BANNER CORP
Form 10-Q
May 04, 2018

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

FORM 10-Q
(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2018

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM ______________ to ______________

Commission File Number 000-26584

BANNER CORPORATION
(Exact name of registrant as specified in its charter)

Washington	91-1691604
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

10 South First Avenue, Walla Walla, Washington 99362
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: (509) 527-3636

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange

Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [x] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes [x] No [ ]

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

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

Emerging growth company [ ]

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. [ ]

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Title of class:	As of April 30, 2018
Common Stock, $.01 par value per share	32,331,108 shares
Non-voting Common Stock, $.01 par value per share	76,928 shares

BANNER CORPORATION AND SUBSIDIARIES

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PART I – FINANCIAL INFORMATION

Item 1 – Financial Statements. The Unaudited Condensed Consolidated Financial Statements of Banner Corporation and Subsidiaries filed as a part of the report are as follows:

Special Note Regarding Forward-Looking Statements

Certain matters in this Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our financial condition, liquidity, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and are generally identified by use of the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar expressions or conditional verbs such as "may," "will," "should," "would" and "could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about future economic performance and projections of financial items. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated or implied by our forward-looking statements, including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets and may lead to increased losses and non-performing assets, and may result in our allowance for loan losses not being adequate to cover actual losses and require us to materially increase our reserves; changes in economic conditions in general and in Washington, Idaho, Oregon and California in particular; changes in the levels of general interest rates and the relative differences between short and long-term interest rates, loan and deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market areas; secondary market conditions for loans and our ability to sell loans in the secondary market; results of safety and soundness and compliance examinations of us by the Board of Governors of the Federal Reserve System and of our bank subsidiaries by the Federal Deposit Insurance Corporation (the FDIC), the Washington State Department of Financial Institutions, Division of Banks (the Washington DFI) or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require restitution or institute an informal or formal enforcement action against us or any of our bank subsidiaries which could require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds, or maintain or increase deposits, or impose additional requirements and restrictions on us, any of which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules, including changes related to Basel III; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the implementing regulations; our ability to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets and liabilities, which estimates may prove to be incorrect and result in significant changes in valuation; difficulties in reducing risk associated with the loans and securities on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; disruptions, security breaches, or other adverse events, failures or interruptions in, or attacks on, our information technology systems or on the third-party vendors who perform several of our critical processing functions; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our business strategies; future goodwill impairment due to changes in our business, changes in market conditions, or other factors; our ability to manage loan delinquency rates; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; our ability to pay dividends on our common stock and non-voting common stock, and interest or principal payments on our junior subordinated debentures; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services; and other risks detailed from time to time in our filings with the U.S. Securities and Exchange Commission

(SEC), including this report on Form 10-Q. Any forward-looking statements are based upon management's beliefs and assumptions at the time they are made. We do not undertake and specifically disclaim any obligation to update any forward-looking statements included in this report or the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. These risks could cause our actual results to differ materially from those expressed in any forward-looking statements by, or on behalf of, us. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this report might not occur, and you should not put undue reliance on any forward-looking statements.

As used throughout this report, the terms "we," "our," "us," or the "Company" refer to Banner Corporation and its consolidated subsidiaries, unless the context otherwise requires. All references to "Banner" refer to Banner Corporation and those to "the Banks" refer to its wholly-owned subsidiaries, Banner Bank and Islanders Bank, collectively.

BANNER CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
(Unaudited) (In thousands, except shares)
March 31, 2018 and December 31, 2017

ASSETS	March 31 2018	December 31 2017
Cash and due from banks	$188,418	$199,624
Interest bearing deposits	53,630	61,576
Total cash and cash equivalents	242,048	261,200
Securities—trading, amortized cost $27,275 and $27,246, respectively	25,574	22,318
Securities—available-for-sale, amortized cost $1,427,764 and $926,112, respectively	1,406,505	919,485
Securities—held-to-maturity, fair value $260,918 and $262,188, respectively	262,645	260,271
Federal Home Loan Bank (FHLB) stock	18,036	10,334
Loans held for sale (includes $137.7 million and $32.4 million, at fair value, respectively)	141,808	40,725
Loans receivable	7,556,046	7,598,884
Allowance for loan losses	(92,207)	(89,028)
Net loans	7,463,839	7,509,856
Accrued interest receivable	32,824	31,259
Real estate owned (REO), held for sale, net	328	360
Property and equipment, net	156,005	154,815
Goodwill	242,659	242,659
Other intangibles, net	21,251	22,655
Bank-owned life insurance (BOLI)	163,519	162,668
Deferred tax assets, net	76,843	71,427
Other assets	63,380	53,177
Total assets	$10,317,264	$9,763,209
LIABILITIES		
Deposits:		
Non-interest-bearing	$3,383,439	$3,265,544
Interest-bearing transaction and savings accounts	4,141,268	3,950,950
Interest-bearing certificates	1,018,355	966,937
Total deposits	8,543,062	8,183,431
Advances from FHLB	192,195	202
Other borrowings	101,844	95,860
Junior subordinated debentures at fair value (issued in connection with Trust Preferred Securities)	112,516	98,707
Accrued expenses and other liabilities	72,497	71,344
Deferred compensation	41,027	41,039
Total liabilities	9,063,141	8,490,583
COMMITMENTS AND CONTINGENCIES (Note 12)		
SHAREHOLDERS' EQUITY		
Preferred stock - $0.01 par value per share, 500,000 shares authorized; no shares outstanding at March 31, 2018 and December 31, 2017	—	—
	1,171,914	1,185,919

Common stock and paid in capital - $0.01 par value per share, 50,000,000 shares authorized; 32,346,745 shares issued and outstanding at March 31, 2018; 32,626,456 shares issued and outstanding at December 31, 2017		
Common stock (non-voting) and paid in capital- $0.01 par value per share, 5,000,000 shares authorized; 76,928 shares issued and outstanding at March 31, 2018; 100,029 shares issued and outstanding at December 31, 2017	1,046	1,208
Retained earnings	79,773	90,535
Carrying value of shares held in trust for stock related compensation plans	(7,371)	(7,351)
Liability for common stock issued to stock related compensation plans	7,371	7,351
Accumulated other comprehensive income (loss) (AOCI)	1,390	

	Number of Shares		Weighted-Average Exercise Price	Weighted-Average Remaining Contract Life
Outstanding options at January 1, 2006	265,571	$	2.25	
Granted	40,000	$	3.97	
Exercised	(45,031)	$	1.39	
Forfeited				
Outstanding options at June 30, 2006	260,540	$	2.66	3.79 Yrs
Outstanding exercisable at June 30, 2006	186,020	$	2.83	3.92 Yrs

At June 30, 2006, the aggregate intrinsic value of options outstanding was $278,881, and the aggregate intrinsic value of options exercisable was $179,012. Total intrinsic value of options exercised was $173,113 for the six months ended June 30, 2006.

Note 7. New Accounting Standards

Effective January 1, 2006, the Company adopted FASB issued Statement No. 151 (SFAS No. 151), Inventory Costs. SFAS No. 151 amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4, previously stated that . . . under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and re-handling costs may be so abnormal as to require treatment as current period charges . . . . SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The adoption of this statement had no impact on the Company s financial position or results of operations for the three and six months ended June 30, 2006.

Effective January 1, 2006, the Company adopted FASB issued Statement No. 154 (SFAS No. 154), Accounting Changes and Error Corrections. This new standard replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements. Among other changes, Statement 154 requires retrospective application of a voluntary change in accounting principle with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. Statement 154 also requires accounting for a change in method of depreciating or amortizing a long-lived non-financial asset as a change in estimate (prospectively) affected by a change in accounting principle. Further, the Statement requires that correction of errors in previously issued financial statements be termed a restatement. The adoption of this statement had no impact on the Company s financial statements for the three and six months ended June 30, 2006.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109 (FIN 48), which clarifies the accounting for uncertainty in tax positions. This interpretation provides that the tax effects from an uncertain tax position can be recognized in our financial statements, only if the position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the

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beginning of fiscal 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. We are currently evaluating the impact of adopting FIN 48 on our financial statements.

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ITEM 2: MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Overview

The Company designs and manufactures circuit board assemblies and higher level products that incorporate them for many OEM customers. The Company is positioned to offer complete solutions to OEM customer needs by providing value-added services that complement the Company s contract manufacturing capabilities. The services provided may include product concept studies, product design, printed circuit board design, design for manufacturing, higher level assembly and box build, and legacy support. These services differentiate the Company from the competition and increase customer satisfaction, confidence, and loyalty. The Company views EMS customers as strategic partners and works to provide these partners with high level customer care and technical services.

The Company also markets proprietary products which include an established family of environmental security products that can monitor critical environments. The Company s security/industrial products include simple and sophisticated microprocessor and mechanically controlled sensors and alarms. These products monitor and detect critical environmental changes, such as changes in temperature or humidity, water leakage and power failures. The Company s ALERT series of products may be connected to many burglar or fire alarm panels to monitor and report unfavorable environmental conditions.

Executive Summary

The Company reported record revenues for the sixth straight quarter breaking the $10 million mark for the first time in Company history. The record $10.7 million in revenue represents an increase of 49.5% compared to $7.1 million reported for the same period last year. The Company introduced 59 new products to manufacturing and saw increased sales from its original equipment manufacture (OEM) customers. The introduction of these new products put pressure on operating efficiencies causing gross profits to decline. The Company also experienced lower gross profits based on price contracts with Select Comfort which were awarded during the first quarter of 2006. In addition, the reserve created for the replacement of the EnviroAlert EA200 and EA400 products had a significant impact on gross profit. The Company was able to report $1.6 million gross profit or 15.1% of net sales for the second quarter of 2006 compared to the $1.9 million or 26.4% reported during the second quarter of 2005. The Company also continued leveraging its business model realizing a decrease in total operating expenses as a percent of net sales. Operating expenses for the three months ended June 30, 2006 were $1,128,773 or 10.6% of net sales compared to $963,985 or 13.5% for the same period last year. Operating income as a percent of net sales decreased to 4.4% or $478,215 for the three months ended June 30, 2006 compared to 12.8% or $914,900 reported for the same period last year. Net income as a percent of net sales decreased to 2.7% or $290,799, $0.08 per basic and fully diluted share for the three months ended June 30, 2006, from 7.9% or $566,539, $0.16 per basic share and $.16 per fully diluted share for the same period last year. The Company utilized 3.7 and 3.6 million fully diluted shares in the calculations for the six months ended June 30, 2006 and 2005, respectively.

The balance sheet remained strong, with stockholders equity increasing 8.0% to $9.81 million as of June 30, 2006, from $9.08 million on December 31, 2005. The Company completed the quarter with $337,096 in cash and a current ratio of 2.05 to 1.

RESULTS OF OPERATIONS

Three months and six months ended June 30, 2006 vs.
Three months and six months ended June 30, 2005

Net Sales: The Company recorded net sales of $10,661,222 for the three months ended June 30, 2006, an increase of $3,531,859, or 49.5%, from $7,129,363 for the same period in 2005. Net sales for original equipment manufacture (OEM) customers increased 55.5%. Revenue from sales of Winland proprietary products, primarily for the security/industrial markets, increased 11.6% while revenue from Engineering Services decreased 54.1%. The Company recorded net sales of $18,808,432 for the six months ended

June 30, 2006, an increase of $4,665,676, or 33.0%, from $14,142,755 for the same period in 2005. The net sales for original equipment manufacture (OEM) customers increased 36.3%. Sales of Winland proprietary products, primarily for the security/industrial markets, increased 12.2% while revenue from engineering design services decreased 24.1%. As of June 30, 2006, the Company s OEM customers have given the Company purchase orders having an aggregate value of $15.3 million for delivery during the remainder of 2006. The Company expects to receive additional orders from current OEM customers for future production. Although the Company has purchase orders in place for many of its OEM customers scheduled to be fulfilled in 2006, these customers may terminate their relationship with the Company at any time pursuant to certain cancellation provisions.

Cost of Sales: Cost of sales was $9,054,234 or 84.9% of net sales for the three months ended June 30, 2006, compared to $5,250,478 or 73.6% of net sales for the same period in 2005. Cost of sales for the six months ended June 30, 2006 were $15,545,662 or 82.7% of net sales compared to $10,564,622 or 74.7% of net sales for the same period in 2005. The Company includes material and supplies, direct labor and other manufacturing expenses in its computation of cost of sales. Other manufacturing expenses, some of which are included in overhead, include, but are not limited to, indirect manufacturing labor and related benefits and expenses, depreciation and maintenance of manufacturing equipment and software, freight expense, purchasing expenses, warehousing expenses, warranty expense, inventory scrap and write-offs, an allocation for facility and information technology usage and product liability insurance. Costs that are capitalized in work in process and finished goods inventory include all of the above, except certain expenses such as warranty expense, inventory scrap and write-offs and some freight.

Gross Profits: Gross profit can fluctuate from period to period due to a variety of factors, including, but not limited to, sales volume, product mix, and plant efficiency. Gross profit dollars decreased 14.5% to $1,606,988 or 15.1% of net sales for the three months ended June 30, 2006, compared to $1,878,885 or 26.4% of net sales for the same period in 2005. Gross profit dollars for the six months ended June 30, 2006 decreased 8.8% to $3,262,769 or 17.3% of net sales compared to $3,578,133 or 25.3% for the same period in 2005. The decrease in gross profit as a percentage of sales during the three and six months ended June 30, 2006 is attributable to the EnviroAlert EA200 and EA400 product replacement, the pricing in the new Select Comfort contract and the introduction of 59 and 92 new products, respectively. Introduction of these products meant higher production costs, component prep charges, manual component placements and manual testing; all of which reduced gross profits for the three and six months ended June 30, 2006. For the three months ended June 30, 2006, the decrease in gross profit was due to warranty expense of $458,428 ($415,000 relating to the EnviroAlert Enhancement Program See Note 5 above), increased salaries and related expenses of $105,882, depreciation expense of $42,543 and repair and maintenance expenses of $22,098. The decrease in gross profit dollars for the six months ended June 30, 2006 was due to warranty expense of $435,310 of which $415,000 relates to the EnviroAlert Enhancement Program (See Note 5 to our Condensed Financial Statements), increased salaries and related expenses of $222,062, depreciation expense of $67,545, and repair and maintenance expenses of $48,520.

Operating Expenses: Operating expenses were $1,128,772 and $2,282,532 or 10.6% and 12.1% of net sales for the three and six months ended June 30, 2006, respectively compared to $963,985 and $2,033,752 or 13.5% and 14.4% for the three and six months ended June 30, 2005. Operating expenses include: 1) general and administrative expenses such as administrative salaries and related benefits and expenses, professional and legal fees, investor relations expenses, board of directors fees, and directors and officers insurance and other general office supplies and expenses; 2) sales and marketing expenses including salaries and related benefits and expenses for direct outside salesmen, customer service and the senior vice president of sales and marketing, sales commissions, trade show expenses, web site maintenance, promotional materials, advertising expense and an allocation for facility and information technology usage; and 3) research and development expense such as salaries and related benefits and expenses, labor and material associated with new product development, depreciation and maintenance of research and development equipment and software, warranty expense associated with engineering projects and an allocation of facility and information technology usage.

General and administrative expense was $618,472 or 5.8% of net sales and $1,211,504 or 6.4% of net sales for the three and six months ended June 30, 2006, respectively, compared to $448,566 or 6.3% of net sales and $957,984 or 6.8% of net sales for the same periods in 2005. The increase in general and administrative expense for the three months ended June 30, 2006 is attributed to increased salaries and related expenses of $74,213, professional fees of $49,383, legal fees of $17,230 and board of directors expense of $14,635, offset in part by declines in investor relations of $13,020 and training related expenses of $9,562. The increase in general and administrative expense for the six months ended June 30, 2006 is attributed to increased salaries and related expenses of $92,081, professional fees of $60,366, board of directors expense of $52,529, legal fees of $23,733 and telephone expense of $14,138, offset in part by declines in investor relations of $22,735 and training related expenses of $9,073.

Sales and marketing expense (including project management) was $389,972 or 3.7% of net sales and $803,877 or 4.3% of net sales for the three and six months ended June 30, 2006, compared to $340,567 or 4.8% of net sales and $676,700 or 4.8% of net sales for the same periods in 2005. The increase in sales and marketing expense for the three months ended June 30, 2006 is attributed to increased salaries and related expenses of $40,633, promotional and trade show expenses of $22,479, offset in part by declines in legal fees of $9,425, training expenses of $5,445 and professional fees of $5,000. The increase in sales and marketing expense for the six months ended June 30, 2006 is attributed to increased salaries and related expenses of $111,840, promotional and trade show expenses of $31,753, offset in part by declines in legal fees $10,225, professional fees of $7,422, advertising expense of $5,457 and employee training expenses of $4,929.

Research and development expense (including the development of new Company products as well as design services and support to the OEM customer base) was $120,329 or 1.1% of net sales and $267,151 or 1.4% of net sales for the three and six months ended June 30, 2006, compared to $174,852 or 2.5% of net sales and $399,068 or 2.8% of net sales for the same periods in 2005. For the three months and six months ended June 30, 2006, the Company s customers had increased research and development projects. The labor cost for these projects was transferred to Engineering Cost of Goods Sold and included in total Cost of Sales shown above. The transfer of COGS was offset with increases in new product development expenses of $77,567 and salaries and related expenses of $34,987 for the three months ended June 30, 2006 compared to the same period last year. For the six months ended June 30, 2006, the transfer of COGS was offset with increases in new product development expenses of $126,410 and salaries and related expenses of $102,524 compared to the same period last year.

<u>Interest Expense</u>: Interest expense was $30,596 or 0.2% of net sales and $59,379 or 0.3% of net sales for the three and six months ended June 30, 2006, compared to $30,164 or 0.4% of net sales and $59,973 or 0.4% of net sales for the same periods in 2005. During the first six months of 2006, the Company paid down $271,069 of long-term debt.

<u>Net Income</u>: The Company reported net income of $290,799 or $0.08 per basic share and $0.08 per diluted share and $601,821 or $0.17 per basic share and $0.16 per diluted share for the three and six months ended June 30, 2006, compared to net income of $566,539 or $0.16 per basic and $0.16 per diluted share and $941,353 $0.27 per basis share and $0.26 per diluted share for the same periods in 2005.

The Company used a blended federal and state income tax rate which was 35% and 39% for the three and six months ended June 30, 2006 and 2005, respectively. The difference in rates used is due to a change in property apportionment factors for Minnesota and Utah used when estimating state tax liabilities. The change in property apportionment factors is due to having inventory in the state of Utah versus in Minnesota for Select Comfort. At June 30, 2006, pre-tax income was $925,821 for 2006 and $1,543,353 for 2005, resulting in income tax expense of $324,000 and $602,000, respectively.

The Company believes inflation has not significantly affected its results of operations.

LIQUIDITY AND CAPITAL RESOURCES

Cash used in operating activities was $92,590 for the six months ended June 30, 2006 compared to cash provided by operating activities of $1,370,198 for the six months ended June 30, 2005, a decrease of $1,462,788. This change was primarily due to increases in inventory and accounts receivable balances offset by increased accounts payable and depreciation expense. Cash used in investing activities was used to acquire capital equipment with a book cost of $1,002,898 and $299,235 for the six months ended June 30, 2006 and 2005, respectively. Financing activities provided cash in the amount of $800,000 and $230,000 by drawing on existing lines of credit for the six months ended June 30, 2006 and 2005, respectively. In addition, issuance of common stock provided $38,472 and $120,415 for the six months ended June 30, 2006 and 2005, respectively. The dollars provided by financing were used in part, to pay down long term debt of $271,069 and $232,816 for the six months ended June 30, 2006 and 2005, respectively.

The current ratio at June 30, 2006 was 2.05 to 1, compared to 2.98 to 1 at December 31, 2005. Working capital equaled $5,859,764 on June 30, 2006, compared to $5,992,118 on December 31, 2005.

The Company had $800,000 outstanding on the revolving line-of-credit agreement at June 30, 2006 and no outstanding balances as of December 31, 2005.

We believe that our cash balance, funds available under a line of credit agreement and anticipated cash flows from operations will be adequate to fund our cash requirements for the next twelve months.

A summary of our contractual cash obligations as of June 30, 2006, excluding the line of credit is as follows:

	2006	**2007**	**2008**	**2009**	**2010+**	**Total**
US Bank Mortgage	68,240	136,480	136,480	136,480	652,098	1,129,778
Wells Fargo Leasing Equipment	38,916					38,916
M&I Bank Loan Equipment	186,119	402,011	217,121	52,939		858,190
M&I Equipment Finance Leased Equipment	53,146	142,975	142,975	142,975	232,803	714,874
Total	346,421	681,466	496,576	332,394	884,901	2,741,757

There are no off balance sheet contractual cash obligations.

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CRITICAL ACCOUNTING POLICIES AND 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. We cannot assure you that actual results will not differ from those estimates. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition. In most cases, the Company recognizes revenue from the sale of products and out of warranty repairs when the product is delivered to a common carrier for shipment and title transfers.

With one particular customer, the Company recognizes revenue from the sale of customized products when the product is delivered to a customer warehouse location within the Company, title is transferred and risk of loss and ownership passes to the buyer. These sales are subject to written purchase orders including a fixed schedule for delivery; the date for delivery is reasonable and consistent with the buyer s business purpose. The product cannot be used to fulfill other customers orders, as this is a unique product for this customer only. We are the sole supplier source of this product for this customer. Because of the unique nature of this product, the customer must have stock on hand and ready to ship to their customers and, therefore, has requested that the transaction be on a bill and hold basis. Since the customer does not have its own warehouse, they rent warehouse space from the Company by paying a monthly rental charge based on the number of pallets containing their inventory. The customer s credit and payment terms are the same as all other OEM customers.

Another portion of the Company s business involves the Company shipping product to a primary customer s location where it is held in a separate warehouse. Revenue is recognized when that customer notifies the Company that the inventory has been removed from the warehouse and title to the product is transferred.

Revenue recognition occurs for engineering design services as the progress billings are made and at the conclusion of the project.

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 goods sold. For all sales, the Company uses either a binding purchase order or customer accepted and signed engineering quote as evidence of the arrangement. The Company does not generally accept returns but does provide a limited warranty as outlined below under Allowance for Rework and Warranty Costs.

Inventory Valuation. Our inventories are stated at the lower of cost, using the first-in, first-out (FIFO) method, or market value. Our industry is characterized by rapid technological change, short-term customer commitments and rapid changes in demand, as well as other market considerations. The Company makes provisions for slow moving, estimated excess and obsolete inventory based on historical experience, an analysis of the existing inventory and specific identification of obsolete inventory. Management s estimated reserve for slow moving and obsolete inventories was valued at $198,900 as of June 30, 2006 and $191,900 as of December 31, 2005.

In addition to the above methodology, we have developed procedures that will provide for estimated excess, slow moving and obsolete inventory reserves based on quarterly reviews for our major customers and annual reviews for lower volume customers of inventory quantities on hand and on order in conjunction with the latest forecasts of product demand and production requirements from these customers. Inventory not specific to a customer is evaluated at least annually.

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Allowance for Doubtful Accounts. We evaluate our allowance for uncollectible accounts on a quarterly basis and review any significant customers with delinquent balances to determine future collectibility. We base our determinations on legal issues (such as bankruptcy status), past history, current financial and credit agency reports, and experience. We reserve accounts deemed to be uncollectible in the quarter in which we make the determination. We maintain additional reserves based on our historical bad debt experience. We believe these values are estimates and may differ from actual results. We believe that, based on past history and credit policies, the net accounts receivable are of good quality. There were no write offs for either the three or six month periods ended June 30, 2006 or 2005. The Allowance for Doubtful Accounts was valued at $20,000 for both periods ended June 30, 2006 and December 31, 2005.

Allowance for Rework and Warranty Costs. We have established a warranty reserve for rework, product warranties and customer refunds. We provide a limited warranty to our OEM customers who require us to repair or replace product that is defective, due to Company workmanship issues, at no cost to the customer. In addition, we provide a limited warranty for our proprietary products for a period of one year, which requires us 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 a percentage of sales for the prior six-month period. Any specific known warranty issues are reserved for individually. The total of these is analyzed to determine the probability and the Company s financial exposure, and the reserve is established. The allowance for rework and warranty costs was valued at $496,242 which includes the allowance of EnviroAlert product enhancement as of June 30, 2006 and $117,300 as of December 31, 2005. The product warranty liability reflects management s best estimate of probable liability under our product warranties and may differ from actual results.

Allowance for EnviroAlert Product Enhancement. We have established a warranty reserve for the return and replacement of the EA200 and EA400 products as described in Note 5 to our Condensed Financial Statements. The reserve reflects the estimated costs for return of non-functional products, replacement of currently installed units in the field and to provide incentives to dealers to carry out the replacements. Going forward, the estimated costs of this program will be reviewed during the third quarter of 2006 and beyond, with adjustments being made during the period in which they are identified. The Allowance for EnviroAlert Product Enhancement was reserved at $354,942 as of June 30, 2006 and $0 as of December 31, 2005.

Deferred Taxes. At June 30, 2006, the financial statements reflect deferred tax assets of $259,300 and deferred tax liabilities of $261,900. Deferred taxes are provided on an asset and liability method, whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carry-forwards, and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Realization of deferred tax assets is dependent on future taxable income during the period that deductible temporary differences and carry-forwards are to be available to reduce taxable income.

Depreciation and Asset Impairment. The Company depreciates property and equipment over its estimated useful life. Impairment charges of $6,005 were taken for the three months ended June 30, 2006 with no impairment charges recorded during the same period in 2005.

Stock Based Compensation. The Company has two equity-based compensation plans from which stock-based compensation awards can be granted to eligible employees, officers or directors; the 2005 Equity Incentive Plan and the 1997 Employee Stock Purchase Plan. Effective January 1, 2006, the Company began accounting for these plans using the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS123R), using the modifiedprospective-transition method. The effect of using SFAS 123R was to decrease income before taxes and net income by $91,448 for the six months ended June 30, 2006. We use the Black Scholes option pricing model to estimate the fair value of stock based awards. The Company uses historical data to estimate option exercises and employee terminations used in the model. Expected volatility is based on daily historical fluctuations of the Company 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.

CAUTIONARY STATEMENTS

Certain statements contained in this Quarterly Report on Form 10-QSB and other written and oral statements made from time to time by the Company 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, pos project, should, will, forecast and similar words or expressions. The Company s forward-looking statements gener relate to the Company s purchase order levels, building market share in the EMS market, 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. As provided for under the Private Securities Litigation Reform Act of 1995, the Company wishes to caution investors that the following important factors, among others, in some cases have affected and in the future could affect the Company 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 the Company.

The Company derives a significant portion of its revenues from a small number of major OEM customers that are not subject to any long-term contracts with the Company. If any major customers should for any reason decrease the volume of their business or stop doing business with the Company, the Company s business would be adversely affected. Some of the Company s customers are not large well-established companies, and the business of each customer is subject to various risks such as market acceptance of new products and continuing availability of financing. To the extent that the Company s customers encounter difficulties or the Company is unable to meet the demands of its OEM customers, the Company s revenues could be adversely affected.

The Company 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 Company competes for new customers with numerous independent contract design and manufacturing firms in the United States and abroad, many of whom have greater financial resources and more established reputations. The Company s ability to compete successfully in this industry depends, in part, upon the price at which the Company is willing to manufacture a proposed product and the quality of the Company s design and manufacturing services. There is no assurance that the Company will be able to continue to obtain contracts from existing and new customers on financially advantageous terms, and the failure to do so could prevent the Company from achieving the growth it anticipates.

The Company s ability to execute its initiatives to increase sales and expand market share depends upon its ability to develop additional value added capabilities and/or 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 the current economic environment, banks and other sources of financing are conservative in their lending and investment policies. There is no assurance that the Company will be able to obtain the financing necessary to achieve its goals.

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The Company s success in providing an improved mix of higher margin products and services depends on the effectiveness of its new product development and planning efforts as well as the timing of such and the availability and costs of any competing products or services on the market.

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ITEM 3. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls Procedures.

The Company s Chief Executive Officer, Lorin E. Krueger, and Chief Financial Officer, Brian D. Lawrence, have reviewed the Company s disclosure controls and procedures as of the end of the period covered by this report. Based upon this review, these officers believe that the Company s disclosure controls and procedures are effective in ensuring that information that is required to be disclosed by the Company in reports that it files under the Securities Exchange Act of 1934 is recorded, processed and summarized and reported within the time periods specified in the rules of the Securities and Exchange Commission.

(b) Changes in Internal Control.

During the period, the employment of the Company s Chief Financial Officer was terminated and the Company s Controller assumed the duties of the Chief Financial Officer thereby eliminating a review of a second individual from the preparation of the financial statements. This elimination of a second review may be deemed a change in the Company s internal control over financial reporting during the period that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table sets out shares of the Company s Common Stock repurchased by the Company in the quarter ended June 30, 2006.

Period	(a) Total Number of Shares (or Units) Purchased(1)	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
Apr. 1 Apr. 30, 2006	4,776	$ 5.65	N/A	N/A
Total	4,776	$ 5.65	N/A	N/A

(1) All of the shares were repurchased by the Company in connection with stock-for-stock option exercises by one employee.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company held its Annual Meeting on May 9, 2006.

Proxies for the annual meeting were solicited pursuant Regulation 14A under the Securities and Exchange Act of 1394. There was no solicitation in opposition to management s nominees as listed in the proxy statement, and all nominees were elected.

The shareholders set the number of directors at five (5) by a vote of 3,265,040 shares in favor, with 1,989 shares voted against and 50,942 shares abstaining. The following persons were elected to serve as directors of the Company until the next annual meeting of shareholders with the following votes:

Nominee	Number of Votes For	Number of Votes Withheld
Thomas J. de Petra	3,290,660	27,311
S. Robert Dessalet	3,290,440	27,531
Lorin E. Krueger	3,293,410	24,561
James L. Reissner	3,289,660	28,311
Richard T. Speckman	3,293,660	24,311

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ITEM 5. OTHER INFORMATION

On June 28, 2006, the Company entered into a Master Lease of Personal Property with M&I Equipment Finance Company for the acquisition of capital equipment in an amount of up to $1,2000,000. The lease is filed as Exhibit 10.1 to this Form 10-QSB and is incorporated by reference herein as appropriate.

On February 2, 2006, the Company entered into Amendment No. 7 to the Credit and Security Agreement with M&I Marshall & Ilsley Bank to allow the Company to incur Capital Expenditures of up to $1,275,000 and $3,000,000 for calendar years 2005 and 2006, respectively.

On June 28, 2006, the Company entered into Amendment No. 8 to the Credit and Security Agreement with M&I Marshall & Ilsley Bank to extend its revolving line of credit and increase the amount under the line of credit to $4,000,000. An Amended and Restated Revolving Note in the amount of $4,000,000 was signed on behalf of the Company in favor of M&I Marshall & Ilsley Bank on June 28, 2006. This extends and increases the direct financial obligation of the Company. The Amendment No. 8 and Note are filed as Exhibit 10.2 to this Form 10-QSB and are incorporated by reference herein as appropriate.

ITEM 6. EXHIBITS

See Exhibit Index following the signature page.

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SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Company has caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

WINLAND ELECTRONICS, INC.
(Company)

Dated: August 10, 2006

/s/ Lorin E. Krueger
Lorin E. Krueger, President and Chief Executive Officer (Principal Executive Officer)

/s/ Brian D. Lawrence
Brian D. Lawrence, Chief Financial Officer
(Principal Financial and Accounting Officer)

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
EXHIBIT INDEX TO FORM 10-QSB

For the fiscal quarter ended June 30, 2006 — **Commission File No. 0-15637**

WINLAND ELECTRONICS, INC.

Exhibit No.	Description
10.1	Master Lease of Personal Property between the Company and M&I Equipment Finance Company dated June 28, 2006
10.2	Amendment No.7 to Credit Agreement between the Company and M&I Marshall & Ilsley Bank dated February 2, 2006
10.3	Amendment No.8 to Credit Agreement between the Company and M&I Marshall & Ilsley Bank dated June 28, 2006 and Amended and Restated Revolving Note dated June 28, 2006.
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002