

WINLAND ELECTRONICS INC
Form 10-K
March 29, 2012

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

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2011

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 No.: 1-15637

WINLAND ELECTRONICS, INC.
(Exact name of registrant in its charter)

Minnesota
(State or other jurisdiction of incorporation or
organization)

41-0992135
(IRS Employer Identification Number)

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

56001
(Zip code)

Registrant's telephone number, including area code: (507) 625-7231

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

Title of Each Class	Name of Exchange
Common Stock, \$.01 par value	NYSE Amex
Preferred Stock Purchase Rights	NYSE Amex

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yes No

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

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required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company

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

The aggregate market value of the Common Stock held by non-affiliates as of June 30, 2011 was \$2,225,486 based on the closing sale price of the Issuer's Common Stock on such date.

There were 3,701,630 shares of Common Stock, \$.01 par value, outstanding as of March 23, 2012.

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PART I

ITEM 1.DESCRPTION OF BUSINESS

General

Winland Electronics, Inc. (“Winland”, “Company”, “we” or “our”) was incorporated as a Minnesota corporation in October 1972. Through distribution to dealers and integrators, Winland provides a line of proprietary critical condition monitoring products to the security industry. In most cases, these products are manufactured to protect against loss of assets due to damage from water, excess humidity, extremes of temperature and loss of power. These Winland branded and trademarked products accounted for 100% of the Company’s revenue in 2011. Prior to January 1, 2011, we also designed and manufactured custom electronic controls and assemblies primarily for original equipment manufacturer (“OEM”) customers, providing services from early concept studies through complete product realization (Electronic Manufacturing Services (EMS) business). On January 1, 2011, we sold our EMS business unit to an unrelated third party, Nortech Systems, Incorporated (Nortech) (see Note 8 of our financial statements). As a result, we classified our EMS business as a discontinued operation for 2011 and 2010. All references contained herein relate to our continuing operations of our proprietary business unless identified as discontinued operations.

Proprietary Products Sales and Distribution

Winland markets and sells its line of proprietary critical condition monitoring products primarily through an established network of distributors, dealers, security installers and integrators. Winland employs full-time sales professionals and has engaged independent manufacturers’ sales representative organizations who are responsible for territory-based commissioned sales. This distribution network is primarily located in the United States.

Competition

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

Source of Goods Available for Sale

Winland has a contract with a single third party contract manufacturer through December 31, 2013 to produce goods held for sale to the Company’s customers. These assemblies are manufactured to design specifications furnished by Winland. Alternative sources are available should the Company’s existing source be unable to perform.

Significant Customers

Approximately 50% of the Company’s Proprietary Products sales in both 2011 and 2010 were to one of the world’s largest distributors of security products. Winland derived approximately 4% and 1% of its revenues from sales outside the United States for the years ended December 31, 2011 and 2010, respectively.

Patents, Trademarks and Licenses

Winland holds federal trademark registrations for marks used in its business as follows: WATERBUG, TEMP ALERT, ENVIRONMENTAL SECURITY and ENVIROALERT.

Personnel

At December 31, 2011, Winland had nine full time employees. During 2011 and 2010, Winland also used temporary labor services. Winland is not subject to a collective bargaining agreement and considers its relations with its employees to be good.

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ITEM 1A.RISK FACTORS

Based on current and known information, Winland believes that the following identifies the most significant risk factors that could affect its business. However, the risks and uncertainties Winland faces are not limited to those discussed below. There could be other unknown or unpredictable economic, business, competitive or regulatory factors, including factors that Winland currently believes to be immaterial, that could in fact have material adverse effects on Winland's financial position, liquidity, and results of operations. Past financial performance may not be a reliable indicator of future performance and historical trends should not be used to anticipate results or trends in future periods.

You should consider the following risk factors, in addition to other information presented or incorporated by reference into this Annual Report on Form 10-K in evaluating Winland's business and your investment in Winland.

Winland is dependent on a small number of customers and such customer's response to the current uncertain economic conditions.

Winland's Proprietary Products sales are dependent on a small number of security products distributors with the top five distributors together representing over 65% of total Company sales in 2011 and 2010. Winland does not obtain firm, long-term purchase commitments from its customers. Customers may also cancel their orders, change quantities, or delay delivery for a number of reasons. Cancellations, reductions, or delays by a significant customer or by a group of customers may harm Winland's results of operations by reducing the volumes of products sold.

Winland outsources the manufacturing of its line of Proprietary Products.

Winland has an agreement with an outside contract manufacturing firm to manufacture its proprietary products through December 31, 2013. Based on the agreement, Winland issues purchase orders with definitive quantities, deliveries and price. Winland cannot guarantee the ability of the manufacturer to timely deliver against the purchase orders which may cause Winland to experience delays in meeting its customer's delivery requirements. If experienced, these delays may impact sales volumes and increase costs.

Winland's operating results may vary significantly from period to period.

Winland experiences fluctuations in its operating results. Some of the principal factors that contribute to these fluctuations are Winland's effectiveness in managing inventory levels; changes in the cost and availability of finished goods purchased from its manufacturer; and changes in demand for Winland's products. Results of operations in any period, therefore, should not be considered indicative of the results to be expected for any future period.

Winland's operating results, financial condition and cash flows may be adversely impacted by the affect the current global economic uncertainty has on its customers.

The current economic uncertainty has severely impacted banks and other lenders, limiting the ability of many businesses to the access of credit markets. Winland's customers may choose to delay or postpone purchases of products from Winland until the economy and their businesses strengthen and this may affect its operating results, financial condition and delay and lengthen sales cycles. A continued uncertainty in the global economy could have a material adverse affect on Winland's results of operations and financial condition.

Market acceptance of our new EA800-ip product is uncertain, and we may be unable to obtain market acceptance of our EA800-ip product.

The success of our EA800-ip product will depend upon the acceptance by customers of our EA800-ip product as equivalent or better than the current product or solution they are currently using for security products. Market acceptance of our EA800-ip product will depend on a number of factors, including:

- the perceived effectiveness of our EA800-ip product relative to its cost;
- the potential advantages of our EA800-ip product over alternative products;
- the development of new products and technologies by our competitors or new alternative security products;and

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the effectiveness of our sales and marketing efforts.

If our EA800-ip product does not achieve adequate acceptance by our customers and potential customers, we may not generate our projected revenue and our business would be materially impacted.

Winland's valuation of circumstances impacting the value of long-lived assets is based on judgment and factors that could change and result in the recognition of an impairment charge.

Winland's management exercises its best judgment in estimating future cash flows and other factors affecting the valuation of long-lived assets including the operating and macroeconomic factors that may affect them. Management uses historical financial information, internal plans and projections and industry information in making such estimates. While Winland currently believes the expected cash flows from these long-lived assets exceeds the carrying amount, materially different assumptions regarding future performance and discount rates could result in future impairment losses. In particular, if Winland no longer believes it will achieve its long-term projected sales or operating expenses, it may conclude in connection with any future impairment tests that the estimated fair value of our long-lived assets is less than the book value and recognize an impairment charge. Such impairment would adversely affect Winland's business and earnings.

Internal control over financial reporting may not prevent or detect misstatements because of its inherent limitations.

Winland requires effective internal control over financial reporting in order to provide reasonable assurance with respect to its financial reports and to effectively prevent fraud. Internal control over financial reporting may not prevent or detect misstatements because of its inherent limitations, including the circumvention or overriding of controls, or fraud. Therefore, even effective internal controls can provide only reasonable assurances with respect to the preparation and fair presentation of financial statements.

Failure to meet financial requirements for the continued listing of Winland's stock on a national stock exchange would impair the liquidity of its stock and its availability to access the capital markets, if necessary.

On December 5, 2011 Winland received a notice from NYSE Amex LLC indicating that Winland was not in compliance with the continued listing standard requiring Winland to maintain minimum stockholders' equity of \$4,000,000 and not report losses from continuing operations and/or net losses in three of its four most recent fiscal years. Winland submitted a plan of compliance which requires Winland to regain compliance with the continued listing standards by May 29, 2013. On February 7, 2012 Winland received a letter from the NYSE Regulation informing Winland that it made a reasonable demonstration of its ability to regain compliance with the continued listing standards by March 29, 2013. Winland is currently not in compliance with the continued listing standards of the NYSE Amex Exchange, however, the NYSE Amex Exchange has given Winland an extension until May 29, 2013 to regain compliance with the continued listing standards. Winland can make no assurance that it will be able to remain listed on the NYSE Amex Exchange. If Winland's stock is delisted from trading on the NYSE Amex Exchange, the liquidity of the stock would be impaired and access to the capital markets, if necessary, may not be possible.

ITEM 1B.UNRESOLVED STAFF COMMENTS

None.

ITEM 2.DESCRPTION OF PROPERTY

Winland owns an office and manufacturing facility located in Mankato, Minnesota. The 58,000 square foot building

consists of 32,500 square feet of manufacturing space, 10,000 square feet of warehouse space and 15,500 square feet of office space. Management carries insurance on its property and believes it is adequately covered. The office and manufacturing facility has a net book value of \$2,135,000 including land.

On January 1, 2011, Winland entered into a commercial building lease (the "Lease") with Nortech Systems, Inc. ("Nortech") to lease the entire office and manufacturing facility. The term of the Lease ends January 1, 2017 with obligation to pay rent of \$5.25 per square foot commencing on January 1, 2012. On January 2, 2011, Winland entered into a sublease agreement with Nortech to lease 1,000 square feet of office space at 1950 Excel Drive, Mankato, MN effective January 1, 2011 and expiring December 31, 2011 at \$5.25 per square foot. In May 2011, Winland amended the sublease agreement with Nortech increasing its leased space to 1,900 square feet of office space at \$5.25 per square foot. On December 28, 2011, Winland and Nortech executed a new sublease agreement with the same terms as the prior agreement with a term expiring on December 31, 2012.

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In August 2011, Winland engaged a real estate broker and listed the office and manufacturing facility for sale. The listing agreement identified the obligations of Winland and the real estate broker and expired on February 29, 2012. Winland will continue, on its own behalf, to look for an interested party to purchase its office and manufacturing facility.

ITEM 3.LEGAL PROCEEDINGS

None.

ITEM 4.MINE SAFETY DISCLOSURES

None.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Winland's Common Stock is listed on the NYSE Amex under the symbol WEX. The following table sets forth the high and the low market closes, as reported by NYSE Amex during 2011 and 2010.

Fiscal Year Ended December 31, 2011	Low	High
First Quarter	\$ 0.71	\$ 0.90
Second Quarter	\$ 0.62	\$ 0.76
Third Quarter	\$ 0.58	\$ 0.69
Fourth Quarter	\$ 0.30	\$ 0.60
Fiscal Year Ended December 31, 2010	Low	High
First Quarter	\$ 0.79	\$ 1.36
Second Quarter	\$ 0.71	\$ 1.07
Third Quarter	\$ 0.60	\$ 0.80
Fourth Quarter	\$ 0.64	\$ 0.87

On March 23, 2012, the fair market value of Winland's Common Stock was \$0.66 based on the closing sale price quoted by NYSE Amex on that date. As of December 31, 2011, Winland had 373 registered shareholders of record.

Winland has never paid cash dividends on its Common Stock. The Board of Directors presently intends to retain any earnings for use in its business and does not anticipate paying cash dividends on Common Stock in the foreseeable future. The payment of cash dividends in the future, if any, will be at the discretion of the Board of Directors and will depend on such factors as earnings levels, capital requirements, Winland's overall financial condition and any other factors deemed relevant by Winland's Board of Directors.

ITEM 6. SELECTED FINANCIAL DATA

None.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

EXECUTIVE SUMMARY

During 2011, we made significant strides towards redefining Winland Electronics, Inc. for the future. We were successful in selling the EMS assets to Nortech Systems Incorporated and receiving \$1,017,000 in cash. The sale eliminated the recent historical under utilization of the manufacturing facility and provided a small gain for the year. Additionally, Nortech consumed \$2,900,000 worth of the remaining EMS inventory providing significant cash flow during the year which allowed us to pay down debt of \$1,697,000.

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Subsequent to the sale of the EMS business segment to Nortech, we turned our attention to our proprietary product offerings and invested in our latest product, the EnviroAlert EA800-ip. This product enhancement to our award winning EA800 product provides for remote monitoring and modification of sensor settings meeting a critical need for companies who must maintain regulatory compliance. We anticipate the EA800-ip to favorably impact our results of operations for 2012.

With Winland's sales team continuing to drive awareness of our critical condition monitoring solutions, we were able to achieve modest growth in sales. This growth was driven by our top ten customers. More important however, is the attention our products have been able to attract with large national security dealers and end-user national accounts in the pharmaceutical and food distribution industries.

RESULTS OF OPERATIONS – 2011 vs. 2010

The Company reported a net loss of \$740,000 or \$0.20 per basic and diluted share for the year ended December 31, 2011 compared to the \$3,532,000 net loss or \$0.96 per basic and diluted share for the same period in 2010.

Net Sales

Proprietary Products net sales for the year ended December 31, 2011 were \$3,444,000 up \$127,000 or 4% compared to the same period in 2010 driven by a 9.2% increase in sales to Winland's largest distributor. Winland's other top ten customers grew 15.6% collectively which were offset by declines by other customers mostly the result of non-recurring projects requiring Winland's products.

Operating Loss

The Company reported an operating loss of \$1,023,000 and \$1,931,000 for the years ended December 31, 2011 and 2010, respectively. Our gross margin percentage of 31.0% in 2011 was down from 35.6% reported in 2010. Declines in gross margin were expected based on changing from a direct internal manufacturing operation to outsourcing our manufacturing requirements upon the sale of our EMS business segment.

For the year ended December 31, 2011, General and Administrative expenses were \$852,000 down from \$2,143,000 from the same period in 2010. The decline in expense was primarily related to decreased salaries expenses of \$786,000 due to headcount reductions and associated severance payments related to the EMS sale, decreased professional fees including audit, legal and tax preparation expenses of \$205,000, reduced information technology expenses of \$104,000, reduced financial advisor fees of \$60,000, reduced software implementation consulting fees of \$50,000, reduced premium costs for directors and officers insurance of \$36,000 and reduced board of director fees of \$35,000 partially offset by lease expense of \$8,000.

For the year ended December 31, 2011, sales and marketing expenses were \$1,000,000, an increase of \$30,000 from the same period in 2010 with increased salaries and benefits expenses of \$47,000 and increased marketing and trade show expenses of \$32,000 related to the Company's EnviroAlert EA800-ip partially offset by decreased product support costs of \$31,000 and reduced certification expenses of \$10,000.

During 2011, the Company funded research and development activities, incurring expenses of \$237,000. The expenses were primarily for new product development of \$168,000 related to the Company's EnviroAlert EA800-ip and salary and benefit expenses of \$59,000.

Interest Expense and Other, Net

Interest expense and other consists primarily of interest expense and miscellaneous income. Interest expense for 2011 was \$54,000 compared to \$175,000 during the same period a year ago. This significant decrease relates to the decreased outstanding balances on the Company's lines of credit during the year. The Company received \$10,800 in interest income from the settlement and payment of refunds related to the settlement reached between the Company and the Internal Revenue Service regarding research and development tax credits.

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Income Tax

Winland records a tax valuation allowance when it is more likely than not that it will not be able to recover the value of its deferred tax assets. The valuation allowance for deferred tax assets as of December 31, 2011 and 2010 was \$1,889,000 and \$1,593,000, respectively. The net change in the total valuation allowance for the years ended December 31, 2011 and 2010 was an increase of \$296,000 and \$1,216,000, respectively. The tax effect of the Company's valuation allowance for deferred tax assets is included in the annual effective tax rate. As of December 31, 2011 and 2010, the Company calculated its estimated annualized effective tax expense (benefit) rate at 1% and (4%), respectively. The Company recognized income tax expense of \$9,000 (net of the valuation allowance) based on its \$790,000 pre-tax loss from continuing operations for year ended 2011 compared to an income tax benefit of \$89,000 (net of the valuation allowance) based on its \$2,098,000 pre-tax loss from continuing operations for the year ended 2010.

Gain (loss) from discontinued operations

On January 1, 2011, the Company sold its EMS business to Nortech. Winland recognized a gain from discontinued operations, net of tax, of \$59,000 for the year ended December 31, 2011 compared to a loss of \$1,523,000 for the same period a year ago. The gain was the result of additional inventory sales to Nortech above the \$2,200,000 commitment which allowed the Company to reduce the reserve for obsolescence for inventory held for discontinued operations by \$73,000. Net sales from discontinued operations for the year ended December 31, 2011 were \$2,906,000 from raw, finished and work-in-process inventories sold to Nortech compared to net sales of \$14,653,000 for finished goods sold to EMS customers for the year ended December 31, 2010. The Company recorded a gross loss from discontinued operations for the year ended December 31, 2010 of \$530,000 compared to no gross profit on the inventory sold to Nortech for the year ended December 31, 2011, as the Company sold inventory to Nortech at historical cost.

LIQUIDITY AND CAPITAL RESOURCES

Operating activities used cash of \$1,505,000 for the year ended December 31, 2011 which resulted from the net loss of \$740,000, a net increase in finished goods inventories of \$455,000 for future customer sales, a reduction of accrued expenses of \$421,000 primarily related to compensation payments of \$339,000 partially offset by federal and state income tax refunds received of \$277,000. Operating activities used cash of \$173,000 for the year ended December 31, 2010 which resulted from the net loss of \$3,532,000 partially offset by increased accounts payable balances of \$1,021,000 for increased raw material inventory levels held for discontinued operations, non-cash depreciation expense of \$775,000, collection of 2009 loss carry-back from the IRS and settlement of uncertain tax positions of \$746,000, collection of \$550,000 accounts receivable balances in excess of sales as a result of the improvement in days sales outstanding of four days and non-cash loss on disposal of equipment of \$173,000.

Investing activities provided cash of \$3,913,000 primarily from the sale of EMS business unit and the sale of related inventory from discontinued operations for year ended December 31, 2011 compared to the use of cash of \$73,000 used to acquire capital equipment for the year ended December 31, 2010. Financing activities used cash of \$1,695,000 for the year ended December 31, 2011 consisting of \$1,249,000 to pay down the Company's revolving line-of-credit and \$448,000 to pay down long-term borrowings. For the year ended December 31, 2010, financing activities provided cash of \$509,000 from borrowing \$882,000 on the Company's accounts receivable agreement offset by \$380,000 cash used to pay down long-term borrowings.

The current ratio was 3.7 to 1 at December 31, 2011 and 1.3 to 1 at December 31, 2010. Working capital equaled \$1,517,000 on December 31, 2011, compared to \$1,315,000 on December 31, 2010. The Company had \$1,249,000 outstanding on its accounts receivable agreement with PrinSource Capital Companies, LLC as of December 31, 2010

with no outstanding balance as of December 31, 2011.

On August 18, 2010, Winland and PrinSource Capital Companies, LLC ("PrinSource") entered into an Accounts Receivable Agreement (the "Agreement"). The Agreement allowed PrinSource to purchase from Winland certain eligible accounts receivable based on PrinSource's sole and absolute discretion. Upon approval and acceptance by PrinSource, PrinSource agreed to pay Winland seventy-five percent (75%) of the eligible account receivable (the "Part Payment") prior to such receivable actually being paid to Winland. Upon the payment of such receivable to Winland, PrinSource paid to Winland one hundred percent (100%) of such eligible account, reduced by a per diem fee equal to 1/18% (one eighteenth of one percent) per day from the time that the Part Payment was made by PrinSource to Winland and a one-time processing fee equal to 1/4% (one fourth of one percent). Winland retained the ultimate responsibility for collection of the receivable, and thus accounted for the Agreement as a secured borrowing transaction. This agreement was paid off and cancelled January 3, 2011.

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Effective January 3, 2011, Winland and TCI Business Capital, Inc. (“TCI”), entered into a Factoring, Security and Service Agreement (the “Agreement”). The Agreement allowed TCI to purchase from the Company certain eligible accounts receivable based on TCI’s sole and absolute discretion and was terminated by mutual agreement between the Company and TCI in April 2011 for a fee of \$5,000. Under the agreement, TCI paid the Company ninety percent (90%) of the eligible account prior to the receivable actually being paid to the Company and one hundred percent (100%) of the eligible account once payment had been made to the Company.

As of December 31, 2010, the Company was in violation of certain financial covenants on its mortgage note payable with US Bank National Association and, as such, US Bank had the ability to demand repayment of the mortgage note payable. On September 2, 2011, the Company and US Bank, executed an Acknowledgement of Default and Agreement to Waiver of Default (the “Waiver Agreement”) pursuant to the Term Loan Agreement and Note, dated September 30, 2004, as amended. The Waiver Agreement waives the default of the Cash Flow Coverage Ratio as of December 31, 2010. In December 2011, the Company paid the outstanding balance satisfying the mortgage note payable.

The Company continues its process of evaluating on-going operations, growth initiatives and strategic alternatives, in light of the current economic conditions.

The Company’s future capital requirements will depend on many factors, including the timing and amount of its revenues and its investment decisions, which may affect the Company’s ability to generate additional cash. The Company’s management believes that its cash balance and expected cash in 2012 from leasing, or sale of, the building will be adequate to fund its cash requirements for working capital, investing and financing activities during the next twelve months.

CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and related disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Winland cannot assure you that actual results will not differ from those estimates. Winland believes the following are the most critical judgments and estimates used in the preparation of its financial statements.

Revenue Recognition: Revenue is recognized from the sale of products and out of warranty repairs when the product is delivered to a common carrier for shipment and title transfers.

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 sales. For all sales, Winland has a binding purchase order from the customer. Winland does not generally accept returns but does provide a limited warranty as outlined below under Allowance for Rework and Warranty Costs. Sales and use taxes are reported on a net basis, excluding them from sales and cost of sales.

Rental revenue includes rents that our tenant pays in accordance with the terms of its lease reported on a straight-line basis over the non-cancellable term of the lease. The lease provides for tenant occupancy during periods where no rent is due or where minimum rent payments change during the term of the lease. Deferred rent in the accompanying balance sheet includes the cumulative difference between rental revenue as recorded on a straight-line basis and rents received from the tenant in accordance with the lease terms.

Inventory Valuation: Inventories are stated at the lower of cost or market and include materials, labor, and overhead costs. Cost is determined using the first-in, first-out method (FIFO). The majority of the inventory is purchased based upon contractual forecasts and customer purchase orders. Even though contractual arrangements may be in place, we are still required to assess the utilization of inventory. In assessing the ultimate realization of inventories, judgments as to future demand requirements are made and compared to the current or committed inventory levels and contractual inventory holding requirements. Reserve requirements generally increase as projected demand requirements decrease due to market conditions, technological and product life cycle changes as well as longer than previously expected usage periods. Management's estimated reserve for slow moving and obsolete finished goods inventories was \$30,000 and \$34,000 as of December 31, 2011 and 2010, respectively.

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Long-lived assets including assets held for sale: Considerable management judgment is necessary in estimating future cash flows and other factors affecting the valuation of long-lived assets including the operating and macroeconomic factors that may affect them. The Company uses historical financial information, internal plans and projections and industry information in making such estimates. While the Company currently believes the expected cash flows from these long-lived assets exceeds the carrying amount, materially different assumptions regarding future performance and discount rates could result in future impairment losses. In particular, if the Company no longer believes it will achieve its long-term projected sales or operating expenses, the Company may conclude in connection with any future impairment tests that the estimated fair value of our long-lived assets are less than the book value and recognize an impairment charge. Such impairment would adversely affect earnings. No impairment losses were recognized in 2011 or 2010.

In September 2011, the Company decided to sell its 58,000 square foot manufacturing facility, including land, with a carrying cost of \$2,135,000. The building was primarily used for the EMS business segment which was sold January 1, 2011. The Company has determined that the sale of the building could provide significant additional resources to be invested in our proprietary business. These assets were reclassified as held for sale at the time a formal decision was made to sell the land and building, and the assets are being carried at cost, which is less than the estimated fair value of the building less selling costs at December 31, 2011. The building and land are expected to be sold within one year.

Allowance for Doubtful Accounts: The Company generally requires no collateral from its customer with respect to trade accounts receivable. Invoices are generally due 30 days after presentation. Accounts receivable over 30 days are considered past due. Winland evaluates its allowance for uncollectible accounts on a quarterly basis and reviews any significant customers with delinquent balances to determine future collectability. Winland bases its determinations on legal issues, past history, current financial and credit agency reports, and experience. Winland reserves for accounts deemed to be uncollectible in the quarter in which the determination is made. Management believes these values are estimates and may differ from actual results. Winland believes that, based on past history and credit policies, the net accounts receivable are of good quality. Bad debt expense for the year ended December 31, 2011 was \$1,000. Bad debt expense for the year ended December 31, 2010 was \$15,000 offset by collection of \$39,000 for a previously written off bad debt. The Company writes off accounts receivable when they are deemed uncollectible and records recoveries of trade receivables previously written off when collected. The Allowance for Doubtful Accounts was \$7,000 and \$10,000 at December 31, 2011 and 2010, respectively.

Allowance for Rework and Warranty Costs: Winland provides a limited warranty for its Proprietary Products for a period of one year, which requires Winland to repair or replace defective product at no cost to the customer or refund the purchase price. Reserves are established based on historical experience and analysis for specific known and potential warranty issues. The reserve reflecting historical experience and potential warranty issues are determined based on experience factors including rate of return by item, average weeks outstanding from production to return, average cost of repair and relation of repair cost to original sales price. Any specific known warranty issues are considered individually. These are analyzed to determine the probability and the amount of financial exposure, and a specific reserve is established. The allowance for rework and warranty costs was \$13,100 and \$11,200 as of December 31, 2011 and 2010, respectively. The product warranty liability reflects management's best estimate of probable liability under Winland's product warranties and may differ from actual results.

Income Taxes: Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Winland records a tax valuation allowance when it is more likely than not that it will not be able to recover the value of its deferred tax assets. The valuation allowance for deferred tax assets as of December 31, 2011 and 2010 was \$1,889,000 and \$1,593,000. The net change in the total valuation allowance for the years ended December 31, 2011 and 2010 was an increase of \$296,000 and \$1,216,000. The tax effect of the Company's valuation allowance for deferred tax assets is included in the annual effective tax rate. As of

December 31, 2011 and 2010, the Company calculated its estimated annualized effective tax expense (benefit) rate at 1% and (4%), respectively. The Company recognized an income tax expense of \$9,000 (net of the valuation allowance) based on its \$790,000 pre-tax loss from continuing operations for year ended 2011 compared to an income tax benefit of \$89,000 (net of the valuation allowance) based on its \$2,098,000 pre-tax loss from continuing operations for the year ended 2010.

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In addition, Winland reevaluates the technical merits of its tax positions and recognizes an uncertain tax benefit, or derecognizes a previously recorded tax benefit, when (i) there is a completion of a tax audit, (ii) there is a change in applicable tax law including a tax case or legislative guidance, or (iii) there is an expiration of the statute of limitations. Significant judgment is required in accounting for tax reserves. Although Winland believes that it has adequately provided for liabilities resulting from tax assessments by taxing authorities, positions taken by these tax authorities could have a material impact on Winland's effective tax rate in future periods.

CAUTIONARY STATEMENTS

Certain statements contained in this Annual Report on Form 10-K and other written and oral statements made from time to time by Winland do not relate strictly to historical or current facts. As such, they are considered "forward-looking statements" that 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," "possibly," "project," "should," "will," "forecast" and similar words or expressions. Winland's forward-looking statements generally relate to its purchase order levels, growth strategies, financial results, product development, sales efforts and sufficiency of capital. 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, among others, those discussed below. Consequently, no forward-looking statement can be guaranteed, and actual results may vary materially from results or circumstances described in such forward looking statements. As provided for under the Private Securities Litigation Reform Act of 1995, Winland wishes to caution investors that the following important factors, among others, in some cases have affected and in the future could affect Winland'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 Winland.

Winland derives a significant portion of its revenues from a limited number of distributors that are not subject to long-term contracts with Winland;

Winland's ability to compete successfully depends, in part, upon the price at which Winland is willing to sell a proposed product and the quality of its design;

there is no assurance that Winland will be able to continue to obtain purchase orders from existing and new customers on financially advantageous terms, and the failure to do so could prevent it from achieving the growth it anticipates;

Winland's current customers may choose to delay or postpone purchases of products from Winland until the economy and their businesses stabilize and this may affect Winland's operating results, financial condition and delay and lengthen sales cycles;

an overall uncertainty in economic activity may also have a negative impact on Winland's customer's ability to pay for the products they purchase from Winland;

Winland'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 acceptance of our EA800-ip by the marketplace; and

Winland's ability to execute its initiatives to increase sales and expand market share depends upon its ability to develop additional Proprietary Products and technologies and on the availability of sufficient financing, both equity and debt, to meet fixed and variable costs associated with such growth.

In addition, see “Risk Factors” under Item 1A, which includes a discussion of additional risk factors and a more complete discussion of some of the cautionary statements noted above.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

None.

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ITEM 8.FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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

Report of Independent Registered Public Accounting Firm as of and for the Years Ended December 31, 2011 and 2010	13
Balance Sheets as of December 31, 2011 and 2010	14-15
Statements of Operations for the Years Ended December 31, 2011 and 2010	16
Statements of Changes in Stockholders' Equity for the Years Ended December 31, 2011 and 2010	17
Statements of Cash Flows for the Years Ended December 31, 2011 and 2010	18
Notes to Financial Statements	19-31

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders, Audit Committee and Board of Directors
Winland Electronics, Inc.
Mankato, Minnesota

We have audited the accompanying balance sheets of Winland Electronics, Inc. as of December 31, 2011 and 2010, and the related statements of operations, 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of its internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting. Accordingly, we express no such opinion. 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 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, 2011 and 2010 and the results of its operations and cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

/s/ Baker Tilly Virchow Krause, LLP

Minneapolis, Minnesota
March 29, 2012

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Winland Electronics, Inc.
Balance Sheets
As of December 31, 2011 and 2010
(In Thousands)

	December 31,	
	2011	2010
Assets		
Current Assets		
Cash and cash equivalents	\$1,031	\$318
Accounts receivable, less allowance for doubtful accounts of \$7 and \$10 as of December 31, 2011 and 2010, respectively (Note 10)	449	547
Refundable income taxes (Note 6)	-	277
Inventories (Note 3)	567	112
Prepaid expenses and other assets	31	87
Current assets of discontinued operations (Note 8)	-	4,649
Total current assets	2,078	5,990
Property and Equipment, at cost (Note 4)		
Land and land improvements	-	383
Building	-	3,064
Machinery and equipment	153	148
Data processing equipment	118	112
Office furniture and equipment	43	43
Total property and equipment	314	3,750
Less accumulated depreciation and amortization	246	1,447
Net property and equipment	68	2,303
Assets held for sale, net (Note 1)	2,135	-
Deferred rent receivable	261	-
Property and equipment of discontinued operations, net (Note 8)	-	1,151
Total assets	\$4,542	\$9,444

See Notes to Financial Statements

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Winland Electronics, Inc.

Balance Sheets
As of December 31, 2011 and 2010
(In Thousands, Except Share and Per Share Data)

	December 31,	
	2011	2010
Liabilities and Stockholders' Equity		
Current Liabilities		
Revolving line-of-credit	\$-	\$1,249
Current maturities of long-term debt (Note 4)	-	448
Accounts payable	421	381
Other short-term tax liabilities	-	68
Accrued liabilities:		
Compensation	110	410
Other	30	35
Current liabilities of discontinued operations (Note 8)	-	2,084
Total current liabilities	561	4,675
Long-Term Liabilities		
Deferred revenue (Note 5)	106	114
Long-term liabilities of discontinued operations (Note 8)	-	29
Total long-term liabilities	106	143
Total liabilities	667	4,818
Commitments and Contingencies		
Stockholders' Equity (Notes 7 and 11)		
Common stock, par value \$0.01 per share; authorized 20,000,000 shares; issued and outstanding 3,701,630 and 3,699,230 shares as of December 31, 2011 and 2010	37	37
Additional paid-in capital	5,014	5,025
Accumulated deficit	(1,176)	(436)
Total stockholders' equity	3,875	4,626
Total liabilities and stockholders' equity	\$4,542	\$9,444

See Notes to Financial Statements

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Winland Electronics, Inc.
 Statements of Operations
 For the Years Ended December 31, 2011 and 2010
 (In Thousands, Except Share and Per Share Data)

	December 31,	
	2011	2010
Net sales (Note 10)	\$3,444	\$3,317
Cost of sales	2,378	2,135
Gross profit	1,066	1,182
Operating expenses:		
General and administrative	852	2,143
Sales and marketing	1,000	970
Research and development	237	-
	2,089	3,113
Operating loss	(1,023)	(1,931)
Other income (expenses):		
Interest expense	(54)	(175)
Rental revenue	261	-
Other, net	26	8
	233	(167)
Loss from continuing operations before income taxes	(790)	(2,098)
Income tax (expense) benefit (Note 6)	(9)	89
Loss from continuing operations	(799)	(2,009)
Gain (loss) from discontinued operations, net of tax	59	(1,523)
Net loss	\$(740)	\$(3,532)
Loss per common share data:		
Basic and diluted	\$(0.20)	\$(0.96)
Loss from continuing operations per common share data:		
Basic and diluted	\$(0.22)	\$(0.55)
Income (loss) from discontinued operations per common share data:		
Basic and diluted	\$0.02	\$(0.41)
Weighted-average number of common shares outstanding:		
Basic and diluted	3,701,045	3,693,009

See Notes to Financial Statements

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Winland Electronics, Inc.

Statements of Changes in Stockholders' Equity
For the Years Ended December 31, 2011 and 2010
(In Thousands, Except Share Data)

	Common Stock		Additional	Retained	
	Shares	Amount	Paid-In	Earnings	Total
			Capital	(Accumulated Deficit)	
Balance on December 31, 2009	3,686,435	\$37	\$5,016	\$ 3,096	\$8,149
Issuance of common stock in accordance with employee stock purchase plan (Note 7)	9,795	-	6	-	6
Issuance of common stock in accordance with employee stock option plan (Note 7)	3,000	-	1	-	1
Stock-based compensation expense	-	-	2	-	2
Net loss	-	-	-	(3,532)	(3,532)
Balance on December 31, 2010	3,699,230	37	5,025	(436)	4,626
Issuance of common stock in accordance with employee stock option plan (Note 7)	2,400	-	2	-	2
Stock-based compensation benefit	-	-	(13)	-	(13)
Net loss	-	-	-	(740)	(740)
Balance on December 31, 2011	3,701,630	\$37	\$5,014	\$ (1,176)	\$3,875

See Notes to Financial Statements

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Winland Electronics, Inc.

Statements of Cash Flows
For the Years Ended December 31, 2011 and 2010
(In Thousands)

	2011	2010
Cash Flows From Operating Activities		
Net loss	\$ (740)	\$ (3,532)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	110	775
Non-cash stock based compensation expense (benefit)	(13)	2
Decrease in allowance for doubtful accounts	(3)	(29)
Loss on disposal of equipment	-	173
Decrease in allowance for obsolete inventory held for discontinued operations	(56)	-
Changes in operating assets and liabilities:		
Accounts receivable	(39)	550
Refundable income taxes	277	746
Inventories	(455)	97
Deferred rent receivable	(261)	-
Prepaid expenses and other assets	56	105
Accounts payable	40	1,021
Accrued liabilities, including deferred revenue and other short-term tax liabilities	(421)	(81)
Net cash used in operating activities	(1,505)	(173)
Cash Flows From Investing Activities		
Purchases of property and equipment	(10)	(80)
Sale of inventory from discontinued operations	2,906	-
Cash from sale of EMS business unit, net of transaction costs	1,017	7
Net cash provided by (used in) investing activities	3,913	(73)
Cash Flows From Financing Activities		
Net advances (repayments) on revolving line-of-credit agreement	(1,249)	882
Principal payments on long-term borrowings, including capital lease obligations	(448)	(380)
Proceeds from issuance of common stock	2	7
Net cash provided by (used in) financing activities	(1,695)	509
Net increase in cash and cash equivalents	713	263
Cash and cash equivalents		
Beginning of year	318	55
End of year	\$ 1,031	\$ 318
Supplemental Disclosures of Cash Flow Information		
Cash payments for interest	\$ 65	\$ 181
Cash receipts from income taxes	\$ 209	\$ 645

See Notes to Financial Statements

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Winland Electronics Inc.

Notes to Financial Statements (Amounts in Thousands Except Share and Per Share Data)

Note 1. Nature of Business and Significant Accounting Policies

Nature of business: Winland Electronics, Inc. (“Winland” or the “Company”) provides a line of proprietary environmental monitoring products to the security industry. In most cases, these products are manufactured to protect against loss of assets due to damage from water, excess humidity, extremes of temperature and loss of power. These Winland branded and trademarked products accounted for 100% of the Company’s revenue in 2011.

Immaterial Errors: On January 1, 2011, Winland entered into a commercial building lease (the “Lease”) with Nortech Systems Incorporated to lease the Company’s entire office and manufacturing facility located at 1950 Excel Drive, Mankato, MN. The term of the Lease ends January 1, 2017 with Nortech required to pay rent of \$5.25 per square foot (\$305 annually) commencing on January 1, 2012. The Lease provides for a 2.5% increase on the third anniversary and requires Nortech to pay all operating costs including real estate taxes. At December 31, 2011, the Company determined it should have recorded rental revenue on a straight-line basis over the non-cancellable term of the lease in accordance with ASC 840 on the Unaudited Condensed Statement of Operations and deferred rent receivable on the Unaudited Condensed Balance Sheets beginning in the first quarter of 2011.

Management has quantitatively and qualitatively evaluated the materiality of the error and has determined the error to be immaterial to the quarterly reports previously filed for the periods ended March 31, 2011, June 30, 2011 and September 30, 2011. Accordingly, all of the resulting adjustments have been recorded prospectively on the Statement of Operations for year ended December 31, 2011 and the Balance Sheet as of December 31, 2011. The Company recorded rental revenue of \$261 on the Statement of Operations for the year ended December 31, 2011 and a deferred rent receivable of \$261 on the Balance Sheet as of December 31, 2011.

The impact of the prospective adjustments on the Unaudited Condensed Statements of Operations for the three months ended March 31, 2011, June 30, 2011 and September 30, 2011, was to decrease the Loss from continuing operations before income taxes by \$65, \$66 and \$65 respectively. The adjustments resulted in an increase of \$0.02 to basic and diluted earnings per common share for each of the prior interim periods. In addition, Total current assets and Stockholders’ equity increased \$65, \$131 and \$196 on the Unaudited Condensed Balance Sheets as of March 31, 2011, June 30, 2011 and September 30, 2011, respectively.

Discontinued Operations: Included in discontinued operations is Winland’s Electronic Manufacturing Services (EMS) operation. The sale of the EMS operations to a third party was completed on January 1, 2011 pursuant to the terms of an Asset Purchase Agreement dated November 15, 2010 (the “APA”). The transaction involved the sale of 100% of Winland’s EMS assets and assumptions of certain liabilities under the APA. The Company’s shareholders approved the sale on December 29, 2010.

The APA met the requirements of ASC 205-20 “Discontinued Operations” as being held for sale at December 31, 2010. Accordingly, the Company has restated the previously reported financial results to report the net results as a separate line in the statements of operations as “Loss from discontinued operations, net of tax” for all periods presented, and the assets and liabilities of EMS on the balance sheets have been separately classified as “Assets/Liabilities of discontinued operations”. In accordance with ASC 205-20-S99-3 “Allocation of Interest to Discontinued Operations”, the Company elected to not allocate interest expense to the discontinued operations where the debt is not directly attributed to or related to the discontinued operations. Notes to the financial statements have been revised to reflect only the results of continuing operations (see Notes 2 and 8).

A summary of Winland's significant accounting policies follow:

Use of estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and related disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates include allowances for obsolete inventories, rework and warranties, valuation of long-lived assets, assets held for sale and doubtful accounts. Winland cannot assure that actual results will not differ from those estimates.

Revenue Recognition: Revenue is recognized from the sale of products and out of warranty repairs when the product is delivered to a common carrier for shipment and title transfers.

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Winland Electronics Inc.

Notes to Financial Statements (Amounts in Thousands Except Share and Per Share Data)

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

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 sales. For all sales, Winland has a binding purchase order from the customer. Winland does not generally accept returns but does provide a limited warranty as outlined below under Allowance for Rework and Warranty Costs. Sales and use taxes are reported on a net basis, excluding them from sales and cost of sales.

Rental revenue includes rents that our tenant pays in accordance with the terms of its lease reported on a straight-line basis over the non-cancellable term of the lease. The lease provides for tenant occupancy during periods where no rent is due or where minimum rent payments change during the term of the lease. Deferred rent in the accompanying balance sheet includes the cumulative difference between rental revenue as recorded on a straight-line basis and rents received from the tenant in accordance with the lease terms.

Cash and cash equivalents: Cash and cash equivalents include money market mutual funds and other highly liquid investments defined as maturities of three months or less from date of purchase. Winland maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. Winland has not experienced any losses in such accounts.

Allowance for Doubtful Accounts: The Company generally requires no collateral from its customer with respect to trade accounts receivable. Invoices are generally due 30 days after presentation. Accounts receivable over 30 days are considered past due. No interest is charged on past due accounts. Winland evaluates its allowance for uncollectible accounts on a quarterly basis and reviews any significant customers with delinquent balances to determine future collectability. Winland bases its determinations on legal issues, past history, current financial and credit agency reports, and experience. Winland reserves for accounts deemed to be uncollectible in the quarter in which the determination is made. Management believes these values are estimates and may differ from actual results. Winland believes that, based on past history and credit policies, the net accounts receivable are of good quality. The Company writes off accounts receivable when they are deemed uncollectible and records recoveries of trade receivables previously written off when collected. The Allowance for Doubtful Accounts was \$7 and \$10 at December 31, 2011 and 2010, respectively.

Inventory Valuation: Raw component and finished goods inventories are stated at the lower of cost, using the first-in, first-out (FIFO) method, or market value. Winland estimates excess, slow moving and obsolete reserves for inventory on a quarterly basis based upon order demand and production requirements for its major customers and annual reviews for other customers. Management's estimated reserve for slow moving and obsolete finished goods inventories was \$30 and \$34 as of December 31, 2011 and 2010, respectively.

Depreciation: Depreciation is computed using the straight-line method based on the estimated useful lives of the various assets, as follows:

	Years
Land improvements	17 – 20
Building	39 – 40
Machinery and equipment	5 – 7
Data processing equipment	3 – 7

Long-lived assets including assets held for sale: Considerable management judgment is necessary in estimating future cash flows and other factors affecting the valuation of long-lived assets including the operating and macroeconomic factors that may affect them. The Company uses historical financial information, internal plans and projections and industry information in making such estimates. While the Company currently believes the expected cash flows from these long-lived assets exceeds the carrying amount, materially different assumptions regarding future performance and discount rates could result in future impairment losses. In particular, if the Company no longer believes it will achieve its long-term projected sales or operating expenses, the Company may conclude in connection with any future impairment tests that the estimated fair value of our long-lived assets is less than the book value and recognize an impairment charge. Such impairment would adversely affect earnings. No impairment losses were recognized in 2011 or 2010.

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Winland Electronics Inc.

Notes to Financial Statements (Amounts in Thousands Except Share and Per Share Data)

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

In September 2011, the Company decided to sell its 58,000 square foot manufacturing facility, including land, with a carrying cost of \$2,135. The building was primarily used for the EMS business segment which was sold January 1, 2011. The Company has determined that the sale of the building could provide significant additional resources to be invested in its proprietary business. These assets were reclassified as held for sale at the time a formal decision was made to sell the land and building, and the assets are being carried at cost, which is less than the estimated fair value of the building less selling costs at December 31, 2011. The building and land are expected to be sold within one year.

Allowance for Rework and Warranty Costs: Winland provides a limited warranty for its Proprietary Products for a period of one year, which requires Winland to repair or replace defective product at no cost to the customer or refund the purchase price. Reserves are established based on historical experience and analysis for specific known and potential warranty issues. The reserve reflecting historical experience and potential warranty issues is determined based on experience factors including rate of return by item, average weeks outstanding from production to return, average cost of repair and relation of repair cost to original sales price. Any specific known warranty issues are considered individually. These are analyzed to determine the probability and the amount of financial exposure, and a specific reserve is established. The allowance for rework and warranty costs was \$13 and \$11 as of December 31, 2011 and 2010, respectively. The product warranty liability reflects management's best estimate of probable liability under Winland's product warranties and may differ from actual results.

Changes in Winland's warranty liability, which is included in other accrued liabilities on the balance sheets, are approximately as follows:

(\$ in thousands)	For the Years Ended December 31,	
	2011	2010
Balance, Beginning	\$ 11	\$ 8
Accruals for products sold	7	18
Expensing of specific warranty items	(3)	(18)
Change in estimate	(2)	3
Balance, Ending	\$ 13	\$ 11

Income taxes: Income taxes are accounted for in accordance with FASB ASC Topic 740 Income Taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. In assessing the realizability of deferred income tax assets, Winland considers whether it is "more likely than not," according to the criteria that some portion or all of the deferred income tax assets will be realized. The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible.

Per FASB ASC 740-10-25-5 Winland recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more likely than not threshold, the amount recognized in the financial statements is the largest

benefit that has a greater than 50% likelihood of being realized upon ultimate settlement with the relevant tax authority.

Fair value of financial instruments: Management estimated the carrying value of long-term debt approximated fair value, estimated based on interest rates for the same or similar debt offered to Winland having the same or similar remaining maturities and collateral requirements. The carrying values of cash, accounts receivable, accounts payable and revolving line-of-credit approximate their fair value due to the short-term nature of these instruments.

Loss per common share: Basic loss per common share is computed by dividing the net loss by the weighted-average number of common shares outstanding during the period. Diluted loss per common share is computed by dividing the net loss by the weighted-average number of common shares outstanding during the period, including potentially dilutive shares such as the options and warrants to purchase shares of common stock at various amounts per share (see Note 7).

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Winland Electronics Inc.

Notes to Financial Statements (Amounts in Thousands Except Share and Per Share Data)

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

For years ended December 31, 2011 and 2010, the diluted loss per share was the same as basic loss per share since the effects of options and warrants would have been anti-dilutive. The diluted share calculation excluded 190,000 and 288,100 weighted average shares for the years ended December 31, 2011 and 2010, respectively, as inclusion of these shares would have been anti-dilutive.

Employee stock based compensation plans: At December 31, 2011, Winland had stock-based compensation plans, which are described more fully in Note 7. Winland accounts for these plans under FASB ASC Topic 718-50, Employee Share Purchase Plans.

Advertising expense: Advertising is expensed as incurred and was \$40 and \$21 for the years ended December 31, 2011 and 2010, respectively.

Research and Development Expense: The Company expenses research and development costs as incurred. Research and development expenses of \$237 were charged to operations during the year ended December 31, 2011. There were no research and development expenses incurred for the year ended December 31, 2010.

Subsequent events: The Company evaluates events occurring after the date of the financial statements for events requiring recording or disclosure in the financial statements. See Note 13 for more information regarding subsequent events.

Note 2. Segment Reporting

Accounting Standards Codification (“ASC”) 280, Segment Reporting, requires an enterprise to report segment information in the same way that management internally organizes its business for assessing performance and making decisions regarding the allocation of resources. The Company evaluates the performance of operating segments and allocates resources based on profit and loss from operations.

For year ended December 31, 2010 and interim reporting periods in 2010, the Company had two reporting segments; EMS and Proprietary Products. As stated in Note 1, the Company sold the EMS segment effective January 1, 2011. Based on this, the financial information presented on the face of the financial statements represents one segment. See Note 8 for more information regarding the EMS segment and discontinued operations.

Note 3. Inventories

The components of inventories at December 31, 2011 and 2010 were as follows:

	December 31	
	2011	2010
Raw materials	\$ 14	\$ -
Finished goods	553	112
Total, net	\$ 567	\$ 112

Note 4. Financing Arrangement and Long-Term Debt

Effective January 3, 2011, Winland and TCI Business Capital, Inc. (“TCI”), entered into a Factoring, Security and Service Agreement (the “Agreement”). The Agreement allowed TCI to purchase from the Company certain eligible accounts receivable based on TCI’s sole and absolute discretion and was terminated by mutual agreement between the Company and TCI in April 2011 for a fee of \$5,000. Under the agreement, TCI paid the Company ninety percent (90%) of the eligible account prior to the receivable actually being paid to the Company and one hundred percent (100%) of the eligible account once payment had been made to the Company.

As of December 31, 2010, the Company was in violation of certain financial covenants on its mortgage note payable with US Bank National Association and, as such, US Bank had the ability to demand repayment of the mortgage note payable. On September 2, 2011, the Company and US Bank executed an Acknowledgement of Default and Agreement to Waiver of Default (the “Waiver Agreement”) pursuant to the Term Loan Agreement and Note, dated September 30, 2004, as amended.

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Winland Electronics Inc.

Notes to Financial Statements (Amounts in Thousands Except Share and Per Share Data)

Note 4. Financing Arrangement and Long-Term Debt

The Waiver Agreement waives the default of the Cash Flow Coverage Ratio as of December 31, 2010. In December 2011, the Company paid the outstanding balance satisfying the mortgage note payable.

On August 18, 2010, Winland and PrinSource Capital Companies, LLC ("PrinSource") entered into an Accounts Receivable Agreement (the "Agreement"). The Agreement allowed PrinSource to purchase from Winland certain eligible accounts receivable based on PrinSource's sole and absolute discretion. Upon approval and acceptance by PrinSource, PrinSource agreed to pay Winland seventy-five percent (75%) of the eligible account receivable (the "Part Payment") prior to such receivable actually being paid to Winland. Upon the payment of such receivable to Winland, PrinSource paid to Winland one hundred percent (100%) of such eligible account, reduced by a per diem fee equal to 1/18th (one eighteenth of one percent) per day from the time that the Part Payment was made by PrinSource to Winland and a one-time processing fee equal to 1/4% (twenty-five hundredths of one percent). Winland retained the ultimate responsibility for collection of the receivable, and thus has accounted for the Agreement as a secured borrowing transaction. This agreement was paid off and cancelled January 3, 2011.

The following is a summary of long-term debt:

	December 31	
	2011	2010
6.44% mortgage note payable, due in monthly installments of \$11,373, including interest, paid in full in December 2011 (a)	\$ -	\$ 448
Less current maturities	-	448
Total long-term debt	\$ -	\$ -

(a) This agreement had certain financial and non-financial covenants, which, among others, required the Company to maintain a minimum tangible net worth, a maximum leverage ratio, a maximum debt to tangible net worth, a minimum cash flow coverage ratio, imposed limits on capital expenditures and disallowed the declaration or payment of dividends.

The Company was in violation of certain financial covenants as of December 31, 2010 and as such, included the full amount of the mortgage note payable in current liabilities.

Note 5. Deferred Revenue

During 1994, Winland and the city of Mankato entered into a tax increment financing agreement for the construction of its operating facility. In connection with this agreement, the city donated land improvements to Winland with a fair value of \$270. 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.

Note 6. Income Taxes

Components of income tax benefit (expense) are as follows:

	Year Ended December 31	
	2011	2010
Current expense	\$ (9)	\$ -
Deferred benefit	-	89
	\$ (9)	\$ 89

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Winland Electronics Inc.

Notes to Financial Statements (Amounts in Thousands Except Share and Per Share Data)

Note 6. Income Taxes (Continued)

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

	December 31	
	2011	2010
Statutory U.S. income tax rate	(34) %	(34) %
State benefit (tax), net of federal tax effect	(3)	(3)
Change in valuation allowance	39	34
Other, including permanent differences	(1)	(1)
Effective income tax benefit rate	1 %	(4) %

Deferred tax assets (liabilities) consist of the following components as of:

	December 31	
	2011	2010
Deferred tax assets:		
Inventory	\$ 22	\$ 423
Allowance for doubtful accounts	2	7
Non-qualified stock options	89	77
Accrued expenses	8	8
Research credit carryover	8	3
Net operating loss carryforward	1,773	1,266
Other	23	22
Valuation allowance	(1,889)	(1,593)
	36	213
Deferred tax liabilities:		
Property and equipment	(25)	(185)
Prepaid expenses	(11)	(28)
	(36)	(213)
Net deferred tax assets	\$ -	\$ -

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Winland records a tax valuation allowance when it is more likely than not that it will not be able to recover the value of its deferred tax assets. The valuation allowance for deferred tax assets as of December 31, 2011 and 2010 was \$1,889 and \$1,593. The net change in the total valuation allowance for the years ended December 31, 2011 and 2010 was an increase of \$296 and \$1,216. The tax effect of the Company's valuation allowance for deferred tax assets is included in the annual effective tax rate. As of December 31, 2011 and 2010, the Company calculated its estimated annualized effective tax expense (benefit) rate at 1% and (4%), respectively. The Company recognized an income tax expense of \$9 (net of the valuation allowance) based on its \$790 pre-tax loss from continuing operations for year ended 2011 compared to an income tax benefit of \$89 (net of the valuation allowance) based on its \$2,098 pre-tax loss from continuing operations for year ended 2010.

Winland recognizes the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement with the relevant tax authority.

The Company files income tax returns in the U.S. federal and state jurisdictions and during 2011 settled an examination by the State of Minnesota for its 2003 through 2006 tax years. The Company recognized a \$301 reduction in income tax expense as of December 31, 2007 for credits filed with the Internal Revenue Service and the State of Minnesota for tax years 2003 through 2007, net of a \$258 reserve for FASB ASC 740, Income Taxes. The Company reached a settlement with the Internal Revenue Service during 2010 which resulted in a reduction of \$200 to the unrecognized tax benefit balance.

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Winland Electronics Inc.

Notes to Financial Statements (Amounts in Thousands Except Share and Per Share Data)

Note 6. Income Taxes (Continued)

The Company reached a settlement with the State of Minnesota during 2011 which resulted in a reduction of \$68 to the unrecognized tax benefit balance. The years 2008 through 2011 remain open for examination by the Internal Revenue Service and other state agencies.

A reconciliation of the unrecognized tax benefit is as follows:

	2011	2010
Beginning Balance	\$ 68	\$ 258
Additions for tax positions taken for open tax years	-	10
Deductions for tax positions closed	(68)	(200)
Ending Balance	\$ -	\$ 68

The Company recognizes interest accrued on unrecognized tax benefits as well as interest received from favorable tax settlements within interest expense. The Company recognizes penalties accrued on unrecognized tax benefits within general and administrative expenses. As of December 31, 2011 and 2010, the Company recognized no interest or penalties related to uncertain tax positions due to their insignificance to its financial position and results of operations.

At December 31, 2011, the Company had net operating loss carryforwards for federal purposes of \$4,395 and \$4,313 for state income tax purposes that are available to offset future taxable income and begin to expire in the year 2022. At December 31, 2011, the Company had Minnesota research and development tax credit carryforwards of \$12 which begin to expire in the year 2022.

The Company does not anticipate that the total amount of unrecognized tax benefits will change significantly in the next twelve months.

Note 7. Warrants and Stock-Based Compensation Plans

Warrants: The Company has warrants outstanding to purchase 2,500 shares of common stock at a weighted average exercise price of \$4.01 per share. These warrants were granted prior to 2007 and expire on February 16, 2016.

Employee stock purchase plan: The 1997 Employee Stock Purchase Plan (ESPP) has provided Winland employees the opportunity to purchase common stock through payroll deductions. The purchase price is set at the lower of 85% of the fair market value of common stock at the beginning of the participation period or 85% of the fair market value on the purchase date. The participation periods have a 6-month duration beginning in January and July of each year. A total of 300,000 shares of common stock were authorized for issuance under the ESPP of which 136,880 have been issued. Winland issued 9,795 shares for the year ended December 31, 2010 incurring \$2 of compensation expense. No shares were issued for the year ended December 31, 2011.

Stock option plans: As of December 31, 2011, Winland had one equity-based compensation plan, the 2008 Equity Incentive Plan, from which stock-based compensation awards can be granted to eligible employees, officers or directors. Previous to this plan, stock-based compensation awards were granted from the 2005 Equity Incentive Plan. The plans are as follows:

2008 Equity Incentive Plan – This plan provides awards in the form of incentive stock options, nonqualified stock options, and restricted stock. Currently, this is the only plan under which awards are authorized for grant. As amended by the shareholders in May 2009, up to 500,000 shares are authorized for issuance under the plan. Awards issued under the plan as of December 31, 2011 include 137,000 shares of incentive stock options and 136,000 nonqualified stock options of which 136,000 are outstanding and which are vested at December 31, 2011. The exercise price is equal to the fair market value of Winland’s common stock at the date of grant. Options generally vest over five years and have a contractual life up to 10 years. Option awards provide for accelerated vesting if substantially all of Winland’s assets are transferred through an acquisition, merger, reorganization or other similar change of control transaction. The Company issues new shares upon the exercise of options.

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Winland Electronics Inc.

Notes to Financial Statements (Amounts in Thousands Except Share and Per Share Data)

Note 7. Warrants and Stock-Based Compensation Plans (Continued)

2005 Equity Incentive Plan – This plan provided grants in the form of incentive stock options, nonqualified stock options, and restricted stock. This plan was terminated as to future grants in May 2008. As of December 31, 2011, there were 51,500 options outstanding under this plan of which 51,500 are vested.

Winland uses the Black-Scholes option pricing model to estimate the fair value of stock-based awards with the following weighted-average assumptions for the indicated periods.

	December 31			
	2011		2010	
Expected life, in years	5		5	
Expected volatility	80.3	%	82.8	%
Risk-free interest rate	1.8	%	2.4	%
Dividend yield	0.0	%	0.0	%

Winland calculates the expected life of awards using historical data to estimate option exercises and employee terminations. Expected volatility is based on daily historical fluctuations of Winland's common stock using the closing market value for the number of days of the expected term immediately preceding the grant. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant for a bond with a similar term.

Winland receives a tax deduction for certain stock option exercises and disqualifying stock dispositions during the period the options are exercised or the stock is sold, generally for the excess of the price at which the options are sold over the exercise prices of the options. In accordance with FASB ASC 718-10-50-1, Winland revised its presentation in the Statements of Cash Flows to report any tax benefit from the exercise of stock options as financing cash flows. For the years ended December 31, 2011 and 2010, there were no such stock option exercises and disqualifying stock dispositions. Net cash proceeds from the exercise of stock options were \$2 and \$1 for the years ended December 31, 2011 and 2010, respectively.

Due to the sale of EMS assets and termination of employment for certain directors of the Company, 32,400 stock options were cancelled with a weighted average exercise price of \$1.85 per share as of December 31, 2010. In addition, in January 2011, 54,000 stock options were cancelled, due to the termination of certain employees related to the sale of the EMS assets, with a weighted average exercise price of \$1.24.

The following table represents stock option activity for the years ended December 31, 2011 and 2010:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life	Aggregate Intrinsic Value
Outstanding options at January 1, 2010	390,000	\$2.22		
Granted	22,000	0.89		
Exercised	(3,000)	0.50		
Forfeited	(123,400)	1.80		
Outstanding options at December 31, 2010	285,600	\$2.31	4.13	\$8

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Exercisable at December 31, 2010	226,800	\$2.39	4.41	\$6
Outstanding options at January 1, 2011	285,600	\$2.31		
Granted	70,000	0.70		
Exercised	(2,400)	0.70		
Forfeited	(165,700)	2.44		
Outstanding options at December 31, 2011	187,500	\$1.62	6.9	\$-
Exercisable at December 31, 2011	187,500	\$1.62	6.9	\$-

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Winland Electronics Inc.

Notes to Financial Statements (Amounts in Thousands Except Share and Per Share Data)

Note 7. Warrants and Stock-Based Compensation Plans (Continued)

The aggregate intrinsic value of options outstanding and options exercisable is based upon the Company's closing stock price on the last trading day of the fiscal year for the in-the-money options.

The total intrinsic value of options exercised during the year ended December 31, 2010 was \$1 with no intrinsic value of options exercised during the year ended December 31, 2011.

The weighted average fair value of stock options granted with an exercise price equal to the deemed stock price on the date of grant during 2011 and 2010 was \$0.44 and \$0.59, respectively.

The total fair value of shares vested during the year ended December 31, 2011 was \$31.

The following table summarizes information about stock options outstanding at December 31, 2011:

Range of Exercise Prices	Number of Shares	Options Outstanding		Options Exercisable	
		Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
\$0.448 - \$0.896	114,000	8.8	\$ 0.72	114,000	\$ 0.72
\$0.896 - \$1.792	22,000	6.3	1.74	22,000	