WINLAND ELECTRONICS INC
Form 10-K
February 27, 2014

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

FORM 10-K

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2013
OR

o 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	41-0992135
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

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

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

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

Title of Each Class
Common Stock, $.01 par value
Preferred Stock Purchase Rights

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yeso Noþ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yeso Noþ

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. Yesþ Noo

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). Yesþ Noo

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. þ

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 o Accelerated filer o Non-accelerated filer o Smaller Reporting Company þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yeso Noþ

The aggregate market value of the Common Stock held by non-affiliates as of June 30, 2013 was $2,286,807 based on the closing sale price of the Issuer's Common Stock on such date.

There were 3,789,522 shares of Common Stock, $.01 par value, outstanding as of February 17, 2014.

TABLE OF CONTENTS

		PAGE
PART I		
ITEM 1.	DESCRIPTION OF BUSINESS.	3
ITEM 1A.	RISK FACTORS.	3 - 6
ITEM 1B.	UNRESOLVED STAFF COMMENTS.	6
ITEM 2.	DESCRIPTION OF PROPERTY.	6 - 7
ITEM 3.	LEGAL PROCEEDINGS.	7
ITEM 4.	MINE SAFETY DISCLOSURES	7
PART II		
ITEM 5.	MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.	7
ITEM 6.	SELECTED FINANCIAL DATA.	7
ITEM 7.	MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION.	7 - 12
ITEM 7A.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.	12
ITEM 8.	FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.	13 - 27
ITEM 9.	CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.	28
ITEM 9A.	CONTROLS AND PROCEDURES.	28 - 29
ITEM 9B.	OTHER INFORMATION.	29
PART III		
ITEM 10.	DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.	29 - 30
ITEM 11.	EXECUTIVE COMPENSATION.	30 - 33
ITEM 12.	SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.	33 - 34
ITEM 13.	CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE.	35
ITEM 14.	PRINCIPAL ACCOUNTANT FEES AND SERVICES.	35
ITEM 15.	EXHIBITS AND FINANCIAL STATEMENT SCHEDULES	35
SIGNATURES		36 - 37
EXHIBIT INDEX		38 - 40
Certification of Chief Financial Officer and Senior Vice President Pursuant to Section 302		41
Certification of Chief Financial Officer and Senior Vice President Pursuant to Section 906		42

Table of Contents

PART I

ITEM 1. DESCRIPTION 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 2013 and 2012. We sold our land and building (asset group) on December 31, 2012 and classified the related operations as discontinued operations for 2012. All references contained herein relate to our continuing operations of our proprietary business unless identified as discontinued operations.

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 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.

Source of Goods Available for Sale

Winland contracts with a single third party contract manufacturer 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% and 52% of the Company’s Proprietary Products sales in 2013 and 2012, respectively were to one of the world’s largest distributors of security products. Winland derived approximately 13% and 12% of its revenues from sales outside the United States for the years ended December 31, 2013 and 2012, respectively.

Patents, Trademarks and Licenses

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

Personnel

At December 31, 2013, Winland had 4 full time employees. During 2013 and 2012, 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.

ITEM 1A. RISK FACTORS

Based on current and known information, we believe that the following identifies the most significant risk factors that could affect our business. However, the risks and uncertainties we face are not limited to those discussed below. There could be other unknown or unpredictable economic, business, competitive or regulatory factors, including factors that we currently believe to be immaterial, that could in fact have material adverse effects on our 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.

Table of Contents

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 our business and your investment in us.

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

Our Proprietary Products sales are dependent on a small number of security products distributors with the top five distributors together representing over 71% of our total sales in 2013 and over 65% of our total sales in 2012. We do not obtain firm, long-term purchase commitments from our 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 our results of operations by reducing the volumes of products sold.

We outsource the manufacturing of our line of Proprietary Products.

We contract with an outside contract manufacturing firm to manufacture our proprietary products. We issue purchase orders with definitive quantities, delivery dates and price. We cannot guarantee the ability of the manufacturer to timely deliver against the purchase orders which may cause us to experience delays in meeting our customer's delivery requirements. If experienced, these delays may impact sales volumes and increase costs.

Our operating results may vary significantly from period to period.

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

Many of our customers are price sensitive, and if the prices we charge for our services are unacceptable to our customers, our operating results will be harmed.

Many of our customers are price sensitive, and we have limited experience with respect to determining the appropriate prices for our services. As the market for our services matures, or as new competitors introduce new products or services that compete with ours, we may be unable to renew our agreements with existing customers or attract new customers at the same price or based on the same pricing model as previously used. As a result, it is possible that competitive dynamics in our market may require us to change our pricing model or reduce our prices, which could harm our revenue, gross margin and operating results.

We rely on key personnel to grow our business, and the loss of one or more key employees or our inability to attract and retain qualified personnel could harm our business.

Our success and future growth depends to a significant degree on the skills and continued services of Brian Lawrence, our Chief Financial Officer. Our future success also depends on our ability to attract, retain and motivate skilled technical, managerial, sales, marketing and support personnel, including members of our management team. Competition for sales, marketing and technical personnel is particularly intense in the technology industries. As a result, we may be unable to successfully attract or retain qualified personnel. Our inability to attract and retain the necessary personnel could harm our business.

If we fail to develop our brand cost-effectively, our business may suffer.

We believe that developing and maintaining awareness of our brand in a cost-effective manner is critical to achieving widespread acceptance of our existing and future products and is an important element in attracting new customers.

Furthermore, we believe that the importance of brand recognition will increase as competition in our market increases. Successful promotion of our brand will depend largely on the effectiveness of our marketing efforts and on our ability to provide reliable and useful products at competitive prices. Brand promotion activities may not yield increased revenue, and even if they do, any increased revenue may not offset the expenses we incurred in building our brand. If we fail to successfully promote and maintain our brand, or incur substantial expenses in an unsuccessful attempt to promote and maintain our brand, we may fail to attract enough new customers or retain our existing customers to the extent necessary to realize a sufficient return on our brand-building efforts, and our business could suffer.

Table of Contents

We may experience delays in product and service development, including delays beyond our control, which could prevent us from achieving our growth objectives and hurt our business.

Many of the problems, delays and expenses we may encounter may be beyond our control. Such problems may include, but are not limited to, problems related to the technical development of our products and services, the competitive environment in which we operate, marketing problems, consumer and advertiser acceptance and costs and expenses that may exceed current estimates. Problems, delays or expenses in any of these areas could have a negative impact on our business, financial conditions or results of operations.

We might require additional capital to support our strategic business plan, and this capital might not be available on acceptable terms, if at all.

We intend to continue to make investments to support our strategic business plan and may require additional funds to respond to business challenges, including the need to develop new solutions or enhance our existing solutions, enhance our operating infrastructure and update our product. Accordingly, we may need to engage in equity or debt financings to secure additional funds. If we raise additional funds through further issuances of equity or convertible debt securities, our existing shareholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our common stock. Any debt financing secured by us in the future could involve restrictive covenants relating to our capital raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities. In addition, we may not be able to obtain additional financing on terms favorable to us, if at all. If we are unable to obtain adequate financing or financing on terms satisfactory to us, when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly limited, and our business, operating results, financial condition and prospects could be adversely affected.

We may be unsuccessful against future competitors. If we do not compete effectively, our operating results and future growth could be harmed.

We may encounter growing competition in our business from many sources. Many of our future competitors may have substantially greater financial, marketing, technological and other resources than we do. Some of these companies may even choose to offer services competitive with ours at no cost as a strategy to attract or retain customers of their other services. If we are unable to compete successfully with traditional and other emerging providers of competing services, our business, financial condition and results of operations could be adversely affected.

Demand for our services is sensitive to price. Many factors, including our advertising, customer acquisition and technology costs, and our current and future competitors' pricing and marketing strategies, can significantly affect our pricing strategies. There can be no assurance that we will not be forced to engage in price-cutting initiatives, or to increase our advertising and other expenses to attract and retain customers in response to competitive pressures, either of which could have a material adverse effect on our revenue, operating results and resources.

Our significant shareholders, two of which are directors, have substantial control over us and could limit shareholders' ability to influence the outcome of key transactions, including changes of control.

As of February 17, 2014, five of our shareholders, including two who are directors, beneficially own 43.2% of our outstanding common stock. Together they may be able to effectively control or influence significantly all matters requiring approval by our shareholders, including the election of directors and the approval of mergers or other significant corporate transactions. These shareholders may have interests that differ from other shareholders, and they may vote in a way with which other shareholders disagree and that may be adverse to the interests of other shareholders. The concentration of ownership of our common stock may have the effect of delaying, preventing or deterring a change of control of our company, could deprive our shareholders of an opportunity to receive a control premium for their common stock as part of a sale of our company, and may affect the liquidity and market price of our common stock.

Table of Contents

Our business could be adversely affected if our clients are not satisfied with our implementation and integration of our solutions or our professional services.

The success of our strategic business plan will depend on our ability to satisfy our clients and meet their business needs. If a client is unsatisfied, we could lose the client, we could incur additional costs to remedy the situation, or the profitability of our relationship with that client may be impaired. Negative publicity resulting from issues related to our client relationships, regardless of accuracy, may damage our business by adversely affecting our ability to attract new clients and maintain and expand our relationships with existing clients.

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

We require effective internal control over financial reporting in order to provide reasonable assurance with respect to our 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.

Our common stock was delisted from the NYSE Amex Exchange and investors may have difficulty trading and obtaining quotations for our common stock, which could impair their investments and our business.

Despite our diligent efforts to meet the requirements of the NYSE Amex Exchange, on March 6, 2013 we were informed by the NYSE Amex Exchange that our common stock would be delisted. Our common stock was immediately eligible for quotation on the OTC Bulletin Board and began trading on the OTC Bulletin Board as of the open of business on March 21, 2013. The OTC Bulletin Board symbol of our common stock is WELX.

Because our common stock is listed on the OTC Bulletin Board, the liquidity of our common stock may be impaired and access to the capital markets, if necessary, may not be possible. An investor may find it difficult to dispose of, or to obtain accurate quotations of the price of, shares of our common stock. The lack of an established trading market severely limits the liquidity of our common stock, and could depress the market price of our common stock and limit our ability to raise additional capital.

We intend to terminate our reporting obligations under the Securities Exchange Act and our stock price may decline.

Because of our size and the number of holders of our common stock, we can suspend our reporting obligations under the Securities Exchange Act at any time by filing a Form 15 with the SEC. We intend to do so in the near future. Once we terminate our reporting obligations, we will no longer be required to file periodic reports, including financial information, proxy solicitation materials, or other information with the SEC. This will cause our common stock to be ineligible for quotation on the OTCBB, which will likely negatively impact the liquidity, trading volume and trading prices of our common stock. We do intend to have our common stock qualified for quotation on the “pink sheets”. In addition, our ability to raise additional capital if needed could be negatively impacted due to a lack of publicly available information about us.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. DESCRIPTION OF PROPERTY

On December 31, 2012, the Company sold its manufacturing facility to Nortech Systems, Inc. (“Nortech”), the then current lessee of the property for $2,650,000. The building and land had a carrying cost of $2,135,000, resulting in a gain of $506,000, after deducting expenses related to the sale of $9,000. Rental revenue for the year ended December 31, 2012, was $261,000, reduced by $218,000 for the reversal of unamortized rental revenue recognized on the straight-line basis in 2011. For the year ended December 31, 2012, the Company also recognized income of $106,000 related to the remaining unamortized deferred revenue associated with the tax increment financing associated with the facility.

Table of Contents

On December 31, 2012, Winland entered in to a month-to-month lease with Nortech to lease 1,924 square feet of office space at 1950 Excel Drive, Mankato, MN, the Company's prior manufacturing facility. This office space is used for the Company's operations including customer service, technical support and finance.

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 OTCQB Market under the symbol WELX. Prior to March 21, 2013, Winland's common stock was listed on the NYSE Amex under the symbol WEX. The following table sets forth the high and the low market closes, as reported by OTCQB Market and NYSE Amex during 2013 and 2012.

Fiscal Year Ended December 31, 2013	Low	High
First Quarter	$0.60	$0.88
Second Quarter	$0.63	$0.89
Third Quarter	$0.55	$0.82
Fourth Quarter	$0.30	$0.75

Fiscal Year Ended December 31, 2012	Low	High
First Quarter	$0.44	$0.83
Second Quarter	$0.47	$0.80
Third Quarter	$0.40	$0.67
Fourth Quarter	$0.43	$0.85

On February 17, 2014, the fair market value of Winland's Common Stock was $0.55 based on the closing sale price quoted by OTCQB Market on that date. As of December 31, 2013, Winland had 367 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

Winland Electronics is a leader in designing and selling critical environmental monitoring solutions. We sell our solutions to customers around the world through a channel of distributors and security systems integrators.

Our solutions assist customers by helping them to: reduce product loss, comply with various regulations, reduce labor costs and potentially mitigate costly litigation.

Table of Contents

Our solutions include:

- The EnviroAlert (EA) product line accounts for approximately 50% of our revenue. The EA product line offers industrial, commercial and residential users the flexibility to simultaneously monitor temperature, humidity, water, gases, pressure and dry contacts in one or more critical environments. This product line includes our recently introduced EA800-ip solution, an industry-leading monitoring system that via software provides two-way access for users to remotely monitor, collect and view real-time data from up to eight sensors. Users can also modify their sensor settings via a wireless connection that eliminates the need for on-site adjustments or service calls.
- The WaterBug Alert, which is designed for dependable water detection, accounts for approximately 30% of our revenue.
- The TempAlert solution, which accounts for approximately 15% of our revenue, delivers reliable and economical temperature detection for residential or commercial security systems.
- Our HumidAlert solution monitors humidity and is ideal for any areas where too much moisture, or not enough, can damage commercial and residential property.

Key markets that we sell our solution into include the distribution and retail segments of the food, healthcare and drug industries.

RESULTS OF OPERATIONS – 2013 vs. 2012

The Company reported a net loss of $2,615,000 or $0.70 loss per basic and diluted share for the year ended December 31, 2013 compared to net income of $21,000 or $0.01 per basic and diluted share for the same period in 2012.

Net Sales

Net sales for the year ended December 31, 2013 were $3,640,000 down $73,000 or 2% compared to the same period in 2012, the result of a one-time project recognized in 2012.

Operating Loss

In January 2013, the Company announced its strategic growth plan to become a provider of real-time, cloud-based environmental monitoring solutions by implementing a Software as a Service (SaaS) business model. For the year ended December 31, 2013, the Company expensed $1,004,000 for sales, marketing and channel management resources and development of the Company's SaaS platform. These costs are contained in the following discussion of the Company's operating loss for the year ended December 31, 2013.

On November 15, 2013, the Company restructured its sales, marketing and channel management resources in response to the slower than anticipated adoption of the SaaS model. This restructuring led to the termination of various employees incurring approximately $313,000 of severance payments to those who had employment agreements with the Company. In addition, lease and rental obligations for office space were terminated to which the Company incurred $78,000 for the period ended December 31, 2013. These costs are contained in the following discussion of the Company's operating loss for the year ended December 31, 2013.

The Company reported an operating loss of $2,618,000 and $644,000 for the years ended December 31, 2013 and 2012, respectively. The Company's gross margin percentage of 24.7% in 2013 was down from 29.4% reported in 2012. The significant decrease in gross margins was due to $215,000 for increased obsolescence reserve on inventory related to the SaaS model.

For the year ended December 31, 2013, general and administrative expenses were $1,540,000 up from $762,000 from the same period in 2012. The significant increase was driven by increased salaries expense of $421,000 primarily for the Company’s chief executive officer salary of $213,000 and $200,000 for severance paid due to the restructuring. Professional fees of $362,000 were up $140,000 for investor relations, audit, legal and tax preparation expenses. The Company incurred expenses of $148,000 for leased offices in the Minneapolis, MN metropolitan area for the Company’s sales, marketing and executive offices including $78,000 for cancellation fees mentioned above. Compensation paid to the Company’s Board of Directors of $98,000 was up $52,000 due to the compensation structure adopted by the board in May 2013 and an additional director being added to the board. Additionally, increased payroll taxes and benefits of $44,000 and increased travel expenses of $38,000 were primarily the result of the addition of the Company’s chief executive officer during 2013. The increase in general and administrative expenses in fiscal 2013, as compared with fiscal 2012, was partially offset by $117,000 for the strategic business project expense incurred in 2012.

8

Table of Contents

For the year ended December 31, 2013, sales and marketing expenses were $1,075,000, an increase of $387,000 from the same period in 2012. The increase was primarily for $285,000 for development of brand and marketing strategies, increased trade show expenses of $38,000, increased salary and benefits expenses of $35,000 and increased manufacturer representatives' commissions of $30,000.

During 2013, the Company funded research and development activities incurring expenses of $902,000 compared to $285,000 for the same time period a year ago. These expenses were primarily for continued product development expenses of $601,000 related to the Company's EnviroAlert EA800-ip and salary and benefit expenses of $276,000.

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, 2013 and 2012 was $2,743,000 and $1,853,000, respectively. The net change in the total valuation allowance for the years ended December 31, 2013 and 2012 was an increase (decrease) of $890,000 and $(36,000), respectively. The tax effect of the Company's valuation allowance for deferred tax assets is included in the annual effective tax rate. The Company calculated its estimated annualized effective tax expense (benefit) rate at 0% for both December 31, 2013 and 2012. The Company had no income tax expense based on its $2,608,000 pre-tax loss from continuing operations for the year ended 2013. The Company had no income tax expense based on its $634,000 pre-tax loss from continuing operations for the year ended 2012.

Gain from discontinued operations

On December 31, 2012, the Company sold its manufacturing facility to Nortech, the then current lessee of the property for $2,650,000. The building and land had a carrying cost of $2,135,000, resulting in a gain of $506,000, after deducting expenses related to the sale of $9,000. Rental revenue for the year ended December 31, 2012, was $261,000, reduced by $218,000 for the reversal of unamortized rental revenue recognized on the straight-line basis in 2011. For the year ended December 31, 2012, the Company also recognized income of $106,000 related to the remaining unamortized deferred revenue associated with the tax increment financing associated with the facility.

LIQUIDITY AND CAPITAL RESOURCES

Operating activities used cash of $2,209,000 for the year ended December 31, 2013 the result of the net loss of $2,615,000, which was partially offset by non-cash expenses of $215,000 for increased obsolescence reserve, stock-based compensation of $69,000 for stock issued to the Company's Board of Directors and vesting of stock options and $28,000 of depreciation expense. The Company decreased its inventory position by $247,000 as the Company has been focusing on reducing inventory on hand, and sold inventory in excess of purchases during the year. This was offset by a decrease in accounts payable of $226,000 due to the timing of purchases and payments of inventories. Additionally, the Company increased its accrued liabilities by $108,000 primarily related to severance payments for employees terminated due to the Company's restructuring efforts. The severance payments will be paid out in the first five months of 2014.

Operating activities used cash of $634,000 for the year ended December 31, 2012 which resulted from a $506,000 non-cash gain on the sale of building, a net increase in finished goods inventories of $317,000 for future customer sales, a $106,000 reduction in deferred revenue for the reversal of tax increment financing related to the building and reduced payroll related expenses of $50,000 for the payment of accrued bonuses and severance partially offset by reduced deferred rent receivable of $261,000 and increased accounts payable balances of $82,000 for purchases of finished goods inventory.

Investing activities provided cash of $2,560,000 for the year ended December 31, 2013 as a result of collecting $2,641,000 held in escrow from the sale of the Company's building. Investing activities used cash of $81,000 to acquire capital equipment for the year ended December 31, 2013. Investing activities used cash of $7,000 for equipment purchases for the year ended December 31, 2012.

Table of Contents

The current ratio was 3.6 to 1 at December 31, 2013 and 7.6 to 1 at December 31, 2012. Working capital equaled $1,239,000 on December 31, 2013, compared to $3,894,000 on December 31, 2012.

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. With reduced overhead expenses in administrative, sales and marketing due the restructuring activities taken in November 2013, the Company's management believes that its cash balance and existing working capital will be adequate to fund its cash requirements for at least the next twelve months.

However, delays in, or changes to any of the above plans, and any additional unforeseen issues and circumstances, could result in the Company needing additional financing, which may not be available to the Company, or may not be available on terms favorable to the Company.

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.

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 $239,000 and $24,000 as of December 31, 2013 and 2012, respectively.

Allowance for Doubtful Accounts: The Company generally requires no collateral from its customer with respect to trade accounts receivable. Invoice terms vary by customer but are generally due 30 days after presentation. Accounts receivable are considered past due if not paid in accordance with the terms established with the customer. 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 had no bad debt expense for the years ended December 31, 2013 and 2012. 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 as of both December 31, 2013 and 2012.

Table of Contents

Allowance for Rework and Warranty Costs: Winland provides a limited warranty for its 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 $15,000 as of both December 31, 2013 and 2012. 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, 2013 and 2012 was $2,743,000 and $1,853,000, respectively. The net change in the total valuation allowance for the years ended December 31, 2013 and 2012 was an increase (decrease) of $890,000 and $(36,000), respectively. The tax effect of the Company's valuation allowance for deferred tax assets is included in the annual effective tax rate. The Company calculated its estimated annualized effective tax expense (benefit) rate at 0% for both December 31, 2013 and 2012. The Company had no income tax expense based on its $2,615,000 pre-tax loss from continuing operations for the year ended 2013. The Company had no income tax expense based on its $634,000 pre-tax loss from continuing operations for the year ended 2012.

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," "possible," "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, our intentions with respect to ceasing our public reporting obligations and the future quotation of our stock, 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;

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

Table of Contents

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;

Winland might require additional capital to support its strategic business plan, and this capital might not be available on acceptable terms, if at all; and

In the event Winland is unable to retain existing proprietary product customers or add new customers, its operating results will be adversely affected.

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.

Table of Contents

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, 2013 and 2012	14
Balance Sheets as of December 31, 2013 and 2012	15
Statements of Operations for the Years Ended December 31, 2013 and 2012	16
Statements of Changes in Stockholders' Equity for the Years Ended December 31, 2013 and 2012	17
Statements of Cash Flows for the Years Ended December 31, 2013 and 2012	18
Notes to Financial Statements	19 - 27

Table of Contents

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, 2013 and 2012, 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, 2013 and 2012 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
February 27, 2014

Table of Contents

Winland Electronics, Inc.
Balance Sheets
As of December 31, 2013 and 2012
(In Thousands)

	December 31,	
Assets	2013	2012
Current Assets		
Cash and cash equivalents	$741	$390
Funds held in escrow from sale of manuafacturing facility, including land (Note 6)	-	2,641
Accounts receivable, less allowance for doubtful accounts of $7as of both December 31, 2013 and 2012 (Note 9)	509	516
Inventories (Note 2)	366	884
Prepaid expenses and other assets	98	56
Total current assets	1,714	4,487
Property and Equipment, at cost (Note 1)		
Machinery and equipment	213	153
Data processing equipment	107	125
Office furniture and equipment	19	43
Total property and equipment	339	321
Less accumulated depreciation and amortization	243	278
Net property and equipment	96	43
Long-term inventories (Note 2)	56	-
Total assets	$1,866	$4,530
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	$277	$503
Accrued liabilities:		
Compensation (Note 11)	130	60
Other	68	30
Total current liabilities	475	593
Commitments and Contingencies		
Stockholders' Equity (Notes 5 and 10)		
Common stock, par value $0.01 per share; authorized 20,000,000shares; issued and outstanding 3,789,522 and 3,701,630 shares as of December 31, 2013 and 2012, respectively	38	37
Additional paid-in capital	5,123	5,055
Accumulated deficit	(3,770)	(1,155)
Total stockholders' equity	1,391	3,937
Total liabilities and stockholders' equity	$1,866	$4,530

See Notes to Financial Statements

Table of Contents

Winland Electronics, Inc.
Statements of Operations
For the Years Ended December 31, 2013 and 2012
(In Thousands, Except Share and Per Share Data)

	December 31, 2013	2012
Net sales (Note 9)	$3,640	$3,713
Cost of sales	2,741	2,622
Gross profit	899	1,091
Operating expenses:		
General and administrative	1,540	762
Sales and marketing	1,075	688
Research and development	902	285
	3,517	1,735
Operating loss	(2,618)	(644)
Other income:		
Other, net	3	10
	3	10
Loss from continuing operations before income taxes	(2,615)	(634)
Income tax expense (Note 4)	-	-
Loss from continuing operations	(2,615)	(634)
Income from discontinued operations, net of tax	-	655
Net income (loss)	$(2,615)	$21
Income (loss) per common share data:		
Basic and diluted	$(0.70)	$0.01
Loss from continuing operations per common share data:		
Basic and diluted	$(0.70)	$(0.17)
Income from discontinued operations per common share data:		
Basic and diluted	$-	$0.18
Weighted-average number of common shares outstanding:		
Basic and diluted	3,753,561	3,701,630

See Notes to Financial Statements

16

Table of Contents

Winland Electronics, Inc.
Statements of Changes in Stockholders' Equity
For the Years Ended December 31, 2013 and 2012
(In Thousands, Except Share Data)

	Common Stock		Additional Paid-In	Accumulated	
	Shares	Amount	Capital	Deficit	Total
Balance on December 31, 2011	3,701,630	$ 37	$ 5,014	$ (1,176)	$3,875
Stock-based compensation expense	-	-	41		