

WSI INDUSTRIES, INC.  
Form 10-K  
November 04, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

**[X] ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Fiscal Year Ended August 28, 2016

**[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. **000-00619**

**WSI Industries, Inc.**

(Exact name of registrant specified in its charter)

Minnesota 41-0691607  
(State or other jurisdiction of (I.R.S. Employer

incorporation or organization) Identification No.)

213 Chelsea Road, Monticello, Minnesota 55362  
(Address of principal executive offices)(Zip code)

Issuer's telephone number, including area code: (763) 295-9202

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

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

Common Stock, \$0.10 par value

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

Yes ☐ No ☒

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

Yes ☐ No ☒

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports); and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such filed). Yes ☒ No ☐

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

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

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☒

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant on February 26, 2016 (the business day immediately prior to the end of the registrant's second fiscal quarter) was \$10,802,000 based upon the closing sale price on that date of \$3.70 as reported by The NASDAQ Capital Market. The number of shares of the registrant's common stock, \$0.10 par value, outstanding as of October 17, 2016 was 2,919,500.

#### DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the Proxy Statement for the Company's Annual Meeting of Shareholders to be held on December 22, 2016, which will be filed within 120 days after the end of the fiscal year covered by this report, are incorporated by reference into Part III of this Form 10-K.

## PART I

### Item 1. Description of Business.

WSI Industries, Inc. (the “Company”) makes its periodic and current reports available free of charge as soon as reasonably practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission. These reports can be obtained by contacting the Company through its website at [www.wsiindustries.com](http://www.wsiindustries.com).

#### Overview

The Company was incorporated in Minnesota in 1950 for the purpose of performing precision contract machining for the aerospace, communication, and industrial markets. The major portions of Company revenues are derived from machining work for the aerospace/avionics/defense industries, recreational powersports vehicles (ATV and motorcycle) markets, energy industry, automotive industry and bioscience industry.

Contract manufacturing constitutes the Company’s entire business.

#### **Products and Services**

The Company manufactures metal components in medium to high volumes requiring tolerances as close as one ten-thousandth (.0001) of an inch. These components are manufactured in accordance with customer specifications using materials both purchased by the Company as well as being supplied by our customer.

#### Sales and Marketing

Our mission is to achieve diversified growth through the expansion of our contract machining and complimentary value-add services, as well as growth through partnerships and acquisitions. We have a team of direct sales force personnel that are dedicated to pursuing opportunities to organically grow our business. We also utilize independent sales reps to search out new business where appropriate. Our overall goal is to add core customers that will diversify

the industries that we serve and will eventually become “pillar” accounts that support the overall organization. Our target markets include aerospace, avionics, defense, automotive, recreational powersports, heavy equipment and other industries that outsource machining services and have the need to build long-term relationships with a dependable supplier. We search out these types of customers via a wide variety of methods including prospecting, trade shows and networking with the goal of receiving request for quotes that we can provide proposals on and eventually win new business.

The Company has a reputation as a dependable supplier capable of meeting stringent specifications to produce quality components at high production rates. The Company has demonstrated an ability to develop sophisticated manufacturing processes and controls essential to produce precision and reliability in its products.

## Customers

Sales were made to Polaris Industries, Inc. and related entities in the amount of \$31,526,000, or 90% of total Company revenues, in fiscal 2016.

## Competition

Although there are a large number of companies engaged in machining, the Company believes the number of entities with the technical capability and capacity for producing products of the class and in the volumes manufactured by the Company is relatively small. Competition is primarily based on product quality, service, timely delivery, and price.

## Research and Development; Intellectual Property

We perform research and development for customers on an as requested and program basis for development of conceptual engineering and design activities prior to manufacturing the products. Our research and development activities are machining process oriented and not done towards the development of products. We did not expend significant dollars in 2016 or 2015 on company-sponsored product research and development. Patents and trademarks are not deemed significant to the Company.

## Employees

At August 28, 2016, the Company had 91 full-time employees, none of whom were subject to a union contract. We consider our relationship with our employees to be good.

## Foreign and Domestic Operations and Export Sales

The Company has no operations or any significant sales in any foreign country.

Item 1A. Risk Factors.

In evaluating us as a company, careful consideration should be given to the following risk factors, in addition to the other information included in this Annual Report on Form 10-K. Each of these risk factors could adversely affect our business, operating results and/or financial condition, as well as adversely affect the value of an investment in our common stock. In addition to the following disclosures, please refer to the other information contained in this report, including our consolidated financial statements and the related notes.

**A large percentage of our sales have been made to a small number of customers in a small number of highly competitive industries, and the loss of a major customer would adversely affect us.** In fiscal years 2016, 2015 and 2014, one customer in the recreational vehicle market accounted for 90%, 86% and 80% of our revenue, respectively. If there is a loss of this customer or a significant decline in sales to this customer it could have an adverse effect on our results from operations.

**The economic conditions in the United States and around the world could adversely affect our financial results.** Demand for our services depends upon worldwide economic conditions, including but not limited to overall economic growth rates, consumer spending, oil prices, financing availability, employment rates, interest rates, inflation, consumer confidence, and the profits, capital spending, and liquidity of large OEMs that we serve. A downturn in any of the markets we serve have caused and could continue to cause our OEM customers to reduce ordering levels, resulting in reschedules, program delays or cancelled orders of our services having an adverse effect on our business and our financial results. In addition, some of our customers have their own internal machining capabilities. A downturn in one of their markets could result in them bringing machining services back in house and thus adversely affect our financial results.

**One of our main markets is in the highly regulated energy industry.** The energy industry we serve, and specifically the shale and gas fracturing (“fracking”) business, is controversial from an environmental perspective. Should environmental laws change to limit the fracking industry, it could have an adverse effect on our financial results.

**We operate in the highly competitive and fragmented contract machining industry.** We compete against many contract machining companies. We also compete with OEM in-house operations that are continually evaluating manufacturing products internally against the advantages of outsourcing. We may also be at a competitive disadvantage with respect to price when compared to manufacturers with excess capacity, lower cost structures and availability of lower cost labor. The availability of excess manufacturing capacity of our competitors also creates competitive pressure on price and winning new business. We also face competition from companies that are based in low cost countries. These companies may have lower cost structures and the availability of lower cost labor. To respond to competitive pressures, we may be required to reduce our prices to customers or increase discounts to customers, which would result in lower gross profit margins and decreased revenue. These factors also impact the Company’s ability to obtain additional manufacturing programs and retain our current programs.

**Controlling manufacturing costs is a significant factor in operating results.** The Company’s ability to manage its costs on existing manufacturing programs and its ability to curtail costs and expenses on potential new manufacturing programs could have a significant impact on the Company’s operating results. The Company also faces increasing quality requirements from its customers that could have an impact on the costs to manufacture product.

**Operating results may vary significantly from period to period.** We can experience significant fluctuations in our revenue and operating results. One of the principal factors that contribute to these fluctuations is the significant changes in our customer’s delivery requirements. Results of operations in any period, therefore, should not be considered indicative of the results to be expected for any future period. Significant fluctuations in our revenue and operating results could also impact the Company’s ability to comply with its debt covenants of its credit facilities.

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

**The market price of our common stock has fluctuated significantly in the past and may continue in the future.** The market price of our common stock has been volatile in the past and several factors could cause the price to fluctuate substantially in the future. These factors include quarterly fluctuations in our financial results, customer contract awards, and general economic and political conditions in our various markets. In addition, the stock prices of



small public contract manufacturing companies have experienced significant price and volume fluctuations that often have been unrelated to the operating performance of such companies. This market volatility may adversely affect the market price of our common stock.

**Complying with securities laws and regulations is costly for us.** Changing laws, regulations and standards relating to corporate governance and public disclosure, including regulations promulgated by the SEC and Nasdaq, are creating particular challenges for smaller publicly-held companies like us. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, our efforts to comply with evolving laws, regulations and standards have resulted in, and are likely to continue to result in, increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. In particular, our efforts to comply with Section 404 of the Sarbanes-Oxley Act of 2002 and the related regulations regarding our assessment of our internal control over financial reporting have required, and will continue to require, the expenditure of significant financial and managerial resources. In addition to Sarbanes-Oxley, we also have been and will continue to be required to expend financial and managerial resources to comply with the SEC requirement that mandates that our quarterly and yearly filings with them be in an XBRL readable format as well as requirements related to the Conflict Minerals Reporting as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Item 1B. Unresolved Staff Comments.

Not applicable.

**Item 2. Properties.**

The Company purchased an existing 49,000 square foot facility located in Monticello, Minnesota in May 2004 to house its production and its headquarters. The purchase price was \$1.9 million and was paid for by a combination of cash and debt. In fiscal 2008, the Company commenced an addition to its facility and with its completion in early fiscal 2009 the addition added 12,500 square feet of manufacturing space. In August 2012, the Company announced a second expansion of 47,000 square feet which roughly doubled the amount of manufacturing space the Company had and increased the total facility size to approximately 107,000 square feet. The expansion was completed in fiscal 2013 and cost approximately \$3.8 million which was paid for by a combination of cash on hand and a new mortgage agreement with its bank which was finalized in May 2013.

The new mortgage with its bank was for \$4.2 million, carries an interest rate of 2.843%, requires monthly payments of \$22,964 based on a 20 year amortization schedule and matures on May 8, 2018. The new mortgage satisfied the original mortgage of \$1.1 million and provided the Company \$3.1 million to use toward its building expansion project.

The Company considers its manufacturing equipment, facilities, and other physical properties to be suitable and adequate to meet the requirements of our business.

**Item 3. Legal Proceedings.**

The Company is not a party to any material legal proceedings; we may be subject from time to time to ordinary routine litigation incidental to its business.

**Item 4. Mine Safety Disclosure**

Not applicable.

## PART II

### Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

The common stock of the Company is traded on The NASDAQ Capital Market of the NASDAQ Stock Market LLC under the symbol "WSOI."

As of October 27, 2016 there were 297 shareholders of record of the Company's common stock.

The following table sets forth, for the periods indicated, the high and low closing sales price information for our common stock as reported by the Nasdaq Capital Market.

	Stock Price	
	High	Low
FISCAL 2016:		
First quarter	\$5.50	\$4.24
Second quarter	4.46	3.50
Third quarter	3.99	2.91
Fourth quarter	3.66	2.77
FISCAL 2015:		
First quarter	\$7.45	\$5.96
Second quarter	6.68	5.51
Third quarter	6.55	5.68
Fourth quarter	6.50	5.20

In the first two quarters of fiscal 2016 and all of fiscal 2015, the Company paid a quarterly cash dividend of \$.04 per share in each quarter. The Company discontinued its quarterly dividend program in March of 2016.

The following table sets forth information regarding our equity compensation plans in effect as of August 28, 2016. Each of our equity compensation plans is an “employee benefit plan” as defined by Rule 405 of Regulation C of the Securities Act of 1933.

Equity Compensation Plan Information

Plan category	Number of shares of common stock to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of shares of common stock remaining available for future issuance under equity compensation plans (excluding securities reflected in the first column)
Equity compensation plans approved by shareholders:			
2005 Stock Plan	415,001	\$ 5.35	227,882
Total	415,001	\$ 5.35	227,882

There are no outstanding equity compensation plans not approved by shareholders.

The Company made no repurchases of its common stock in fiscal year 2016.

Item 6. Selected Financial Data

Not applicable.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Critical Accounting Policies and Estimates:

Management's Discussion and Analysis of Financial Condition and Results of Operations discuss our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities.

We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the result of which forms the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Results may differ from these estimates due to actual outcomes being different from those on which we based our assumptions. The estimates and judgments utilized are reviewed by management on an ongoing basis and by the audit committee of our board of directors at the end of each quarter prior to the public release of our financial results. We made no significant changes to our critical accounting policies during fiscal 2016.

**Application of Critical Accounting Policies:**

*Excess and Obsolete Inventory:*

Inventories, which are composed of raw materials, work in process and finished goods, are valued at the lower of cost or market by comparing the cost of each item in inventory to its most recent sales price or sales order price. Inventory cost is adjusted down for any excess cost over net realizable value of inventory components.

In addition, the Company determines whether its inventory is obsolete by analyzing the sales history of its inventory, sales orders on hand and indications from the Company's customers as to the future of various parts or programs. If, in the Company's determination, the inventory value has become impaired, the Company adjusts the inventory value to the amount the Company estimates as the ultimate net realizable value for that inventory. Actual customer requirements in any future periods are inherently uncertain and thus may differ from our estimates. The Company performs its lower of cost or market testing, as well as its excess or obsolete inventory analyses, quarterly.

The Company has no specific timeline to dispose of its remaining obsolete inventory and intends to sell this obsolete inventory from time to time, as market conditions allow.

*Goodwill Impairment:*

The Company evaluates the valuation of its goodwill according to the provisions of Accounting Standards Codification ("ASC") 350 to determine if the current value of goodwill has been impaired. The Company believes that its stock price is not necessarily an indicator of the Company's value given its limited trading volume and its wide price fluctuations. The Company has also adopted Accounting Standard Update (ASU) No. 2011-08, *Intangibles—Goodwill and Other (Topic 350)*. With ASU No. 2011-08, an entity is given the option to make a qualitative evaluation of goodwill impairment to determine whether it should calculate the fair value of its reporting unit. In the fiscal 2016 fourth quarter, the Company made its qualitative evaluation of its goodwill considering, among other things, the overall macroeconomic conditions, industry and market considerations, overall financial performance and other relevant company specific events. Based on this qualitative evaluation, the Company concluded that it was more likely than not that its goodwill was not impaired and that it wasn't required to calculate the fair value of its reporting unit. If the Company has changes in events or circumstances, including reductions in anticipated cash flows generated by its operations, goodwill could become impaired which would result in a charge to earnings.

*Deferred Taxes:*

The Company accounts for income taxes using the liability method. Deferred income taxes are provided for temporary differences between the financial reporting and tax bases of assets and liabilities. A deferred tax valuation allowance is set up should the realization of any deferred taxes become less likely than not to occur. The valuation allowance is analyzed periodically by the Company and may result in income tax expense being different than statutory rates. The Company established a valuation allowance in fiscal 2016 as it believes it is more likely than not that it will not fully realize the benefit of certain of its tax assets. Currently, the Company's deferred tax assets consists primarily of the temporary accruals that will reverse in future years as well as tax credits.

*Revenue Recognition:*

The Company considers its revenue recognition policy to fall under the guidance of FASB's conceptual framework for revenue recognition. The Company recognizes revenue only after: (a) The Company has received a purchase order identifying price and delivery terms or services to be rendered; (b) shipment has occurred, or in the case of services, after the service has been completed; (c) the Company's price is fixed as evidenced by the purchase order; and (d) collectability is reasonably assured. The Company continually monitors its accounts receivable for any delinquent or slow paying accounts. The Company believes that based upon its past history with minimal bad debt write-offs, that all accounts are collectible upon shipment or delivery of services. Credit losses from customers have been minimal and within management's expectations. Based on management's evaluation of uncollected accounts receivable, bad debts are provided for on the allowance method. Accounts are considered delinquent if they are 120 days past due. If an uncollectible account should arise during the year, it would be written-off at the point it was determined to be uncollectible. The Company mitigates its credit risk by performing periodic credit checks and actively pursuing past due accounts. The Company refers to "net sales" in its consolidated statements of operations as the Company's sales are sometimes reduced by product returned by its customers.

**Liquidity and Capital Resources:**

The Company's net working capital at the end of fiscal 2016 was \$7,081,000 as compared to \$8,828,000 at the end of fiscal 2015. The decrease was due in large measure to the Company being required by its bank to keep \$1,250,000 in a deposit account maintained by the bank. Since the Company has no right of withdrawal, the restricted cash is classified as a long-term asset and therefore not an element of working capital. The ratio of current assets to current liabilities increased to 2.86 to 1.0 at August 28, 2016 from 2.79 to 1.0 as both current assets and current liabilities decreased by roughly the same percentages which led to the small increase. The Company generated \$2,978,000, \$3,241,000 and \$3,925,000 in cash from operations in fiscal 2016, 2015 and 2014, respectively.

In fiscal 2016 and fiscal 2015, additions to property, plant and equipment either by cash or financing were \$392,000 and \$1,584,000, respectively. In fiscal 2015, of the \$1,584,000 in additions, \$1,392,000 was acquired using financing arrangements.



In fiscal 2015, the Company added three milling machines in the Company's third quarter for a new program in its recreational powersports business. There were no major pieces of equipment acquired during fiscal 2016 and 2014.

At August 26, 2016, the Company amended and modified its revolving loan and term loan agreements with its bank. Under the revolving loan agreement the Company can borrow up to \$1 million in revolving loans. Both agreements expire on February 28, 2017 and are collateralized by all assets of the Company. The revolving loan agreement carries an interest rate of LIBOR plus 2%. Both agreements also contain restrictive provisions requiring a minimum year-to-date earnings before interest, taxes, depreciation and amortization (EBITDA) measured quarterly, a minimum liquidity, a maximum debt to tangible net worth ratio, as well as a debt service coverage ratio. In addition, the Company is required to keep \$1,250,000 in a deposit account maintained by the bank. Since the Company has no right of withdrawal, and the account is to serve as collateral for outstanding debt obligations, restricted cash has been excluded from cash and cash equivalents. No balances were owed at August 28, 2016 and August 30, 2015 on the credit line.

The Company's total debt was \$8,343,000 at August 28, 2016 which consisted of a mortgage on its building of \$3,676,000 and debt secured by production equipment of \$4,667,000. Current maturities of long-term debt at August 28, 2016 consist of \$1,386,000 due on equipment related debt and \$172,000 on its building related debt. During fiscal 2016, the Company made principal payments on its debt of \$1,527,000. It is management's belief that the combination of its current cash balance, its internally generated funds, as well as its revolving line of credit will be sufficient to enable the Company to meet its financial requirements during fiscal 2017.

### **Results of Operations:**

The Company's sales decreased 18% in fiscal 2016 as compared to increases of 1% in fiscal 2015 and 26% fiscal 2014, respectively. Net sales in fiscal 2016 were approximately \$35.2 million as compared to \$43.0 million in fiscal 2015 and \$42.7 million in fiscal 2014.

Sales in fiscal 2016 decreased 18% as compared to the prior two fiscal years which experienced increases of 1% and 26%, respectively. In fiscal 2016, sales were negatively affected by a 15% decrease in sales in the recreational powersports business as well as an 88% decrease in the level of energy business. These two declining factors were partially offset by an increase in the Company's automotive business. In prior fiscal years 2015 and 2014, sales increases in recreational powersports business and automotive market were partially offset by decreases in the energy business. Sales to the recreational powersports vehicle market totaled approximately 90%, 86% and 80% of total sales in fiscal 2016, 2015 and 2014, respectively. Sales to the energy industry totaled approximately 1%, 7% and 12% of sales in fiscal 2016, 2015 and 2014, respectively. Sales to the aerospace/avionics/defense markets totaled approximately 5% of total sales in each of fiscal 2016, 2015 and 2014, respectively. Sales to the automotive industries totaled 3% and 1% in fiscal 2016 and 2015, respectively. Sales to the bioscience and other industries amounted to approximately 1% - 2% of total sales in each of fiscal years 2014 - 2016.



The following is a reconciliation of sales by major market:

	Fiscal 2016	Fiscal 2015	Fiscal 2014
Recreational vehicle	\$31,526,000	\$36,937,000	\$34,244,000
Aerospace and defense	1,767,000	2,103,000	2,273,000
Energy	389,000	3,128,000	5,308,000
Automotive	910,000	389,000	95,000
Biosciences & Other	624,000	426,000	794,000
	\$35,216,000	\$42,983,000	\$42,714,000

In fiscal 2016, sales in the recreational powersports business decreased 15% with a decrease in one product line due primarily to the Company's main customer dual sourcing that product line, offset by increases in another product line due to increased demand. The increase in sales in the recreational vehicle market in fiscal 2015 resulted from the overall increase in demand from the Company's largest customer for the parts the Company supplies as well as new programs that had been awarded and started in fiscal 2015.

Sales from the Company's aerospace and defense markets were down 16% in fiscal 2016 and 7% in fiscal 2015. The Company believes the year to year changes are attributable to a general softening in demand for the products that the Company supplies to its customers.

Sales from the Company's energy business continued to decrease in fiscal 2016 with year over year sales down 88%. In fiscal 2015, sales were down 41% as compared to the prior year. All of the Company's customers in the energy market have their own internal machining capabilities and therefore the Company's sales are generated primarily when their customers have limited machining capacity and need to outsource. Circumstances such as a low price for oil will tend to drive machining in house and therefore lower the Company's sales. This fact tends to create volatility in the Company's sales to the energy industry on top of an energy market that has volatile tendencies.

Sales to the Company's automotive business increased 134% in fiscal 2016 and 309% in fiscal 2015. Much of the sales increase in fiscal 2016 came from programs that appear to be sporadic in nature, and it is unclear to the Company how much of the existing automotive business will repeat in future periods.

Sales to the Company's bioscience and other markets are relatively small as sales from these markets only amount to approximately 1% - 2% of total sales. The fluctuations in these markets have been minimal in the last two fiscal years.

The Company's gross margin decreased to 8.3% in fiscal 2016 from 10.0% in fiscal 2015 while fiscal 2014 gross margins were at 12.6%. The decreases in both fiscal 2016 and 2015 were attributable to lower levels of business which led to excess capacity and a higher percentage of sales in fixed costs such as depreciation. The lower level of sales also caused manufacturing inefficiencies which created a drag on gross margins.

The Company's margins can also vary widely depending on whether the Company purchases its raw material or whether raw material is provided or consigned to them by its customer. Generally, the Company will experience a higher gross margin percentage of sales where material has been consigned or provided by the customer. Therefore, in any particular quarter or year, the Company's gross margin can vary depending on the mix of parts sold and whether those parts had material that was purchased or had material that had been consigned to them.

No significant sales of obsolete items occurred in fiscal years 2014 through 2016 and, correspondingly, no significant gross margin was recognized.

Selling and administrative expense has remained steady from fiscal 2014 through fiscal 2016 with \$3,012,000 incurred in fiscal 2016 and \$2,972,000 and \$3,077,000 spent in fiscal 2015 and 2104, respectively. Any change from year to year results primarily from fluctuations in incentive compensation and profit sharing expense, if any, as well as overall payroll costs. The Company also incurred professional service expense in each of those three fiscal years in connection with its analysis of internal controls over financial reporting as required by the Sarbanes-Oxley Act as well as requirements related to Conflict Minerals Reporting as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Interest expense in fiscal 2016 decreased \$38,000 to \$308,000 from fiscal 2015, due primarily to a lower average level of debt as well as a lower overall interest rate. Interest expense in fiscal 2015 decreased \$64,000 to \$346,000 from fiscal 2014 also due primarily to those same reasons.

The Company's effective tax rate in its year ended August 28, 2016 was a negative (146.2%) as compared to 1.5% in the year ended August 30, 2015 and 36.0% in the year ended August 31, 2014, respectively. During the current fiscal year, the Company hired an outside consulting firm to conduct an analysis to determine if certain activities the Company performs qualifies for the Research & Development tax credit (R&D credit) as defined by Internal Revenue Code Section 41. As a result of the analysis, the Company determined that it is performing activities that qualify for the R&D credit, and during the fiscal year 2016 recognized tax benefits related to R&D tax credits from several prior years which lowered the overall effective tax rate. In addition, during the Company's fiscal second quarter, the Federal R&D tax credit law was retroactively renewed for calendar year 2015 and also made permanent going forward. Since for calendar year 2015 the law was enacted retroactively, any effects are recognized as a component of income tax expense or benefit from continuing operations in the financial statements in the interim period that the law was enacted, which in this case was the Company's fiscal 2016 second quarter. The Company believes that it has recognized R&D tax benefits for all prior years to the extent possible.

#### Caution Regarding Forward-Looking Statements

Statements included in this Management's Discussion and Analysis of Financial Condition and Results of Operations elsewhere in this Annual Report on Form 10-K, in future filings by the Company with the Securities and Exchange Commission, in the Company's press releases and in oral statements made with the approval of an authorized executive officer which are not historical or current facts are "forward-looking statements." These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made and are not predictions of actual future results. Forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated

or projected. These risks and uncertainties are described above under Item 1A. Risk Factors.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

**Item 8. Financial Statements and Supplementary Data.**

See Consolidated Financial Statements section of this Annual Report on Form 10-K beginning on page 22, attached hereto, which consolidated financial statements are incorporated herein by reference.

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

**Disclosure Controls and Procedures**

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended. Based on that evaluation, Benjamin T. Rashleger, the chief executive officer, and Paul D. Sheely, the chief financial officer, have concluded that as of August 28, 2016 our disclosure controls and procedures were effective.

**Changes in Internal Controls over Financial Reporting**

There have been no changes in internal control over financial reporting that occurred during the fourth quarter ended August 28, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Management's Report on Internal Control Over Financial Reporting**

The management of the Company is responsible for the preparation of the financial statements and related financial information appearing in this Annual Report on Form 10-K. The financial statements and notes have been prepared in conformity with accounting principles generally accepted in the United States of America. The management of the Company also is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. A company's internal control over financial reporting is defined as a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Management, including the chief executive officer and chief financial officer, does not expect that the Company's internal controls will prevent all error and all fraud. Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable, not absolute, assurance that the objectives of the control system are met and may not prevent or detect misstatements. Further, over time control may become inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate.

The Company's management hired an outside consulting firm to assist it in the evaluation of the effectiveness of the Company's internal control over financial reporting. The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of August 28, 2016 based upon the framework in Internal Control –Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on the results of that evaluation, our management has concluded that, as of August 28, 2016, the Company's internal control over financial reporting was effective.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's independent registered public accounting firm pursuant to rules of the Securities and Exchange Commission.

Item 9B. Other Information.

None.



### PART III

Pursuant to General Instruction E (3), the Company omits Part III, Items 10, 11, 12, 13 and 14, as a definitive proxy statement will be filed with the Commission pursuant to Regulation 14(a) within 120 days after August 28, 2016 and such information required by such items is incorporated herein by reference from the proxy statement.

### PART IV

Item 15. Exhibits.

(a) Documents filed as part of this report.

1. Consolidated Financial Statements: Reference is made to the Index to Consolidated Financial Statements (page 20) hereinafter contained for all Consolidated Financial Statements.

2. Exhibits.

Exhibit No.	Description
3.1	Restated Articles of Incorporation of WSI Industries, Inc. Incorporated by reference from Exhibit 3 of the Registrant's Form 10-Q for the quarter ended November 29, 1998.
3.2	Restated and Amended Bylaws, as amended through January 6, 2005. Incorporated by reference from Exhibit 3.2 of the Registrant's Form 10-K for the year ended August 28, 2005.
10.1	WSI Industries, Inc. 2005 Stock Plan. Incorporated by reference from Exhibit 4.1 of the Registrant's Registration Statement on Form S-8 (SEC File No. 333-203225).
10.2	Form of Restricted Stock Award Agreement under the Company's 2005 Stock Plan. Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K dated February 23, 2007.
10.3	Form of Non-Qualified Stock Option and Stock Appreciation Rights Agreement under the Company's 2005 Stock Plan. Incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K dated February 23, 2007.
10.4	

Form of Restricted Stock Bonus Award Agreement under the Company's 2005 Stock Plan. Incorporated by reference to Exhibit 10.5 to the Registrant's Annual Report on Form 10-K for the year ended August 30, 2009.

Exhibit No.	Description
10.5	Board of Directors Retirement Program dated June 25, 1982. Incorporated by reference from Exhibit 10.12 of the Registrant's Form 10-K for the year ended August 25, 2002.
10.6	Employment (change in control) Agreement between Paul D. Sheely and Registrant dated January 11, 2001 incorporated by reference from Exhibit 10.2 of the Registrant's Form 10-Q for the quarter ended May 27, 2001.
10.7	Amendment No. 1 to Employment (change in control) Agreement between Paul D. Sheely and Registrant dated November 1, 2002. Incorporated by reference from Exhibit 10.11 of the Registrant's Form 10-K for the year ended August 25, 2002.
10.8	Second Amendment to Employment (Change in Control) Agreement dated December 29, 2008 by and between WSI Industries, Inc. and Paul D. Sheely. Incorporated by reference to Exhibit 10.3 to the Registrant's Form 8-K dated December 29, 2008.
10.9	Severance Letter Agreement dated October 7, 2009 by and between WSI Industries, Inc. and Paul D. Sheely. Incorporated by reference to Exhibit 10.5 to the Registrant's Form 8-K dated October 7, 2009.
10.10	Employment Offer Letter dated October 5, 2009 by WSI Industries, Inc. to Benjamin Rashleger. Incorporated by reference to Exhibit 10.1 to the Registrant's Form 8-K dated October 7, 2009.
10.11	Employment (Change In Control) Agreement dated October 12, 2009 by and between WSI Industries, Inc. and Benjamin Rashleger. Incorporated by reference to Exhibit 10.2 to the Registrant's Form 8-K dated October 7, 2009.
10.12	Form of Restrictive Covenant Agreement by and between WSI Industries, Inc. and Michael J. Pudil, Paul D. Sheely and Benjamin Rashleger. Incorporated by reference to Exhibit 10.3 to the Registrant's Form 8-K dated October 7, 2009.
10.13	Loan agreement dated February 1, 2011 between WSI Industries, Inc., Taurus Numeric Tool, Inc., WSI Rochester, Inc., and M&I Marshall & Ilsley Bank (now BMO Harris Bank N.A.). Incorporated by reference to Exhibit 10.1 of the Registrant's Form 10-Q for the quarter ended February 27, 2011.

Exhibit No.	Description
10.14	Amended and Restated Revolving Credit Promissory Note dated February 1, 2011 in the principal amount of \$1,000,000 by WSI Industries, Inc. in favor of M&I Marshall & Ilsley Bank (now BMO Harris Bank N.A.). Incorporated by reference from Exhibit 10.24 of the Registrant's Form 10-K for the year ended August 28, 2011.
10.15	Amended and Restated Security Agreement dated February 1, 2011 by and between WSI Industries, Inc. and M&I Marshall & Ilsley Bank (now BMO Harris Bank N.A.). Incorporated by reference from Exhibit 10.25 of the Registrant's Form 10-K for the year ended August 28, 2011.
10.16	Amended and Restated Security Agreement dated February 1, 2011 by and between Taurus Numeric Tool, Inc. and M&I Marshall & Ilsley Bank (now BMO Harris Bank N.A.). Incorporated by reference from Exhibit 10.26 of the Registrant's Form 10-K for the year ended August 28, 2011.
10.17	Amended and Restated Security Agreement dated February 1, 2011 by and between WSI Rochester, Inc. and M&I Marshall & Ilsley Bank (now BMO Harris Bank N.A.). Incorporated by reference from Exhibit 10.27 of the Registrant's Form 10-K for the year ended August 28, 2011.
10.18	Guaranty dated February 1, 2011 by and WSI Rochester, Inc. and M&I Marshall & Ilsley Bank (now BMO Harris Bank N.A.). Incorporated by reference from Exhibit 10.28 of the Registrant's Form 10-K for the year ended August 28, 2011.
10.19	Guaranty dated February 1, 2011 by and between Taurus Numeric Tool, Inc. and M&I Marshall & Ilsley Bank (now BMO Harris Bank N.A.). Incorporated by reference from Exhibit 10.29 of the Registrant's Form 10-K for the year ended August 28, 2011.
10.20	First Amendment and Modification of Revolving Line of Credit Promissory Note, Loan Agreement and Reaffirmation of Guaranties dated February 1, 2012 and incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K dated February 15, 2012.
10.21	Second Amendment and Modification of Revolving Line of Credit Promissory Note, Loan Agreement and Reaffirmation of Guaranties, and Amended and Restated Revolving Credit Promissory Note dated January 30, 2013 by and among WSI Industries, Inc., WSI Industries, Co., WSI Rochester, Inc. and BMO Harris Bank, N.A. Incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K dated January 30, 2013.

Exhibit No.	Description
10.22	Amended and Restated Real Estate Mortgage, Security Agreement and Financing Statement dated May 8, 2013 between WSI Industries, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K dated May 8, 2013.
10.23	Amended and Restated Promissory Note in the principal amount of up to \$4,200,000 dated May 8, 2013 between WSI Industries, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.2 of the Registrant's Form 8-K dated May 8, 2013.
10.24	Term Loan Agreement dated May 8, 2013 between WSI Industries, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.3 of the Registrant's Form 8-K dated May 8, 2013.
10.25	Assignment of Leases and Rents dated May 8, 2013 between WSI Industries, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.4 of the Registrant's Form 8-K dated May 8, 2013.
10.26	Guaranty dated May 8, 2013 between WSI Rochester, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.5 of the Registrant's Form 8-K dated May 8, 2013.
10.27	Guaranty dated May 8, 2013 between WSI Industries, Co. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.6 of the Registrant's Form 8-K dated May 8, 2013.
10.28	First Amendment to Term Loan Agreement dated January 31, 2014 between WSI Industries, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.1 of the Registrant's Form 8-K dated January 31, 2014.
10.29	Third Amendment to Revolving Loan Agreement and First Amendment to Amended and Restated Revolving Credit Promissory Note dated January 31, 2014 between WSI Industries, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.2 of the Registrant's Form 8-K dated January 31, 2014.
10.30	Acknowledgement of Guarantors dated January 31, 2014 between WSI Rochester, Inc., WSI Industries, Co. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.3 of the Registrant's Form 8-K dated January 31, 2014.
10.31	Fourth Amendment to Revolving Loan Agreement and First Amendment to Amended and Restated Revolving Credit Promissory Note dated January 26, 2015 between WSI Industries, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.2 of the Registrant's Form 8-K dated January 26, 2015.

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Exhibit No. Description

10.32	Acknowledgement of Guarantors dated January 26, 2015 between WSI Rochester, Inc., WSI Industries, Co. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.3 of the Registrant's Form 8-K dated January 26, 2015.
10.33	Fifth Amendment to Revolving Loan Agreement and Second Amendment to Term Loan Agreement and Amended and Restated Revolving Credit Promissory Note dated November 27, 2015 between WSI Industries, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibits 10.1, 10.2 and 10.3 of the Registrant's Form 8-K dated November 27, 2015.
10.34	Acknowledgement of Guarantors dated November 27, 2015 between WSI Rochester, Inc., WSI Industries, Co. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.4 of the Registrant's Form 8-K dated November 27, 2015.
10.35	Sixth Amendment to Revolving Loan Agreement and Third Amendment to Term Loan Agreement dated February 28, 2016 between WSI Industries, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibits 10.1 and 10.2 of the Registrant's Form 8-K dated February 28, 2016.
10.36	Acknowledgement of Guarantors dated February 28, 2016 between WSI Rochester, Inc., WSI Industries, Co. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.3 of the Registrant's Form 8-K dated February 28, 2016.
10.37	Seventh Amendment to Revolving Loan Agreement and Fourth Amendment to Term Loan Agreement dated August 26, 2016 between WSI Industries, Inc. and BMO Harris Bank N.A. Incorporated by reference from Exhibits 10.1 and 10.2 of the Registrant's Form 8-K dated August 26, 2016.
10.38	Acknowledgement of Guarantors dated August 26, 2016 between WSI Rochester, Inc., WSI Industries, Co. and BMO Harris Bank N.A. Incorporated by reference from Exhibit 10.3 of the Registrant's Form 8-K dated August 26, 2016.
14.1	Code of Ethics & Business Conduct adopted by WSI Industries, Inc. on October 29, 2003. Incorporated by reference to Exhibit 14.1 of the Registrant's Annual Report on Form 10-K for the year ended August 31, 2003.
21.1	Subsidiaries of the Registrant.
23.1	Consent of Schechter Dokken Kanter Andrews & Selcer Ltd.
31.1	Certification of Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) of the Exchange Act.
31.2	Certification of Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) of the Exchange Act.
32.1	Certification pursuant to 18 U.S.C. §1350.
101.INS**	XBRL Instance
101.SCH**	XBRL Taxonomy Extension Schema

101.CAL\*\* XBRL Taxonomy Extension Calculation

101.DEF\*\* XBRL Taxonomy Extension Definition

101.LAB\*\* XBRL Taxonomy Extension Labels

101.PRE\*\* XBRL Taxonomy Extension Presentation

## SIGNATURES

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

WSI INDUSTRIES, INC.

BY: */s/ Benjamin T. Rashleger*  
Benjamin T. Rashleger  
Chief Executive Officer  
(principal executive officer)

BY: */s/ Paul D. Sheely*  
Paul D. Sheely  
Vice President, Finance, Chief Financial Officer and Treasurer  
(principal financial and accounting officer)

DATE: November 4, 2016

Each person whose signature appears below hereby constitutes and appoints Benjamin T. Rashleger and Paul D. Sheely, and each of them, as his true and lawful attorney-in-fact and agent, with full power of substitution, to sign on his behalf, individually and in each capacity stated below, all amendments to this Form 10-K and to file the same, with all exhibits thereto and any other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully and to all intents and purposes as each might or could do in person, hereby ratifying and confirming each act that said attorneys-in-fact and agents may lawfully do or cause to be done by virtue thereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

Signature	Title	Date
<i>/s/ Benjamin T. Rashleger</i>	President, Chief Executive Officer and Director	November 4, 2016



Benjamin T. Rashleger

<i>/s/ Michael J. Pudil</i>	Director	November 4, 2016
Michael J. Pudil		

<i>/s/ Thomas C. Bender</i>	Director	November 4, 2016
Thomas C. Bender		

<i>/s/ Burton F. Myers II</i>	Director	November 4, 2016
Burton F. Myers II		

<i>/s/ James D. Hartman</i>	Director	November 4, 2016
James D. Hartman		

<i>/s/ Jack R. Veach</i>	Director	November 4, 2016
Jack R. Veach		

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

WSI Industries, Inc.

Monticello, Minnesota

We have audited the consolidated balance sheets of WSI Industries, Inc. and Subsidiaries as of August 28, 2016 and August 30, 2015 and the related consolidated statements of income, stockholders' equity and cash flows for each of the years in the three-year period ended August 28, 2016. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of WSI Industries, Inc. and Subsidiaries as of August 28, 2016 and August 30, 2015, and the results of its operations and its cash flows for each of the years in the three-year period ended August 28, 2016, in conformity with United States generally accepted accounting principles.

*/s/ Schechter Dokken Kanter*  
Andrews & Selcer Ltd.

Minneapolis, Minnesota  
November 4, 2016

**WSI INDUSTRIES, INC.  
AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS  
AUGUST 28, 2016 AND AUGUST 30, 2015**

	2016	2015
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$3,739,324	\$4,149,645
Accounts receivable, less allowance for doubtful accounts of \$10,074	3,823,545	2,985,256
Inventories (Note 2)	3,047,512	5,951,706
Prepaid and other current assets	286,251	542,064
Deferred tax assets (Note 6)	-	117,904
Total current assets	10,896,632	13,746,575
Property, plant, and equipment, at cost:		
Land	819,000	819,000
Building and improvements	6,288,811	6,256,562
Machinery and equipment	21,466,372	21,634,723
Less accumulated depreciation	(17,113,365)	(15,809,385)
Total property, plant, and equipment	11,460,818	12,900,900
Restricted cash (Note 3)	1,250,000	-
Other assets (Note 10):		
Goodwill and other assets	2,375,136	2,379,147
	\$25,982,586	\$29,026,622
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Trade accounts payable	\$1,729,251	\$2,793,948
Accrued compensation and employee withholdings	394,657	388,770
Other accrued expenses	133,477	208,364
Current portion of long-term debt (Note 3)	1,557,801	1,527,688
Total current liabilities	3,815,186	4,918,770
Long-term debt, less current portion (Note 3)	6,785,432	8,342,926
Deferred tax liabilities (Note 6)	1,402,735	1,890,194

Stockholders' equity (Note 5):

Common stock, par value \$.10 a share; authorized 10,000,000 shares; issued and outstanding 2,919,500 shares	291,950	291,950
Capital in excess of par value	3,848,484	3,683,471
Retained earnings	9,838,799	9,899,311
Total stockholders' equity	13,979,233	13,874,732
	\$25,982,586	\$29,026,622

See notes to consolidated financial statements.

**WSI INDUSTRIES, INC.  
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**  
**YEARS ENDED AUGUST 28, 2016, AUGUST 30, 2015 AND AUGUST 31, 2014**

	2016	2015	2014
Net sales (Note 8)	\$35,215,984	\$42,982,937	\$42,714,240
Cost of products sold	32,291,726	38,658,881	37,319,981
Gross margin	2,924,258	4,324,056	5,394,259
Selling and administrative expense	3,011,651	2,971,576	3,076,663
Interest and other income	(21,606 )	(5,601 )	(5,404 )
Interest expense	308,461	346,297	410,165
	3,298,506	3,312,272	3,481,424
Income (loss) before income taxes	(374,248 )	1,011,784	1,912,835
Income tax expense (benefit) (Note 6)	(547,296 )	14,716	688,711
Net income	\$173,048	\$997,068	\$1,224,124
Basic earnings per share	\$.06	\$.34	\$.42
Diluted earnings per share	\$.06	\$.34	\$.41
Cash dividend per share	\$.08	\$.16	\$.16
Weighted average number of common shares outstanding, basic	2,919,500	2,910,426	2,899,576
Weighted average number of common shares outstanding, diluted	2,928,126	2,960,398	2,964,384

See notes to consolidated financial statements.

**WSI INDUSTRIES, INC.  
AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**
**YEARS ENDED AUGUST 28, 2016, AUGUST 30, 2015 AND AUGUST 31, 2014**

	Common Stock Shares	Amount	Capital in Excess of Par Value	Deferred Compensation	Retained Earnings	Total Stockholders' Equity
Balance at August 25, 2013	2,903,852	\$290,384	\$3,314,193	\$ (73,874 )	\$8,607,227	\$12,137,930
Net income	-	-	-	-	1,224,124	1,224,124
Restricted stock grants	197	20	1,230	(1,250 )	-	-
Restricted stock vesting	-	-	(50,480 )	50,480	-	-
Stock option compensation	-	-	241,662	-	-	241,662
Restricted stock grants payment of withholding taxes	(3,532 )	(353 )	(21,656 )	-	-	(22,009 )
Exercise of stock options and appreciation rights and payment of withholding taxes	8,376	838	(4,499 )	-	-	(3,661 )
Dividends paid	-	-	-	-	(463,771 )	(463,771 )
Balance at August 31, 2014	2,908,893	\$290,889	\$3,480,450	\$ (24,644 )	\$9,367,580	\$13,114,275
Net income	-	-	-	-	997,068	997,068
Restricted stock grants	54	6	323	(329 )	-	-
Restricted stock vesting	-	-	(24,973 )	24,973	-	-
Stock option compensation	-	-	235,208	-	-	235,208
Restricted stock grants payment of withholding taxes	(504 )	(51 )	(2,863 )	-	-	(2,914 )
Exercise of stock options and appreciation rights and payment of withholding taxes	11,057	1,106	(4,674 )	-	-	(3,568 )
Dividends paid	-	-	-	-	(465,337 )	(465,337 )
Balance at August 30, 2015	2,919,500	\$291,950	\$3,683,471	\$ -	\$9,899,311	\$13,874,732
Net income	-	-	-	-	173,048	173,048
Stock option compensation	-	-	165,013	-	-	165,013
Dividends paid	-	-	-	-	(233,560 )	(233,560 )
Balance at August 28, 2016	2,919,500	\$291,950	\$3,848,484	\$ -	\$9,838,799	\$13,979,233

See notes to consolidated financial statements.



**WSI INDUSTRIES, INC.  
AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS  
YEARS ENDED AUGUST 28, 2016, AUGUST 30, 2015 AND AUGUST 31, 2014**

	2016	2015	2014
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 173,048	\$ 997,068	\$ 1,224,124
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization of property and equipment	1,832,393	1,986,513	2,223,946
Amortization	4,011	4,010	4,011
Net tax benefits related to share based compensation	-	(15,885 )	-
Gain on sale of property, plant and equipment	(15,000 )	-	-
Deferred taxes	(369,555 )	(98,553 )	684,071
Stock option compensation	165,013	235,208	241,662
Changes in assets and liabilities:			
Decrease (increase) in:			
Accounts receivable	(838,289 )	2,978,242	(645,213 )
Inventories	2,904,194	(2,184,679 )	(487,521 )
Prepaid and other current assets	255,813	(314,532 )	82,783
Increase (decrease) in accounts payable and accrued expenses	(1,133,697 )	(346,849 )	598,055
Net cash provided by operating activities	2,977,931	3,240,710	3,925,918
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Proceeds from sales of equipment	15,000	-	-
Additions to property, plant, and equipment	(392,311 )	(192,009 )	(228,747 )
Net cash used in investing activities	(377,311 )	(192,009 )	(228,747 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Payment of long-term debt	(1,527,381 )	(1,691,560 )	(1,920,021 )
Net tax benefits related to share based compensation	-	15,885	-
Restricted cash requirement	(1,250,000 )	-	-
Issuance of common stock	-	8,520	13,840
Dividends paid	(233,560 )	(465,337 )	(463,772 )
Net cash used in financing activities	(3,010,941 )	(2,132,492 )	(2,369,953 )
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>(410,321 )</b>	<b>916,209</b>	<b>1,327,218</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR</b>	<b>4,149,645</b>	<b>3,233,436</b>	<b>1,906,218</b>
<b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>	<b>\$3,739,324</b>	<b>\$4,149,645</b>	<b>\$3,233,436</b>

SUPPLEMENTAL CASH FLOW INFORMATION:

Cash paid during the year for:

Interest	\$309,357	\$346,604	\$408,492
Payroll withholding taxes in cashless stock option exercise	-	30,887	39,509
Income taxes	-	468,735	5,404
Noncash investing and financing activities:			
Acquisition of machinery through debt	-	1,391,890	-
Cash received during the year for income tax refunds	398,750	-	-

See notes to consolidated financial statements.

**WSI INDUSTRIES, INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
YEARS ENDED AUGUST 28, 2016, AUGUST 30, 2015 AND AUGUST 31, 2014**

**1.SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Business Description* – WSI Industries, Inc. and Subsidiaries (the Company) is involved in the precision contract metal machining business primarily serving the recreational vehicle, energy, aerospace/avionics and bioscience industries.

*Fiscal Year* - WSI Industries, Inc.'s fiscal years represent a 52- to 53-week period ending the last Sunday in August. Fiscal 2014 consisted of 53 weeks while fiscal 2015 and 2016 each consisted of 52 weeks.

*Basis of Presentation* - The consolidated financial statements include the accounts of WSI Industries, Inc. and its subsidiaries. All material intercompany balances and transactions have been eliminated.

*Cash and Cash Equivalents* - Cash and cash equivalents include cash on hand, demand deposits with financial institutions and short-term, highly liquid investments with original maturities of three months or less. At times bank balances may exceed federally insured limits. The Company has experienced no losses with this practice. Cash equivalents are carried at cost plus accrued interest which approximates fair value.

*Inventories* - Inventory costs are determined using the average cost method and consist of material, direct labor, and manufacturing overhead. They are valued at the lower of cost or market by comparing the cost of each item in inventory to its most recent sales price or sales order price. Inventory cost is adjusted down for any excess of cost over the net realizable value of inventory components.

In addition, the Company determines whether its inventory is excess and obsolete by analyzing the sales history of its inventory, sales orders on hand and indications from the Company's customers as to the future of various parts or programs. If, in the Company's determination, the inventory value has become impaired, the Company adjusts the inventory value to the amount the Company estimates as the ultimate net realizable value for that inventory. The Company performs its lower of cost or market testing, as well as its excess or obsolete inventory analyses, quarterly.

*Property, plant, equipment and depreciation and amortization* - The cost of substantially all machinery and equipment, and buildings and improvements are being depreciated using the straight-line method. The estimated useful lives of the assets are as follows:

Machinery and equipment 3 to 7 years  
Building and improvements 15 to 40 years

*Restricted cash* - The Company is currently required to keep cash in a deposit account maintained by its Bank. Since the Company has no right of withdrawal, and the account is to serve as collateral for outstanding debt obligations, restricted cash has been excluded from cash and cash equivalents and classified as long-term.

*Long-lived Assets* - The Company evaluates long-term assets on a periodic basis in compliance with Accounting Standards Codification (“ASC”) 360, *Accounting for the Impairment of Long-lived Assets* when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets carrying amount. If the undiscounted cash flows are less than the carrying amount, the impairment recognized is measured by the amount the carrying value of the assets exceeds their fair value determined primarily through the present value of estimated future cash flows.

*Goodwill* - The Company assesses the valuation of its goodwill according to the provisions of ASC 350 to determine if the current value of goodwill has been impaired. The Company has also adopted Accounting Standard Update (ASU) No. 2011-08, *Intangibles—Goodwill and Other (Topic 350)*. With ASU No. 2011-08, an entity is given the option to make a qualitative evaluation of goodwill impairment to determine whether it should calculate the fair value of its reporting unit. In the fiscal 2016 fourth quarter, the Company made its qualitative evaluation of its goodwill considering, among other things, the overall macroeconomic conditions, industry and market considerations, overall financial performance and other relevant company specific events. Based on this qualitative evaluation, the Company concluded that it was more likely than not that its goodwill was not impaired and that it wasn’t required to calculate the fair value of its reporting unit. If the Company has changes in events or circumstances, including reductions in anticipated cash flows generated by our operations, goodwill could become impaired which would result in a charge to earnings.

*Income Taxes* - The determination of the Company’s income tax-related account balances requires the exercise of significant judgment by management. Accordingly, the Company determines deferred tax assets and liabilities based upon the difference between financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year the differences are expected to affect taxable income. Management assesses the likelihood that deferred tax assets will be recovered from future taxable income and establishes a valuation allowance when management believes recovery is unlikely.

*Revenue Recognition* - Revenues from sales of product are recorded generally upon shipment. The Company considers its revenue recognition policy to fall under the guidance of FASB’s conceptual framework for revenue recognition. The Company recognizes revenue only after: (a) the Company has received a purchase order identifying price and delivery terms or services to be rendered; (b) shipment has occurred, or in the case of services, after the service has been completed; (c) the Company’s price is fixed as evidenced by the purchase order; and (d) collectability is reasonably assured. The Company refers to its revenues as “net sales” in its Consolidated Statements of Income as the Company’s sales are reduced for any product returned by customers.

The Company generally does not require collateral on its trade receivables. The maximum loss that the Company would incur if a customer failed to pay amounts owed would be limited to the recorded amount due after any allowances provided. Credit losses relating to customers have been minimal and within management’s expectations. Based on management’s evaluation of uncollected accounts receivable throughout the year, bad debts are provided for on the allowance method. Accounts are considered delinquent if they are 120 days past due. The Company mitigates its credit risk by performing credit checks and actively pursuing past due accounts.

*Freight costs* – The Company includes freight, shipping and handling costs, in the cost of goods sold.

*Use of Estimates* - The preparation of financial statements in conformity with United States of America generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Significant estimates made in those financial statements consist of estimates related to the impairment of goodwill, the evaluation of excess or obsolete inventory and the valuation allowance connected to the deferred tax assets.

*Earnings per Share* – Basic earnings per share is computed using the weighted average number of common shares outstanding. Diluted earnings per share is computed using the combination of dilutive common share equivalents and the weighted average number of common shares outstanding.

*Stock-based compensation* - The following information has been determined as if the Company had accounted for its stock options under the fair value method of ASC 718. The fair value for these options was estimated, for the purpose of determining compensation, at the date of grant using the Black-Scholes option pricing model with the following assumptions as set forth in the table below. The estimated fair value of the options is amortized to expense over the options' vesting period.

Date of Grant in fiscal -	2016		2015		2014	
Dividend yield	1.8	%	2.2%-2.7	%	2.2%-2.6	%
Expected volatility	31.8	%	51.2%-51.3	%	52.4%-62.6	%
Risk free interest rate	1.7%-2.3	%	1.7%-2.3	%	1.6%-1.9	%
Expected term	5-10 years		5-10 years		5-10 years	

ASC 718 also requires the benefit of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than an operating cash flow under current accounting literature.

#### *Recent Accounting Pronouncements*

In May 2014, the FASB issued Accounting Standards Update No. 2014-09 (ASU 2014-09), *Revenue from Contracts with Customers* to clarify the principles for recognizing revenue from contracts with customers. The guidance requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. The guidance also requires expanded disclosures relating to the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Additionally, qualitative and quantitative disclosures are required about customer contracts, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. The requirements are effective for annual reporting periods beginning after December 15, 2017 using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). Early adoption is not permitted. We are evaluating the impact of the amended revenue recognition guidance on our financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases*. ASU 2016-01 requires that a lessee recognize the assets and liabilities that arise from operating leases. A lessee should recognize in its balance sheet a liability to make lease

payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The guidance in ASU 2016-02 is effective for annual and interim reporting periods beginning after December 15, 2018. The Company is currently evaluating the potential effects of the adoption of this guidance on the consolidated financial statements.



In November 2015, the FASB issued ASU No. 2015-17, *“Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes”*. The standard requires that deferred tax assets and liabilities be classified as noncurrent on the balance sheet rather than being separated into current and noncurrent. ASU 2015-17 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016. Early adoption is permitted and the standard may be applied either retrospectively or on a prospective basis to all deferred tax assets and liabilities. We early adopted ASU 2015-17 during our fourth quarter of fiscal year 2016 on a prospective basis.

In March 2016, the FASB issued ASU No. 2016-09, *Compensation – Stock Compensation*. ASU 2016-09 identifies areas for simplification involving several aspects of accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, an option to recognize gross stock compensation expense with actual forfeitures recognized as they occur, as well as certain classifications on the statement of cash flows. The amendments in this update will be effective for the first interim period within annual reporting periods beginning after December 15, 2016. Early adoption is permitted. The Company is currently assessing the impact that adopting this new accounting guidance will have on its financial statements and footnote disclosures.

## 2. INVENTORIES

Inventories consist primarily of raw material, work-in-process (WIP) and finished goods valued at the lower of cost or market value:

	August 28, 2016	August 30, 2015
Raw material	\$1,598,874	\$3,340,594
WIP	913,494	1,373,904
Finished goods	535,144	1,237,208
	\$3,047,512	\$5,951,706

## 3. DEBT

Long-term debt consists of the following:

	August 28, 2016	August 30, 2015
Building related mortgages & term debt	\$3,675,794	\$3,842,499

Capitalized lease obligations	4,667,439	6,028,115
	8,343,233	9,870,614
Less current portion	1,557,801	1,527,688
Long-term debt	\$6,785,432	\$8,342,926

The Company expanded its Monticello, Minnesota facility during fiscal 2013 which increased the total facility size to approximately 107,000 square feet. The expansion cost approximately \$3.8 million which was paid for by a combination of cash on hand and a new mortgage agreement with its bank which was finalized in May 2013. The new mortgage was for \$4.2 million, which satisfied the original mortgage of \$1.1 million and provided the Company \$3.1 million to use toward the building expansion project. The mortgage carries an interest rate of 2.843%, requires monthly payments of \$22,964 based on a 20 year amortization schedule and matures on May 8, 2018. The mortgage is secured by all assets of the Company.

Maturities of long-term debt are as follows:

Fiscal years ending August:

2017	\$1,557,801
2018	4,820,500
2019	994,447
2020	628,513
2021	216,057
Thereafter	125,915

Included in the consolidated balance sheet at August 28, 2016 are cost and accumulated depreciation on equipment subject to capitalized leases of \$9,510,889 and \$5,086,481 respectively. At August 30, 2015, the amounts were \$10,433,179 and \$4,617,133, respectively. The capital leases carry interest rates from 3.5% to 5.2% and mature from 2017 – 2022.

The present value of the net minimum payments on capital leases which is included in long-term debt as of August 28, 2016 is as follows:

Fiscal years ending August:

2017	\$1,534,035
2018	1,412,563
2019	1,046,852
2020	651,216
2021	224,619
Thereafter	127,319
Total minimum lease payments	4,996,604
Less amount representing interest	329,165
Present value of net minimum lease payments	4,667,439
Current portion	1,385,911
Capital lease obligation, less current portion	\$3,281,528

Line of Credit:

At August 26, 2016, the Company amended and modified its Revolving Line of Credit with its bank. Under the agreement the Company can borrow up to \$1 million. The agreement expires on February 28, 2017, is collateralized by all assets of the Company and carries an interest rate of LIBOR plus 2%. The agreement also contains restrictive provisions requiring a minimum year-to-date earnings before interest, taxes, depreciation and amortization (EBITDA) measured quarterly, a minimum liquidity, a maximum debt to tangible net worth ratio, as well as a debt service

coverage ratio. In addition, the Company is required to keep \$1,250,000 in a deposit account maintained by the bank. Since the Company has no right of withdrawal, and the account is to serve as collateral for outstanding debt obligations, restricted cash has been excluded from cash and cash equivalents. At August 28, 2016, the Company was in compliance with these provisions. There were no amounts outstanding related to its revolving credit agreement at August 28, 2016 and August 30, 2015, respectively.

#### **4. FAIR VALUE OF FINANCIAL INSTRUMENTS**

The carrying amounts of financial instruments, including cash and equivalents, receivables, accounts payable and accrued expenses, and current maturities on long-term debt obligations approximates fair values due to their short term nature. Interest on long-term debt is primarily at fixed rates which do not differ significantly from approximate market rates at August 28, 2016.

## 5. STOCK-BASED COMPENSATION

*Stock Options* - The 2005 Stock Option Plan was approved and 800,000 shares of common stock were reserved for granting of options to officers, key employees and directors. The Plan has been renewed by the Company's shareholders for a term of 10 years and will expire in 2025. Stock options vest over a period of six months to three years.

Option transactions during the three years ended August 28, 2016 are summarized as follows:

	2005 Stock Option Plan	
	Shares	Average Price
Outstanding at August 25, 2013	259,916	\$4.97
Granted	70,250	6.23
Exercised	(26,915 )	4.63
Outstanding at August 31, 2014	303,251	\$5.30
Granted	78,750	6.01
Exercised	(29,500 )	3.13
Outstanding at August 30, 2015	352,501	\$5.64
Granted	96,500	4.43
Forfeit	(26,000 )	5.63
Lapsed	(8,000 )	6.09
Exercised	-	-
Outstanding at August 28, 2016	415,001	\$ 5 . 3 5

Of the 29,500 and 26,915 stock options from the 2005 Plan that were exercised in fiscal 2015 and 2014, 18,443 and 18,539 shares were returned to the Company to pay for the exercise price and for related payroll withholding taxes, respectively.

The weighted fair value of options granted during the years ended August 28, 2016, August 30, 2015 and August 31, 2014 was \$1.05, \$2.57 and \$3.20, respectively. The total intrinsic value of options exercised for the years August 30, 2015 and August 30, 2014 was \$85,705 and \$58,087, respectively. The intrinsic value for all options outstanding at August 28, 2016 was \$0.

Cash received from option exercises for years ended August 30, 2015 and August 31, 2014 was \$8,520 and \$13,840, respectively. The actual tax benefit realized for the tax deductions from option exercises totaled \$15,885 for fiscal year 2015.

As of August 28, 2016, there was \$111,299 of total unearned compensation cost related to option-based compensation arrangements to be recognized over an expected weighted average of 1 year.

As of August 28, 2016, there were 8,000 shares with an exercise price of \$2.13, 25,000 shares with exercise prices between \$3.00 and \$3.47, 96,500 options outstanding with exercise prices between \$4.37 and \$4.44, 78,500 options outstanding with exercise prices between \$4.93 and \$5.39 and 207,001 with exercise prices between \$5.84 and \$7.45. At August 28, 2016, outstanding options had a weighted-average remaining contractual life of 6.4 years.

The number of options exercisable as of August 28, 2016, August 30, 2015 and August 31, 2014 were 318,830, 267,748 and 228,747, respectively, at weighted average share prices of \$5.46, \$5.49 and \$4.97 per share, respectively. At August 26, 2016, there were 96,171 options that had not vested. The aggregate intrinsic values of options exercisable as of August 28, 2016, August 30, 2015 and August 31, 2014 was \$0, \$33,059 and \$601,419, respectively, with weighted-average remaining contractual lives of 5.8, 6.3 and 6.1 years.

The Company can also grant non-vested restricted shares as part of the 2005 Stock Option Plan. These shares typically vest over a three year period and sometimes contain required minimum threshold levels before the shares are earned. Non-vested restricted share transactions during the three years ended August 28, 2016 are as follows:

	Options	Average Price
Outstanding at August 25, 2013	13,941	\$ 5.34
Granted	197	6.35
Vested	(9,362 )	5.37
Outstanding at August 31, 2014	4,776	\$ 5.16
Granted	54	6.09
Vested	(4,830 )	5.32
Outstanding at August 30, 2015	-	\$ -
Granted	-	-
Vested	-	-
Outstanding at August 28, 2016	-	\$ -

As of August 28, 2016, there was \$0 in total unrecognized compensation cost related to non-vested restricted stock compensation arrangements granted under the Plan.

## 6. INCOME TAXES

Income taxes consisted of the following:

	Years Ended		
	August 28, 2016	August 30, 2015	August 31, 2014
Current:			
Federal	\$(187,241)	\$102,448	\$-
State	9,500	10,821	22,616
	(177,741)	113,269	22,616
Deferred:			

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Federal	(200,433)	(44,441 )	650,454
State	(169,122)	(54,112 )	15,641
	(369,555)	(98,553 )	666,095
Total	\$(547,296)	\$14,716	\$688,711



A reconciliation of the federal income tax provision at the statutory rate with actual taxes provided on earnings from continuing operations is as follows:

	Years Ended		
	August 28, 2016	August 30, 2015	August 31, 2014
Ordinary federal income tax statutory rate	(34.0 )%	34.0 %	34.0 %
Income tax credits	(107.1 )	(27.0 )	-
Domestic production activities deduction	(6.1 )	(6.5 )	-
State income taxes net of federal tax effect	1.0	1.0	2.0
Effective rate	(146.2 )%	1.5 %	36.0 %

Deferred income taxes are provided for the temporary differences between the financial reporting and tax basis of the Company's assets and liabilities. Temporary differences comprising the net deferred taxes on the balance sheet are as follows:

	August 28, 2016	August 30, 2015
Deferred Tax Assets		
Accrued liabilities	\$61,977	\$53,801
Inventory	122,871	58,865
Tax credit carryforwards	717,856	18,749
Stock option expense	323,728	304,471
Other	7,346	5,451
	1,233,778	441,337
Less: valuation allowance	(21,212 )	-
Net deferred tax assets	1,212,566	441,337
Deferred Tax Liabilities		
Tax depreciation and amortization greater than book	(2,615,301)	(2,213,627)
Net deferred taxes	\$(1,402,735)	\$(1,772,290)

The Company's effective tax rate in its year ended August 28, 2016 was a negative (146.2%) as compared to 1.5% in the year ended August 30, 2015 and 36.0% in the year ended August 31, 2014, respectively. During the current fiscal year, the Company hired an outside consulting firm to conduct an analysis to determine if certain activities the Company performs qualifies for the Research & Development tax credit (R&D credit) as defined by Internal Revenue Code Section 41. As a result of the analysis, the Company determined that it is performing activities that qualify for the R&D credit, and during the fiscal year 2016 recognized tax benefits related to R&D tax credits from several prior years which lowered the overall effective tax rate. In addition, during the Company's fiscal second quarter, the Federal R&D tax credit law was retroactively renewed for calendar year 2015 and also made permanent going forward. Since

for calendar year 2015 the law was enacted retroactively, any effects are recognized as a component of income tax expense or benefit from continuing operations in the financial statements in the interim period that the law was enacted, which in this case was the Company's fiscal 2016 second quarter. The Company believes that it has recognized R&D tax benefits for all prior years to the extent possible.

As of August 28, 2016, the Company has federal alternative minimum tax credit carryforwards of approximately \$404,000 and approximately \$129,000 in federal R&D tax credit carryforwards. The Company also has \$194,000 in state R&D tax credit carryforwards and \$25,000 in State alternative minimum tax credit carry forwards. The R&D tax credit carryforwards that are related to State jurisdictions begin to expire starting in 2017. The federal R&D tax credits begin to expire in 2022 while the alternative minimum tax credit carry forwards do not expire.

The Company files income tax returns in the U.S. federal and various state jurisdictions. With few exceptions, the Company is no longer subject to federal and state income tax examinations by tax authorities for years before 2012. The Company classifies interest and penalties arising from unrecognized income tax positions in income tax expense if they occur. At August 28, 2016 and August 30, 2015, the Company had no accrued interest or penalties related to uncertain tax positions.

As previously discussed, the Company has R&D tax credits related to State jurisdictions. These credits can be carried forward for fifteen years before they expire. The Company applies the accounting standard for recognition of deferred tax assets pursuant to a more-likely-than-not threshold. The Company believes that it is more likely than not that some of its' State R&D tax credits will expire before they can be utilized. Due to this, the Company established a valuation allowance of \$21,212 at August 28, 2016. The Company also applies the more-likely-than-not accounting standard for uncertain tax positions to determine the recognition and derecognition of uncertain tax positions. Once the more-likely-than-not threshold is met, the amount of benefit to be recognized is the largest amount of tax benefit that is greater than 50 percent likely of being ultimately realized upon settlement. It further requires that a change in judgment related to the expected ultimate resolution of uncertain tax positions be recognized in earnings in the period of such a change. Below is a summary of uncertain tax positions:

Uncertain tax positions at August 31, 2014	\$-
Increase for tax positions related to prior years	30,000
Uncertain tax positions at August 30, 2015	30,000
Increases for tax positions related to prior years	3,778
Uncertain tax positions at August 28, 2016	\$33,778

The Company does not believe there will be significant changes to the estimates in the next 12 month period. Due to the complexity of some of these uncertainties, the ultimate settlement may result in payments that are different from our current estimate of tax liabilities, resulting in the recognition of additional charges or benefits to income tax expense.

## 7.EMPLOYEE BENEFITS

The Company maintains a 401(k) retirement savings plan that all employees are eligible to participate in as well as a profit sharing plan. Profit sharing contributions are discretionary and are based on Company results. Contributions charged to operations for the profit sharing plan and matching contributions for the 401(k) plan for fiscal 2016, 2015 and 2014, were \$190,084, \$260,727 and \$321,337, respectively.

## 8.INFORMATION CONCERNING SALES TO MAJOR CUSTOMERS

The Company had sales to one customer that exceeded 10 percent of total sales during fiscal year 2016. Sales in each of fiscal year 2016, 2015 and 2014 for that customer are listed below:

	2016	2015	2014
Customer	\$31,526,000	\$36,937,000	\$34,244,000

The Company had accounts receivable from the customer of \$2,874,000 and \$2,566,000 at August 28, 2016 and August 30, 2015, respectively. Realization of these receivables, sale of inventory, and its future operations could be significantly affected by adverse changes in the financial condition or the Company's relationship with this customer.

**9.EARNINGS PER SHARE**

The following table sets forth the computation of basic and diluted earnings per share:

	2016	2015	2014
Net Income	\$ 173,048	\$ 997,068	\$ 1,224,124
Denominator for earnings per share:			
Weighted average shares; denominator for basic earnings per share	2,919,500	2,910,426	2,899,576
Effect of dilutive securities; employee and non-employee options	8,626	49,972	64,808
Dilutive common shares; denominator for diluted earnings per share	2,928,126	2,960,398	2,964,384
Basic earnings per share	\$.06	\$.34	\$.42
Dilutive earnings per share	\$.06	\$.34	\$.41

Stock options to purchase 397,001 and 226,501 shares of common stock were outstanding during the years ended August 28, 2016 and August 30, 2015, respectively, but were not included in the computation of diluted income per share. The inclusion of these options would have been anti-dilutive as the options' exercise prices were greater than the average market price of the Company's common shares during the relevant period.

**10.OTHER ASSETS**

Other assets consist of goodwill which resulted from costs from business acquisitions which total \$2,368,452 (net of accumulated amortization of \$344,812 recorded prior to the adoption of ASC 350 *Goodwill and Other Intangible Assets*) as well as deferred financing costs of \$6,684 (net of accumulated amortization of \$13,368) incurred in connection with the mortgage discussed in Note 3.

**11.CLAIMS AND CONTINGENCIES**

The Company is exposed to a number of asserted and unasserted claims encountered in the ordinary course of business. Although the outcome of any such claim cannot be predicted, management believes that there are no pending legal proceedings or claims against or involving the Company for which the outcome is likely to have a material adverse effect upon its financial position or results of operations.



