Extension Definition
101.LAB**	XBRL Taxonomy Extension Labels
101.PRE**	XBRL Taxonomy Extension Presentation

SIGNATURES

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

	WSI INDUSTRIES, INC.
Date: December 22, 2017	*/s/ Michael J. Pudil* Michael J. Pudil, President & CEO
Date: December 22, 2017	*/s/ Paul D. Sheely* Paul D. Sheely, Vice President, Finance & CFO