ARTS WAY MANUFACTURING CO INC
Form 10QSB
April 13, 2006

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

FORM 10-QSB

(Mark One)

[x] Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934. For the quarterly period ended February 28, 2006

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

Commission File No. 0-5131

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

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

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

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

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

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

Number of common shares outstanding as of April 17, 2006: 1,973,176

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

ART'S-WAY MANUFACTURING CO., INC.

Consolidated Statement of Operations
Condensed
(Unaudited)

	Three Months Ended	
	February 28, 2006	February 28, 2005

Net Sales	$ 4,302,088	$ 3,591,843
Cost of goods sold	2,926,683	2,336,859
Gross Profit	1,375,405	1,254,984
Expenses:		
Engineering	91,040	128,920
Selling	192,259	216,872
General and administrative	601,448	377,822
Total expenses	884,747	723,614
Income from operations	490,658	531,370
Other expenses (income):		
Interest expense	82,342	50,207
Other, net	(16,636)	(38,371)
Total other expenses	65,706	11,836
Income before income taxes	424,952	519,534
Income tax expense	152,982	176,642
Net income	$ 271,970	$ 342,892
Net income per share:		
Basic	$ 0.14	$ 0.18
Diluted	$ 0.14	$ 0.17
Common shares and equivalent outstanding:		
Basic	1,964,009	1,938,176
Diluted	1,976,443	1,964,784

See accompaning notes to consolidated condensed financial statements.

ART'S-WAY MANUFACTURING CO., INC.

Consolidated Balance Sheet
Condensed
(Unaudited)

	February 28, 2006	November 30, 2005
ASSETS		
Current Assets		
Cash	$ 1,115,139	$ 1,198,238
Accounts receivable-customers, net of allowance for doubtful accounts of $54,900 and $46,385 in February and November, respectively	2,369,428	956,391
Inventories, net	6,507,505	6,525,051
Deferred taxes	684,000	673,000
Other current assets	156,348	128,877
Total current assets	10,832,420	9,481,557
Property, plant and equipment, at cost	12,597,975	12,263,478
Less accumulated depreciation	10,428,950	10,372,818
Net property, plant and equipment	2,169,025	1,890,660
Inventories, noncurrent	174,027	144,871

Deferred taxes	40,000	191,000
Other assets	77,056	74,353
Total Assets	$ 13,292,528	$ 11,782,441
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Line of Credit	$ 43,484	$ 0
Current portion of long-term debt	135,235	223,946
Accounts payable	692,273	530,722
Customer deposits	1,722,048	569,354
Accrued expenses	648,148	736,464
Total current liabilities	3,241,188	2,060,486
Long-term debt, excluding current portion	2,602,833	2,558,273
Total liabilities	5,844,021	4,618,759
Stockholders' Equity		
Common stock - $.01 par value. Authorized 5,000,000 shares; issued 1,968,176 and 1,963,176 shares in February and in November	19,682	19,632
Additional paid-in capital	1,732,592	1,719,787
Retained earnings	5,696,233	5,424,263
Total stockholders' equity	7,448,507	7,163,682
Total liabilities and stockholders' equity	$ 13,292,528	$ 11,782,441

See accompanying notes to consolidated condensed financial statements.

ART'S-WAY MANUFACTURING CO., INC.

Consolidated Statement of Cash Flow
Condensed
(Unaudited)

	Three Months Ended	
	February 28, 2006	February 28, 2005
CASH FLOW FROM OPERATIONS:		
Net income	$ 271,970	$ 342,892
Adjustment to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	53,429	74,509
Stock based compensation	1,256	0
Deferred income taxes	140,000	178,186
Changes in working capital components:		
(Increase) decrease in:		
Accounts receivable	(1,413,037)	(448,597)
Inventories	(11,610)	(185,186)
Other current assets	(27,471)	(26,217)
Other	0	165,725
Increase (decrease) in:		
Accounts payable	161,551	(150,424)
Customer deposits	1,152,694	1,586,095
Accrued expenses	(88,316)	56,157
Net cash provided by operating activities	240,466	1,593,140

CASH FLOW FROM INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(334,497)	(11,912)
CASH FLOW FROM FINANCING ACTIVITIES:		
Proceeds from/(Principal payments) on line of credit	43,484	(870,071)
Proceeds from notes payable	0	1,000,000
Principal payments on term debt	(44,151)	(41,894)
Proceeds from the exercise of stock options	11,599	0
Loan origination fees paid	0	(18,550)
Net cash provided by financing activities	10,932	69,485
Net increase/(decrease) in cash	(83,099)	1,650,713
Cash at beginning of period	1,198,238	116,001
Cash at end of period	$ 1,115,139	$ 1,766,714
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 90,906	$ 50,207
Income taxes	12,902	14,498

See accompanying notes to consolidated condensed financial statements.

ART'S-WAY MANUFACTURING CO., INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Statement Presentation

The financial statements are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and operating results for the interim periods. The financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company's Annual Report on Form 10-KSB for the year ended November 30, 2005. The results of operations for the first quarter ended February 28, 2006 are not necessarily indicative of the results for the fiscal year ending November 30, 2006.

2. INCOME PER SHARE

At February 28, 2006, we had two stock-based employee compensation plans, which are described more fully in Note 9 of our 2005 Annual Report to Stockholders. We adopted Statement No. 123 (Revised 2004), Share-Based Payment ("SFAS123R") which replaces SFAS No. 123, Accounting for Stock-Based Compensation and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, effective December 1, 2005. SFAS123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS No. 123 are no longer an alternative to financial statement recognition. Upon adoption, we used the prospective transition method. The prospective method requires that compensation expense be recorded for all non-vested stock options beginning with the first quarter after adoption of SFAS123R. Stock-based compensation expense for the three months ended February 28, 2006 totaled $1,256.

Previously, we applied Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for these plans. Accordingly, prior to December 1, 2005 no compensation cost had been recognized for its stock options in the condensed consolidated financial statements when the options were issued at a price equivalent to the stock price at the time of issuance. Set forth below is a reconciliation of net income and earnings per share information for the three months ended February 28, 2005, as if we had applied the fair value recognition provisions of SFAS 123, Accounting for Stock-based Compensation, to stock-based employee compensation for that period.

	Three months ended February 28, 2005
Net income, as reported	$ 342,892
Deduct: Total stock-based compensation expense determined under the fair value method for all awards, net of tax effects	($ 2,662)
Pro forma net income	$ 340,230
Pro forma basic earnings per share	.18
Pro forma diluted earnings per share	.17

The fair value of each option grant has been estimated using the Black-Scholes option-pricing model.

3. INVENTORIES

Major classes of inventory are:	February 28, 2006	November 30, 2005
Raw material	$ 2,544,047	$ 2,820,591
Work-in-process	592,482	455,077
Finished goods	3,545,003	3,394,254
Total	$ 6,681,532	$ 6,669,922
Less inventories classified as noncurrent	174,027	144,871
Inventories, current	$ 6,507,505	$ 6,525,051

4. ACCRUED EXPENSES

	February 28, 2006	November 30, 2005
Major components of accrued expenses are:		
Salaries, wages and commissions	$ 361,032	$ 371,680
Accrued warranty expense	84,440	131,832
Income taxes	5,782	5,702
Other	196,894	227,250
Total	$ 648,148	$ 736,464

5. PRODUCT WARRANTY

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

Changes in the Company's product warranty liability for the three months ended February 28, 2006 and February 28, 2005 are as follows:

	2006	2005
Balance, beginning	$131,832	$119,912
Settlements made in cash or in-kind	(110,413)	(23,697)
Warranties issued	63,021	59,719
Balance, ending	$84,440	$155,934

6. LOAN AND CREDIT AGREEMENTS

The Company has a revolving line of credit for $3,500,000 with advances funding the working capital, letter of credit and corporate credit card needs that matures on April 30, 2007. The interest rate is West Bank's prime interest rate, adjusted daily. Monthly interest only payments are required and the unpaid principal is due on the maturity date. Collateral consists of a first position on assets owned by the Company including, but not limited to inventories, accounts receivable, machinery and equipment. As of February 28, 2006 and 2005, the Company had borrowed approximately $43,000 and none, respectively. Other terms and conditions of the debt with West Bank include providing monthly internally prepared financial reports including accounts receivable aging schedules and borrowing base certificates and year-end audited financial statements. The borrowing base shall limit advances from line of credit to 60% of accounts receivable less than 90 days, 60% of finished goods inventory, 50% of raw material inventory and 50% of work-in-process inventory plus 40% of appraisal value of machinery and equipment.

J. Ward McConnell, Jr. was required to personally guarantee the debt with West Bank on an unlimited and unconditional basis. The guarantee of the term debt shall be reduced after the first three years to a percentage representing his ownership of the Company. Mr. McConnell's guarantee shall be removed from the term debt in the event that his ownership interest in the Company is reduced to a level less than 20% after the first three years of the loan. The Company compensates Mr. McConnell for his personal guarantee at an annual percentage rate of 2% of the outstanding balance to be paid monthly. Guarantee fee payments to Mr. McConnell were approximately $14,000 and $10,000, for the quarter ended February 28, 2006, and 2005, respectively.

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

	February 28, 2006	November 30, 2005
West Bank loan payable in monthly installments of $17,776 including interest at Bank's prime rate plus 1.5%, due March 31, 2023 (A) (B)	$ 1,738,546	$ 1,754,866
West Bank loan payable in monthly installments of $10,000 including interest at Bank's prime rate plus 1.5%, due March 31, 2015 (A) (B)	$ 964,906	$ 974,356

State of Iowa Community Development Block Grant promissory notes at zero percent interest, maturity September 2006, with quarterly principal payments of $11,111	$ 22,222	$ 33,334
State of Iowa Community Development Block Grant local participation promissory notes at 4% interest, maturity September 2006, with quarterly payments of $7,007	$ 12,394	$ 19,663
Total term debt	$ 2,738,068	$ 2,782,219
Less current portion of term debt	$ 135,235	$ 223,946
Term debt, excluding current portion	$ 2,602,833	$ 2,558,273

(A) Notes are supported by a guarantee issued by the United States Department of Agriculture (USDA) for 75% of the loan amount outstanding. Collateral for these loans are primarily real estate with a second position on assets securing the line of credit. The USDA subordinates collateral rights in all assets other than real estate in an amount equal to West Bank's other credit commitments.

(B) Covenants include, but are not limited to, restrictions on payment of dividends, debt service coverage ratio, debt/tangible net worth ratio, current ratio, limitation on capital expenditures, and tangible net worth. During the first quarter ended February 28, 2006, the Company violated certain debt covenants that were waived.

7. RELATED PARTY TRANSACTIONS

J. Ward McConnell, Jr. owns and operates Adamson Global. During the first quarter ended February 28, 2006 Adamson sold Art's-Way Vessels, Inc., certain raw material and equipment for an aggregate price of approximately $131,000. Adamson also purchased pressurized vessels from Art's-Way Vessels, Inc. in the first quarter, for an aggregate price of approximately $65,000. The Company believes that the transactions were done in accordance with prevailing market terms and conditions.

8. SEGMENT INFORMATION

On October 4, 2005, the Company purchased certain assets of Vessels Systems, Inc. which created a separate operating segment. Prior to the date of this acquisition the Company operated in one reportable segment.

Our reportable segments are strategic business units that offer different products. They are managed separately because each business requires different technology and marketing strategies.

There are two reportable segments: agricultural products and pressurized vessels. The agricultural products segment fabricates and sells farming products as well as replacement parts for these products throughout the United States. The pressurized vessel segment produces pressurized tanks.

The accounting policies applied to determine the segment information are the same as those described in the summary of significant accounting policies. Currently interest expense on long-term debt is all located within the agricultural products segment with no interest being charged to the pressurized vessels segment related to intercompany borrowings. Intersegment sales and transfers, if any, are accounted for at historical cost.

Management evaluates the performance of each segment based on profit or loss from operations before income taxes, exclusive of nonrecurring gains and losses.

Approximate financial information with respect to the reportable segments is as follows. The agricultural products and the pressurized vessels segment information is for the quarter ended February 28, 2006.

	Agricultural Products	Pressurized Vessels	Consolidated
Revenue from external customers	$3,628,000	$674,000	$4,302,000
Income from operations	478,000	13,000	491,000
Income before tax	409,000	16,000	425,000
Segment profit	262,000	10,000	272,000
Total Assets	13,046,000	247,000	13,293,000
Capital expenditures	320,000	14,000	334,000
Depreciation	42,000	11,000	53,000

Item 2

MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

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

(a) Plan of Operation

In the current fiscal year we plan to continue growth through new product development and when appropriate acquisition. We continue to look for new and better ways to improve our product offerings for our end users. We persist in our attempt to improve our efficiencies, through the implementation of lean manufacturing processes.

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

(i) Critical Accounting Policies

Our critical accounting policies involving the more significant judgments and assumptions used in the preparation of the financial statements as of February 28, 2006 have remained unchanged from November 30, 2005. These policies involve revenue recognition, inventory valuation and income taxes. Disclosure of these critical accounting policies is incorporated by reference under Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operation" in our annual report on Form 10-KSB for the year ended November 30, 2005.

(ii) Results of Operations

Our consolidated net sales for the first quarter of 2006 increased 20% to $4,302,000 as compared to $3,592,000 for 2005. A majority of this increase was due to the inclusion of Art's-Way Vessels, Inc., net sales of $674,000, for the first quarter which was acquired October 4, 2005 and therefore was not included in last year's first quarter. Art's-Way Manufacturing had revenues totaling $3,628,000 for the first quarter, compared to $3,592,000 for the same period in 2005.

Art's-Way Manufacturing's gross profit decreased in the quarter to 31% as compared to 35% in 2005. The decrease was due primarily to a shift in the product mix during the quarter as compared to the prior year. In 2006, we had more OEM equipment sales which have a lower gross profit margin. In 2005 a higher percentage of our sales consisted of grinder mixers which have a higher gross profit margin. The lower gross profit margin was somewhat offset by Art's-Way Vessel's gross profit margin of 35% for the quarter.

Operating expenses for the quarter increased $161,000 compared to 2005. However, as a percent of sales, operating expenses remained consistent at 21% in 2006 and 20% in 2005. Art's-Way Manufacturing's operating expense as a percentage of sales decreased from 20% in 2005 to 18% in 2006. Art's-Way Vessel operating expenses as a percentage of sales were 33%.

General and administrative expenses for the quarter increased $224,000 as compared to 2005. Substantially all of the increase was due to the addition of Art's-Way Vessels.

Engineering expenses are down $38,000 for the first quarter of 2006 as compared to 2005. In 2005 we hired an outside engineering firm to aid in the development of an exportable beet harvester. In the first quarter of 2006 we did not incur those costs.

Selling expenses were also down for the first quarter of 2006 by 25,000. This was due primarily to the shift in product mix. Our higher OEM sales in 2006 carry a lower commission rate then our grinder mixer products which had higher sales levels in the first quarter of 2005. We also spent approximately $4,000 less on the promotion of our Cherokee Truck Body line.

We experienced an increase in interest expense of $32,000 in the first quarter of 2006 as a result of a rise in the prime interest rate from the first quarter of 2005. Other income is down in 2006 compared to 2005 by $21,000. In 2005 other income included a settlement of a legal dispute which resulted in approximately $34,000 of other income.

The order backlog as of March 31, 2006 is $5,436,000 compared to $4,104,000 one year ago. Art's-Way Manufacturing's order backlog as of March is $3,304,000 while Art's-Way Vessels is $2,132,000. In 2005 our production of blowers was pushed back to meet the demand of our grinder mixers. In 2006 we only had about 1/3 of our production of blowers remaining as of February 28, 2006. Gehl, one of our main competitors in the grinder mixer market, announced earlier this month, that they were ceasing operation of their ag product lines. We feel that we are in an excellent position to capture some of this market share and are optimistic that this will increase our grinder mixer sales.

(iii) Liquidity and Capital Resources

Late in the first quarter we produced blowers for our OEM customers. Those blowers were invoiced in the last weeks of the quarter, these transactions elevated our accounts receivable, with an increase of $1,413,000. Our customer deposits also increased significantly as our beet programs ran in the first quarter, we offer discounts to our customers for making downpayments on their orders.

In late 2005 we entered into an agreement to purchase a new Bystronic laser, a machine that cuts metal. The agrrement called for three payments totaling approximately $627,000. We made the second payment in the first quarter of 2006. Overall our cash position declined by $83,000. However we believe strongly in investing in our future through new equipment and acquisitions.

See footnote 6 of the notes to the consolidated condensed financial statements for a discussion of our credit facilities.

Item 3

CONTROLS AND PROCEDURES

Senior management, including the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is (a) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure; and (b) recorded, processed, summarized and reported, within the time specified in the SEC's rules and forms. Since that evaluation process was completed there have been no significant changes in our disclosure controls or in other factors that could significantly affect these controls.

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

Part II - Other Information

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 6. EXHIBITS

See exhibit index on page 15.

SIGNATURES

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

ART'S-WAY MANUFACTURING CO., INC.

By: ____________________________	By: _______________________________
John C. Breitung	Carrie L. Majeski
Chief Executive Officer	Chief Financial Officer
Date:______________________	Date:_________________________

Exhibits Index

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