ARTS WAY MANUFACTURING CO INC
Form 10QSB
July 17, 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 May 31, 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 July 17, 2006: 1,973,176

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

ART'S-WAY MANUFACTURING CO., INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended		Year to Date	
	May 31, 2006	May 31, 2005	May 31, 2006	May 31, 2005
Net sales	$ 4,111,729	$ 3,799,873	$ 8,413,817	$ 7,391,716
Cost of goods sold	2,822,374	2,776,938	5,749,057	5,113,797
Gross profit	1,289,355	1,022,935	2,664,760	2,277,919

Operating expenses:				
Engineering	108,858	150,367	199,898	279,287
Selling	192,978	118,231	385,237	335,103
General & administrative	677,356	432,248	1,278,804	810,070
Total expenses	979,192	700,846	1,863,939	1,424,460
Income from operations	310,163	322,089	800,821	853,459
Other expenses:				
Interest expense	99,969	80,087	182,311	130,294
Other	(24,822)	(6,510)	(41,458)	(44,881)
Total other expenses	75,147	73,577	140,853	85,413
Income before income taxes	235,016	248,512	659,968	768,046
Income tax expense	81,847	98,754	234,829	275,396
Net income	$ 153,169	$ 149,758	$ 425,139	$ 492,650
Net income per share:				
Basic	$ 0.08	$ 0.08	$ 0.22	$ 0.25
Diluted	$ 0.08	$ 0.08	$ 0.21	$ 0.25
Common shares and equivalent outstanding:				
Basic	1,972,796	1,944,385	1,968,451	1,941,280
Diluted	1,979,570	1,966,405	1,977,619	1,965,566

See accompanying notes to condensed consolidated financial statements.

ART'S-WAY MANUFACTURING CO., INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	May 31, 2006	November 30, 2005
ASSETS		
Current Assets		
Cash	$ 2,341,217	$ 1,198,238
Accounts receivable-customers, net of allowance for doubtful accounts of $75,066 and $46,385 in May and November, respectively	1,645,561	956,391
Inventories, net	7,510,531	6,525,051
Deferred taxes	709,000	673,000
Other current assets	173,871	128,877
Total current assets	12,380,180	9,481,557
Property, plant and equipment, at cost	12,474,068	12,263,478
Less accumulated depreciation	10,067,180	10,372,818
Net property, plant and equipment	2,406,888	1,890,660
Inventories, noncurrent	136,171	144,871
Deferred taxes	32,000	191,000
Other assets	102,603	74,353
Total Assets	$ 15,057,842	$ 11,782,441

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities		
Current portion of long-term debt	$ 254,094	$ 223,946
Accounts payable	699,662	530,722
Customer deposits	1,602,534	569,354
Accrued expenses	949,901	736,464
Total current liabilities	3,506,191	2,060,486
Long-term debt, excluding current portion	3,936,992	2,558,273
Total liabilities	7,443,183	4,618,759
Stockholders' Equity		
Common stock - $.01 par value. Authorized 5,000,000 shares; issued 1,973,176 and 1,963,176 shares in May and in November	19,732	19,632
Additional paid-in capital	1,745,525	1,719,787
Retained earnings	5,849,402	5,424,263
Total stockholders' equity	7,614,659	7,163,682
Total liabilities and stockholders' equity	$ 15,057,842	$ 11,782,441

See accompanying notes to condensed consolidated financial statements.

ART'S-WAY MANUFACTURING CO., INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Year to Date May 31, 2006	May 31, 2005
CASH FLOW FROM OPERATIONS:		
Net income	$ 425,139	$ 492,650
Adjustment to reconcile net income to net cash provided by operating activities:		
Stock compensation expense	2,638	0
(Gain) on sale of equipment	(16,238)	0
Depreciation and amortization	132,266	125,612
Deferred income tax	123,000	262,772
Changes in working capital components:		
(Increase) decrease in:		
Accounts receivable	(689,170)	(122,388)
Inventories	(976,780)	(465,127)
Other current assets	(44,994)	(57,054)
Other	(3,698)	108,883
Increase (decrease) in:		
Accounts payable	168,940	(18,745)
Customer deposits	1,033,180	1,758,302
Accrued expenses	213,437	(32,417)
Net cash provided by operating activities	367,720	2,052,488
CASH FLOW FROM INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(712,427)	(75,330)
Proceeds from sale of property, plant and equipment	82,689	0
Net cash (used in) investing activities	(629,738)	(75,330)

CASH FLOW FROM FINANCING ACTIVITIES:		
Principal payments on line of credit	0	(870,071)
Proceeds from notes payable	1,500,000	1,000,000
Principal payments on long term debt	(91,133)	(85,790)
Loan origination fees paid	(27,070)	(18,550)
Proceeds from the exercises of stock options	23,200	57,050
Net cash provided by financing activities	1,404,997	82,639
Net increase in cash	1,142,979	2,059,797
Cash at beginning of period	1,198,238	116,001
Cash at end of period	$ 2,341,217	$ 2,175,798
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest	$ 169,569	$ 104,980
Income taxes	$ 24,100	$ 12,624

See accompanying notes to condensed consolidated financial statements.

ART'S-WAY MANUFACTURING CO., INC.

NOTES TO CONDENSED CONSOLIDATED 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 six months ended May 31, 2006 are not necessarily indicative of the results for the fiscal year ending November 30, 2006.

2. STOCK OPTIONS

At May 31, 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 six months ended May 31, 2006 totaled $2,638.

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 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 six months ended May 31, 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 May 31, 2005	Six months ended May 31, 2005
Net income, as reported	$ 149,758	$ 492,650
Deduct:		
Total stock-based compensation expense determined under the fair value method for all awards, net of tax effects	($ 1,755)	($ 3,510)
Pro forma net income	$ 148,003	$ 489,140
Pro forma basic earnings per share	.08	.25
Pro forma diluted earnings per share	.08	.25

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

3. INVENTORIES

Major classes of inventory are:	May 31, 2006	November 30, 2005
Raw material	$ 3,629,737	$ 2,820,591
Work-in-process	319,258	455,077
Finished goods	3,697,707	3,394,254
Total	$ 7,646,702	$ 6,669,922
Less inventories classified as noncurrent	136,171	144,871
Inventories, current	$ 7,510,531	$ 6,525,051

4. ACCRUED EXPENSES

Major components of accrued expenses are:	May 31, 2006	November 30, 2005
Salaries, wages and commissions	$ 431,432	$ 371,680
Accrued warranty expense	167,487	131,832
Income taxes	93,431	5,702
Other	257,551	227,250
Total	$ 949,901	$ 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 and six months ended May 31, 2006 and 2005 are as follows:

	Three Months Ended		Six Months Ended	
	May 31, 2006	May 31, 2005	May 31, 2006	May 31, 2005
Balance, beginning	$84,440	$155,934	$131,832	$119,912
Settlements made in cash or in-kind	(36,906)	(224,556)	(147,319)	(248,253)
Warranties issued	119,953	184,615	182,974	244,334
Balance, ending	$167,487	$115,993	$167,487	$115,993

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 will mature 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 May 31, 2006 and November 2005, the Company had no borrowings against the line of credit. 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 the 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 $31,000 and $24,000, for the six months ended May 31, 2006 and 2005, respectively.

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

	May 31, 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)	$ 1,724,904	$ 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)	$ 956,928	$ 974,356
West Bank loan payable in monthly installments of $22,000 including interest at Bank's prime rate plus		

1.0%, due April 30, 2016 (A) (B)	$ 1,493,040	$ 0
State of Iowa Community Development Block Grant promissory notes at zero percent interest, maturity September 2006, with quarterly principal payments of $11,111	$ 11,111	$ 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	$ 5,103	$ 19,663
Total term debt	$ 4,191,086	$ 2,782,219
Less current portion of term debt	$ 254,094	$ 223,946
Term debt, excluding current portion	$ 3,936,992	$ 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 second quarter ended May 31, 2006, the Company did not comply with covenant limitations on capital expenditures and the disposal of assets. The bank waived the limitations.

7. RELATED PARTY TRANSACTIONS

J. Ward McConnell, Jr. owns and operates Adamson Global. During the first six months ended May 31, 2006 Adamson sold Art's-Way Vessels, Inc., certain raw material and equipment for an aggregate price of approximately $171,000. Adamson also purchased pressurized vessels from Art's-Way Vessels, Inc. in the first six months, for an aggregate price of approximately $84,000. 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 three and six months ended May 31, 2006.

	Three Months Ended May 31, 2006		
	Agricultural Products	Pressurized Vessels	Consolidated
Revenue from external customers	$3,301,000	$811,000	$4,112,000
Income from operations	106,000	204,000	310,000
Income before tax	24,000	211,000	235,000
Segment profit	22,000	131,000	153,000
Total Assets	14,512,000	546,000	15,058,000
Capital expenditures	361,000	17,000	378,000
Depreciation & Amortization	69,000	10,000	79,000

	Six Months Ended May 31, 2006		
	Agricultural Products	Pressurized Vessels	Consolidated
Revenue from external customers	$6,929,000	$1,485,000	$8,414,000
Income from operations	584,000	217,000	801,000
Income before tax	433,000	227,000	660,000
Segment profit	284,000	141,000	425,000
Total Assets	14,512,000	546,000	15,058,000
Capital expenditures	681,000	31,000	712,000
Depreciation & Amortization	111,000	21,000	132,000

Item 2

MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

The following discussion and analysis should be read in conjunction with the condensed 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 May 31, 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 2006 consolidated net sales for the six months end were $8,414,000, representing a 14% increase compared to the same period one year ago. A majority of this increase was due to the inclusion of Art's-Way Vessels, Inc.'s, net sales of $1,485,000, for the six months just ended. Art's-Way Vessels, Inc., was acquired October 4, 2005 and therefore was not included in last year's same six month period. Art's-Way Manufacturing had revenues totaling $6,929,000 for the first six months, compared to $7,392,000 for the same period in 2005.

Art's-Way Manufacturing's consolidated gross profit of 32% year to date has remained stable compared to the same period one year ago of 31%. Art's-Way Manufacturing's gross profit is down from 31% to 29% year to date. This slight decline is due to a reduction in sales of grinder mixers which have a slightly higher margin than some of our other product offerings. Art's-Way Vessel's had a gross profit of 45% year to date. When we purchased Art's-Way Vessel's orders that were already booked were at a much lower profit margin than we are currently charging. This, coupled with the additional expenses of getting shop supplies and repairs and maintenance, drove our gross margin down in the first quarter of 2006.

Operating expenses for the six months increased $439,000 compared to 2005. Of this amount $451,000 relates directly to the addition of Art's-Way Vessels.

Engineering expenses were down $79,000 for the six months 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 half of 2006 our overall engineering cost savings was offset by expenses of an engineering consultant, who is helping to bring the export harvester to production and is expected to complete his work by the end of July.

Selling expenses were up for the first six months of 2006 by $50,000 over the same period one year ago. This increase is mainly due to an increase in advertising and show expenses. Advertising expenses were up by approximately $10,000 as we have tried to reach new customers. Show expense was also up by approximately $25,000 due to machine enhancement for show purposes.

Income from operations had decreased year to date from $853,000 in 2005 to $800,000 in 2006. Art's-Way Manufacturing's income from operation was $584,000, representing a $269,000 decrease year to date compared to 2005, which is due to the decrease in sales of 6% year to date compared to 2005 and the slight decrease in our gross profit margin. Art's-Way started fiscal year 2005 with a backlog over a milion dollars, for our new model 5165 grinder mixers. Once we manufactured our first run of the new model our sales increased significantly to fulfill the build up of orders. While sales have decreased from 2005 to 2006 the cause is due to the extaordinary year we had in fiscal year 2005. Art's-Way Vessel's income from operations was $217,000 year to date.

We experienced an increase in interest expense of $52,000 in the first six months of 2006 as a result of a rise in the prime interest rate over the past 18 months and an additional borrowing of $1,500,000 during the second quarter.

The order backlog as of May 31, 2006 was $ 5,790,000 compared to $3,042,000 one year ago. Art's-Way Manufacturing's order backlog as of May 31 was $3,099,000 while Art's-Way Vessel's was $2,691,000. Gehl, one of our main competitors in the grinder mixer market, announced in April, 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

Accounts receivable increased $689,000 during the first six month period. This is due primarily to sales of OEM products.

Our customer deposits also increased by $1,033,00 as our beet programs offer discounts to our customers for making downpayments on their orders.

Our inventory level increased $977,000 over November 2005. This is due to the production of our beet harvesting equipment. We expect to see our inventory levels drop back down by the end of the third quarter when the majority of our beet equipment will have been shipped.

In late 2005 we entered into an agreement to purchase a new Bystronic laser, used to cut metal, which called for three payments totaling approximately $627,000. We made the second and third payments in the first half of 2006.

In April of 2006 we obtained additional long term financing through West Bank of $1,500,000. This money will be used for future acquisitions and asset purchases, and has not been drawn upon to date.

See footnote 6 of the notes to the condensed consolidated financial statements for further 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 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At our annual meeting of stockholders held April 27, 2006, the following individuals were elected to our Board of Directors to hold office until the next annual meeting or until their successors are elected and qualified, with the following votes in favor of election:

	FOR	WITHHELD
David R. Castle	1,717,190	121,974
Fred W. Krahmer	1,716,390	122,774
James Lynch	1,717,171	121,993
Douglas McClellan	1,717,190	121,974
J. Ward McConnell, Jr.	1,717,190	121,974
Marc H. McConnell	1,716,869	122,295
Thomas E. Buffamante	1,717,188	121,976

The stockholders also ratified the selection of McGladrey & Pullen, LLP as independent public accountants for the year ending November 30, 2006.

Total number of shares voted in favor: 1,832,842
Total number of shares voted against: 600
Total number of abstentions: 625
Total number of broker non-votes: 0

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: ______________________
Carrie L. Majeski	Carrie L. Majeski
Interim 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.