

UNIVERSAL MFG. CO.

ANNUAL REPORT TO SHAREHOLDERS

2017

President's Message to Our Shareholders

UMC has concluded another year and from a financial point of view it was not a successful one. Lower than anticipated sales across all product lines impacted the divisions' ability to absorb variable indirect manufacturing costs and SG&A. Sales for the year slid by \$23.9 Million over prior year, tied mostly to sales erosion in our Shelby operations and specifically related to the one time US SOCOM project in 2016 that did not repeat in 2017. UMC was impacted substantially as well by an increase in health claims due to unexpected and non-historic medical costs.

In 2017 we confirmed and expanded our long-term strategy for Ultra Armoring, LLC ("UA") and Metal Works Mfg. Co. ("MW"). We will be strengthening our focus in three core areas, prime work associated with the U.S. Government, sub-prime work associated with manufacturing armor plating for large defense companies, and the commercial market associated with "big, heavy, thick" where there is value-add for our unique capabilities. Man Lift Mfg. Co. ("MLM") will continue to develop a product strategy around its existing products, and, as value and market is proven, develop new products or designs. UMC ReTech will reinforce its core competencies around Transfer Case with enlarged distribution and expand its product line into Power Take-Off (PTO) units. We believe this strategy will allow for growth in revenue and income improvement in 2018.

2017 was a pivotal year in further defining our brands and our approach to those brands. This precipitated the need to restructure and refocus around our core strengths in armoring, metal forming, Man Lift products and the remanufacturing of Transfer Cases. In 2nd quarter 2017, we reorganized Shelby and split MLM into its own division separate from MW and UA from a management perspective. This allowed complete focus around MLM revenue generation and improved COGS. Sales for MLM improved over prior year by 21% and MLM enters fiscal year 2018 with \$3.6 Million in backlog. MLM COGS as a percentage of sales improved by 19% over prior year.

The reorganization had a similar impact on UA and MW as it allowed these subsidiaries to focus on their core capabilities. UA was awarded a Department of State ("DOS") contract for \$15 Million which will be executed in fiscal year 2018. This victory also allows UA to continue to bid on future variants for DOS over the next 10 years. MW brand developed well throughout fiscal year 2017 as MW added new market space outside the traditional build to print armor to selling our core competencies and value around bending, cutting and welding large, thick plate steel. MW's unique capabilities in the "big, thick and large" sheet metal forming allow MW to enter niche and premium value markets. Plans are to continue to drive revenue expansion in 2018 in this space.

UMC ReTech saw flat sales and eroding gross margin in fiscal year 2017 as the market shifted. Market consolidation and increased material cost especially in our core area of Transfer Cases drove gross margin lower. This combined with increased fixed cost impacted income unfavorably. To overcome these issues, plans were put into place to expand our reseller and mass distributor base and a number of major well-known store front chains were added. These additions will have an impact on increased revenue in fiscal year 2018. Tied to this expansion, UMC ReTech entered into an agreement with a major reseller for the remanufacturing of Fuel Pumps. This contract will extend into 2020.

In summary 2017 was a pivot year, much work was done to ensure 2018 would see increasing revenue and a manufacturing cost structure aligned correctly. Much time was also spent on new

market development for all brands, an organizational structure and improved manufacturing “control and discipline” to ensure a solid foundation for long term growth.

We at UMC and our subsidiaries are convinced that the best is yet to come, and we are at the start of something great.

Thank you

A handwritten signature in blue ink, consisting of several overlapping loops and a long horizontal stroke extending to the right.

Thomas C. Hance
President & CEO

Management's Discussion and Analysis of the Company's Structure, Operations and Financial Results

Overall results for UMC significantly declined from prior year. Our sales decreased 36% year over year, we report operating loss of \$2.9 Million and net loss after taxes of \$3.3 Million. Sales of UMC ReTech declined 2.2% year over year and they reported an operating loss of \$100 Thousand compared to operating income of \$560 Thousand in the prior year. The driver behind the erosion was due to unplanned and unforeseen increase in COGS in our largest revenue and gross margin generating product line. Sales price erosions due to market consolidation also played a role in gross margin and sales reduction. UMC ReTech sales were also adversely impacted as we continue plans to shed poor performing products in the fuel pump and caliper product lines. Although there will be a near term impact on revenue and cost absorption, gross margin should improve as we complete the elimination of these products from the portfolio.

Our Shelby operation, including Man Lift Mfg. Co., ("MLM") Metal Works Mfg. Co., ("MW") and Ultra Armoring, LLC ("UA") saw sales decrease by 41% and operating loss was \$1.8 Million compared to operating income of \$1.7 Million in the prior year. Sales and income in 2016 were favorably and materially impacted by a significant single contract that was completed without manufacturing cost absorption impact on our operating facility. Removing the impact of this non-manufactured work results in manufacturing cost and overhead costs improvement year over year, as a percentage of operationally generated sales. Operational sales also improved by 33%. MLM had significant operational cost improvements, and the cost structure is now at levels prior to moving MLM to our Shelby facility, with COGS improving by almost 19% over 2016. In summary major strides were made in Shelby with operational costs and manufactured sales improving over 2016. These improvements have created a clear path to positive financial performance in 2018. Increased sales tied with several significant cost improvement and restructuring plans completed in 2017 with continue to lead to improved UMC performance as well.

UMC ReTech Strategy for 2018 continues to be on driveline products and specifically Transfer Cases. This division made some investments in personnel throughout the year and is working on a program to drive down variable costs within the Transfer Case product line.

The reorganization of MLM as described in our President's Message provides additional focus on revenue and margin growth for that subsidiary as well as MW & UA. Strategy development within all these units will continue to drive market and product growth.

We continue to see both the positive impact and risk associated with the acquisition in North Carolina completed in FY2015. On the positive side, we were awarded a \$15 Million contract by the Department of State ("DOS") and will be executing that in FY2018. Winning this work allows UA to continue bidding on additional work with the DOS over the next 10 years. Without the acquisition in North Carolina, we would not have been able to compete for this work. On the risk side of the equation, we have acquired a large facility with a significant amount of fixed costs. Increased revenue will help us cover these large costs, so revenue generation continues to be a focus.

The upside still remains, and we are prepared to effectively and efficiently perform when the next opportunity presents. We are addressing the risk portion of the model by taking steps to both generate additional regular reoccurring work from multiple customers and becoming

Management's Discussion and Analysis of the Company's Structure, Operations and Financial Results

substantially more efficient in scheduling and performing work and substantially reducing the need for rework and warranty claims. Progress on all of these items has been made and all remain a primary focus as we move into our next year.

We recorded a valuation allowance against our Net Operating Loss ("NOL"), as required by U.S. GAAP. The amount remaining on the balance sheet represents the maximum net deferred income tax benefit that may be shown per U.S. GAAP. The recording of the allowance impacted the income tax expense line on the income statement but did not impact cash.

Our cash use continues to increase as we are building inventory and receivables; the line of credit reflects the increased cash usage. We do not have any new significant long term debt and continue to pay down existing debt on schedule. We made no material capital expenditures during the year. Accounts payable decreased significantly primarily due to a prior year liability for a customer who provides material to us. This liability was paid through a reduction in accounts receivable as we provided finished goods to them throughout the year. There was no income statement impact for this item as it was fully accrued in the prior year financials.

Our reporting status has not changed in the past year. Effective October 25, 2002, the Company made the necessary filing with the Security and Exchange Commission to deregister its common stock. As a result of this deregistration, the Company requested a voluntary delisting of its common stock from NASDAQ Small Cap Market. The stock continues to be listed on the pink sheets using the symbol UFMG. The Company understands and believes that some firms continue to make a market in the Company's stock.

FORWARD LOOKING STATEMENTS - SAFE HARBOR

Statements herein that are not historical facts, including statements about the company's confidence and strategies and the Company's expectations about future market opportunities, market demand or acceptance of the Company's products are forward looking statements that involve risks and uncertainties. These uncertainties include, without limitation, the effect of general economic and market conditions, customer requirement for our products, the continuing strength of the industries in which we operate, competitor pricing, maintenance of our current momentum, weather conditions and other factors.



RSM US LLP

Independent Auditor's Report

Board of Directors
Universal Mfg. Co. and Subsidiaries

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Universal Mfg. Co. and Subsidiaries, which comprise the consolidated balance sheets as of July 31, 2017 and 2016, the related consolidated statements of operations, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, the financial statements).

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Universal Mfg. Co. and Subsidiaries as of July 31, 2017 and 2016, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

RSM US LLP

Omaha, Nebraska
September 28, 2017

Universal Mfg. Co. and Subsidiaries

**Consolidated Balance Sheets
July 31, 2017 and 2016**

| | 2017 | 2016 |
|--------------------------------------------------------------------------------------------------------------------------|----------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 67,780 | \$ 33,204 |
| Receivables: | | |
| Trade receivables, less allowance of \$118,208 and \$103,927, respectively | 6,458,818 | 3,761,022 |
| Other receivables, net | 249,586 | 223,402 |
| Inventories, net | 14,211,930 | 8,701,271 |
| Prepaid expenses | 203,420 | 1,322,824 |
| Income tax receivable | 186,172 | 1,009,649 |
| Deferred income taxes | 737,915 | 632,513 |
| Total current assets | 22,115,621 | 15,683,885 |
| Property, plant and equipment, net | 6,449,592 | 7,700,810 |
| Other noncurrent assets: | | |
| Intangibles, net of amortization | 79,402 | 93,496 |
| Goodwill | 4,904,350 | 4,904,350 |
| | 4,983,752 | 4,997,846 |
| Total assets | \$ 33,548,965 | \$ 28,382,541 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Outstanding checks in excess of bank balance | \$ 802,180 | \$ 199,741 |
| Lines of credit | 8,308,135 | 1,941,730 |
| Current portion of long-term debt | 595,831 | 531,554 |
| Accounts payable | 3,641,144 | 5,829,097 |
| Deferred revenue | 4,155,118 | 205,225 |
| Accrued expenses and other liabilities | 2,288,503 | 2,119,462 |
| Total current liabilities | 19,790,911 | 10,826,809 |
| Noncurrent liabilities: | | |
| Long-term debt, less current portion | 5,198,594 | 5,672,622 |
| Deferred income taxes | 737,915 | 883,831 |
| Total noncurrent liabilities | 5,936,509 | 6,556,453 |
| Stockholders' equity: | | |
| Common stock—\$1 par value, 2,000,000 shares authorized; 876,067 and 866,067 shares issued and outstanding, respectively | 876,067 | 866,067 |
| Additional paid-in capital | 923,326 | 842,326 |
| Retained earnings | 6,022,152 | 9,290,886 |
| Total stockholders' equity | 7,821,545 | 10,999,279 |
| Total liabilities and stockholders' equity | \$ 33,548,965 | \$ 28,382,541 |

See notes to consolidated financial statements.

Universal Mfg. Co. and Subsidiaries

**Consolidated Statements of Operations
Years Ended July 31, 2017 and 2016**

| | 2017 | 2016 |
|----------------------------------------------------------|-----------------------|---------------------|
| Net sales | \$ 43,370,806 | \$ 67,319,758 |
| Cost of goods sold | <u>(39,193,699)</u> | <u>(58,585,360)</u> |
| Gross profit | 4,177,107 | 8,734,398 |
| Operating expenses: | | |
| Selling, general and administrative expenses | 6,100,326 | 6,635,403 |
| Other corporate operations | 997,535 | 776,458 |
| Total operating expenses | 7,097,861 | 7,411,861 |
| Operating (loss) income | (2,920,754) | 1,322,537 |
| Other income (expense): | | |
| Interest expense | (540,507) | (730,151) |
| Loss on sale of assets | (6,800) | (20,330) |
| Other, net | (8,032) | 20,809 |
| Total other expense | (555,339) | (729,672) |
| (Loss) income before income tax benefit (expense) | (3,476,093) | 592,865 |
| Income tax benefit (expense) | <u>207,359</u> | <u>(270,503)</u> |
| Net (loss) income | \$ (3,268,734) | \$ 322,362 |
| Net (loss) income per common share—basic | \$ (3.75) | \$ 0.39 |
| Net (loss) income per common share—diluted | \$ (3.71) | \$ 0.39 |

See notes to consolidated financial statements.

Universal Mfg. Co. and Subsidiaries

**Consolidated Statements of Changes in Stockholders' Equity
Years Ended July 31, 2017 and 2016**

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Total Stockholders' Equity |
|----------------------------------|-------------------|----------------------------------|----------------------|----------------------------------|
| Balance, July 31, 2015 | \$ 816,000 | \$ 137,517 | \$ 8,968,524 | \$ 9,922,041 |
| Net income | - | - | 322,362 | 322,362 |
| Stock issuance | 50,067 | 699,933 | - | 750,000 |
| Noncash stock-based compensation | - | 4,876 | - | 4,876 |
| Balance, July 31, 2016 | 866,067 | 842,326 | 9,290,886 | 10,999,279 |
| Net loss | - | - | (3,268,734) | (3,268,734) |
| Stock issuance | 10,000 | 81,000 | - | 91,000 |
| Balance, July 31, 2017 | \$ 876,067 | \$ 923,326 | \$ 6,022,152 | \$ 7,821,545 |

See notes to consolidated financial statements.

Universal Mfg. Co. and Subsidiaries

**Consolidated Statements of Cash Flows
Years Ended July 31, 2017 and 2016**

| | 2017 | 2016 |
|----------------------------------------------------------------------------------------------------|--------------------|---------------------|
| Cash flows from operating activities: | | |
| Net (loss) income | \$ (3,268,734) | \$ 322,362 |
| Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities: | | |
| Depreciation and amortization | 1,450,593 | 1,438,944 |
| Deferred income taxes | (251,318) | 420,299 |
| Loss on sale of assets | 6,800 | 20,330 |
| Noncash stock-based compensation | 91,000 | 4,876 |
| Changes in assets and liabilities: | | |
| Receivables and accounts payable, net | (4,911,933) | 3,052,136 |
| Income tax receivable | 823,477 | (285,037) |
| Inventories | (5,510,659) | 17,650,862 |
| Prepaid expenses | 1,119,404 | (852,361) |
| Deferred revenue | 3,949,893 | (837,660) |
| Contingent consideration liability | - | (853,000) |
| Accrued expenses and other liabilities | 169,041 | (57,821) |
| Net cash (used in) provided by operating activities | (6,332,436) | 20,023,930 |
| Cash flows from investing activities: | | |
| Purchases of property, plant and equipment | (107,981) | (334,574) |
| Proceeds from sales of property and equipment | 1,900 | 36,000 |
| Net cash used in investing activities | (106,081) | (298,574) |
| Cash flows from financing activities: | | |
| Change in outstanding checks in excess of bank balance | 602,439 | (158,543) |
| Change in restricted cash | - | 156,268 |
| Net activity on lines of credit | 6,366,405 | (16,320,310) |
| Repayment of long-term debt | (495,751) | (506,350) |
| Cash paid in conjunction with settlement of contingent liability | - | (2,897,000) |
| Net cash provided by (used in) financing activities | 6,473,093 | (19,725,935) |
| Net increase (decrease) in cash and cash equivalents | 34,576 | (579) |
| Cash and cash equivalents: | | |
| Beginning | 33,204 | 33,783 |
| Ending | \$ 67,780 | \$ 33,204 |

(Continued)

Universal Mfg. Co. and Subsidiaries

Consolidated Statements of Cash Flows (Continued)
Years Ended July 31, 2017 and 2016

| | <u>2017</u> | <u>2016</u> |
|---------------------------------------------------------------------|---------------------|-------------------|
| Supplemental disclosures of cash flow information: | | |
| Cash paid for interest | <u>\$ 520,455</u> | <u>\$ 720,925</u> |
| Cash paid for income taxes, net | <u>\$ 58,118</u> | <u>\$ 408,800</u> |
| Supplemental disclosures of noncash information: | | |
| Accounts payable settled through trade receivable reductions | <u>\$ 3,594,535</u> | <u>\$ -</u> |
| Stock issued in conjunction with settlement of contingent liability | <u>\$ -</u> | <u>\$ 75,000</u> |

See notes to consolidated financial statements.

Universal Mfg. Co. and Subsidiaries

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies

Nature of operations: Universal Mfg. Co. is engaged in the business of remanufacturing and/or distribution, on a wholesale basis, of electric fuel pumps, transfer cases, calipers, transmission assemblies and other automotive parts for many makes and models of vehicles. The principal markets for Universal Mfg. Co.'s products are automotive dealers, jobbers, repair shops and other automotive parts distributors located throughout the United States and Canada.

Universal Mfg. Co.'s wholly owned subsidiary, Man Lift Mfg. Co., is engaged in the business of assembly, manufacture, distribution and sale of specialty Man Lift products and mobile hydraulic equipment, such as hazardous environment, scissor, pedestal, aerial, clean-room and explosion-proof lifts.

Universal Mfg. Co.'s wholly owned subsidiary, Ultra Armoring, LLC, is engaged in the business of design, manufacture and assembly of products for the United States government with a principal focus on armor for military equipment.

Universal Mfg. Co.'s wholly owned subsidiary, Metal Works Mfg. Co., is engaged in the business of cutting, forming, bending, welding and assembling of steel for original equipment manufacturers and other customers that have a need for large, heavy-gauge steel parts and products.

Principles of consolidation: The consolidated financial statements include the accounts of the parent company, Universal Mfg. Co., and its wholly owned subsidiaries (collectively, the Company). All material intercompany accounts and transactions have been eliminated in consolidation.

Cash and cash equivalents: All highly liquid investments with a maturity of three months or less at the time of purchase are considered cash equivalents.

Trade receivables: Accounts receivable are reported net of an allowance for doubtful accounts. The allowance is based on management's estimate of the amount of receivables that will actually be collected. Trade receivables are written off when deemed uncollectible. Recoveries of trade receivables are recorded when received. Interest is charged on past-due receivables at one of the divisions of the Company.

Inventories: Inventory is stated at the lower of cost or market. The cost of inventory is determined using the last-in, first-out (LIFO) and the first-in, first-out (FIFO) methods.

Property, plant and equipment: Property, plant and equipment are generally recorded at cost, less accumulated depreciation. Depreciation expense is computed using accelerated and straight-line methods and is recorded over the estimated useful lives of the individual assets. The depreciation methods generally used and the estimated useful lives are as follows:

| Assets | Depreciation Method | Lives |
|-------------------------------|-------------------------------------|-------------|
| Buildings | Straight-line and declining-balance | 10-39 years |
| Machinery and equipment | Straight-line and declining-balance | 7-10 years |
| Office equipment and software | Straight-line and declining-balance | 3-7 years |
| Motor vehicles | Straight-line and declining-balance | 3-5 years |

Maintenance and repairs are charged to operations as incurred. Gains or losses are recognized at the time of disposal.

Universal Mfg. Co. and Subsidiaries

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

The Company would provide for impairment losses on 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 respective asset's carrying amount. Based on current conditions, management does not believe any of the Company's long-lived assets are impaired.

Goodwill: Goodwill represents the excess of purchase price and related costs over the value assigned to the net assets acquired. Goodwill is not amortized, but the Company performs impairment tests annually and whenever events or circumstances occur indicating that goodwill might be impaired. Based upon the Company's annual assessment for the years ended July 31, 2017 and 2016, no impairment of goodwill has occurred.

Income taxes: The Company files a consolidated federal tax return for income tax purposes.

Deferred taxes are provided using the liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards, and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

The Company recognizes the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by taxing authorities, based on technical merits of the position. The tax benefits recognized in consolidated financial statements from such a position are measured based on the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement. The guidance for accounting for uncertainty in income taxes also addresses derecognition, classification, interest and penalties on income taxes, and accounting in interim periods.

Revenue and cost recognition: The Company recognizes sales when there is evidence of a sales agreement, the delivery of goods has occurred, the sales price is fixed or determinable, and the collectibility of revenue is reasonably assured. The Company generally records sales upon shipment of product to customers and transfer of title under standard commercial terms. Certain customers have long-term contracts in place where billings are scheduled in advance of the delivery of product. Deferred revenue is recorded for these customers based on the terms of these contracts.

Warranties: The Company generally provides a one-year warranty on certain products manufactured and sold. A provision for warranty is calculated and recognized for each covered product based on available past historical data on the levels of repairs and returns.

Income per common share: Income per common share for 2017 and 2016 was computed by dividing the weighted-average number of shares of common stock outstanding into net income (loss). The basic weighted-average number of shares of common stock outstanding for the years ended July 31, 2017 and 2016, was 871,820 and 828,482, respectively. The diluted weighted-average number of shares of common stock outstanding for the years ended July 31, 2017 and 2016, was 882,095 and 836,348, respectively. The additional dilutive shares relate to outstanding stock options.

Use of estimates: In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP), management uses estimates and assumptions. Those estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the

Universal Mfg. Co. and Subsidiaries

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Subsequent events: The Company has evaluated subsequent events through September 28, 2017, the date on which the consolidated financial statements were available to be issued.

Reclassifications: Certain prior-year amounts have been reclassified to conform with current-year presentation. These reclassifications have not affected previously reported results of operations or retained earnings.

Recently issued accounting pronouncements: In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The updated standard will replace most existing revenue recognition guidance for U.S. GAAP when it becomes effective and permits the use of either a full retrospective or retrospective with cumulative-effect transition method. In August 2015, the FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, which deferred the effective date to annual reporting periods beginning after December 15, 2018. Accordingly, the Company will be required to adopt the new guidance beginning in the fiscal year beginning on August 1, 2019. In May 2016, the FASB issued ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*, providing additional clarification on specific aspects of the new revenue guidance. The Company has not yet selected a transition method, nor has it determined the effect of the standard on its ongoing financial reporting.

In July 2015, the FASB issued ASU No. 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*. The amendments in the ASU require entities that measure inventory using the first-in, first-out or average-cost methods to measure inventory at the lower of cost and net realizable value. Net realizable value is defined as estimated selling price in the ordinary course of business less reasonably predictable costs of completion, disposal and transportation. This ASU will be effective for the Company for fiscal years beginning after December 15, 2016. Early adoption of ASU 2015-11 is permitted. The Company is currently evaluating the effects adoption of this guidance will have on its consolidated financial statements.

In November 2015, the FASB issued ASU No. 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*. This ASU simplifies the presentation of deferred income taxes by eliminating the requirement for entities to separate deferred tax liabilities and assets into current and noncurrent amounts in classified balance sheets. Instead, it requires deferred tax assets and liabilities be classified as noncurrent in the balance sheet. ASU 2015-17 is effective for financial statements issued for annual periods beginning after December 15, 2016. The Company is currently evaluating the impact of the adoption of this standard on its consolidated financial statements.

Universal Mfg. Co. and Subsidiaries

Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies (Continued)

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*, which sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract (i.e., lessees and lessors). The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase by the lessee. This classification will determine whether lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease, respectively. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months regardless of their classification. Leases with a term of 12 months or less will be accounted for similar to existing guidance for operating leases today. The new standard requires lessors to account for leases using an approach that is substantially equivalent to existing guidance for sales-type leases, direct financing leases and operating leases. The new standard is effective for fiscal years beginning after December 15, 2019. The Company is in the process of evaluating the impact of this new guidance.

Note 2. Inventories

Inventories consisted of the following as of July 31:

| | 2017 | 2016 |
|-----------------------------------------|----------------------|---------------------|
| Inventories (on an average-cost basis): | | |
| Product core | \$ 1,712,955 | \$ 1,833,712 |
| Raw materials | 1,154,414 | 1,290,380 |
| Finished small parts | 2,047,455 | 1,827,862 |
| | <u>4,914,824</u> | <u>4,951,954</u> |
| LIFO reserves | (991,781) | (965,845) |
| Inventories at LIFO | <u>3,923,043</u> | <u>3,986,109</u> |
| Work in process at FIFO | 5,412,553 | 3,559,396 |
| Other inventories, principally FIFO | 5,520,297 | 1,607,707 |
| Obsolescence reserves | (643,963) | (451,941) |
| | <u>\$ 14,211,930</u> | <u>\$ 8,701,271</u> |

Universal Mfg. Co. and Subsidiaries

Notes to Consolidated Financial Statements

Note 3. Property, Plant and Equipment

Property, plant and equipment by major classification as of July 31 were as follows:

| | 2017 | 2016 |
|---------------------------------|---------------------|---------------------|
| Land | \$ 68,279 | \$ 68,279 |
| Buildings and land improvements | 1,531,791 | 1,467,691 |
| Machinery and equipment | 9,321,515 | 9,279,582 |
| Office equipment and software | 933,509 | 908,114 |
| Motor vehicles | 193,353 | 193,353 |
| | <u>12,048,447</u> | <u>11,917,019</u> |
| Less accumulated depreciation | 5,689,851 | 4,258,638 |
| | <u>6,358,596</u> | <u>7,658,381</u> |
| Construction in progress | 71,996 | 23,429 |
| Property held for future use | 19,000 | 19,000 |
| | <u>\$ 6,449,592</u> | <u>\$ 7,700,810</u> |

Depreciation expense was \$1,436,499 and \$1,424,849 for the years ended July 31, 2017 and 2016, respectively.

Note 4. Lines of Credit

As of July 31, 2017, the Company had agreements with Security First Bank for two lines of credit up to \$7,500,000 and \$3,000,000, respectively. Maximum borrowing under the lines of credit is limited to the lesser of \$10,500,000 or a borrowing base calculation (\$9,666,576 at July 31, 2017). The approved lines of credit are available until August 1, 2017, and August 28, 2017, respectively. The lines of credit accrue interest on the outstanding principal balances at an annual variable rate equal to the *Wall Street Journal* U.S. prime rate plus 0.5 percent (4.75 percent as of July 31, 2017) and 4.25 percent, respectively. The lines of credit are secured by blanket security agreements over the general business assets of the Company. At July 31, 2017, and July 31, 2016, the Company had balances on the lines of credit of \$8,308,135 and \$1,941,730, respectively.

As of August 25, 2017, the Company renewed and increased the \$7,500,000 line of credit with Security First Bank up to \$10,000,000. The approved line of credit is available until July 26, 2018. The line of credit accrues interest on the outstanding principal balances at an annual variable rate equal to the *Wall Street Journal* U.S. prime rate plus 0.5 percent.

Universal Mfg. Co. and Subsidiaries

Notes to Consolidated Financial Statements

Note 5. Long-Term Debt

Long-term debt as of July 31 consists of the following:

| | 2017 | 2016 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------|---------------------|
| Capital lease to Snap36, LLC, payable in monthly installments, maturing January 2019 | \$ 86,000 | \$ - |
| Note payable to Security First Bank, interest fixed at 4%, payable in monthly installments, maturing July 2024 | 1,492,028 | 1,672,371 |
| Note payable to Security First Bank, interest fixed at 4.25%, payable in monthly installments, maturing February 2020 | 3,216,397 | 3,531,805 |
| Note payable to Ultra Machine & Fabrication, Inc., variable interest (3.50% at July 31, 2017), interest payable in monthly installments, principal due upon note maturing February 2019 | 1,000,000 | 1,000,000 |
| Total long-term debt | <u>5,794,425</u> | <u>6,204,176</u> |
| Less current portion | 595,831 | 531,554 |
| | <u>\$ 5,198,594</u> | <u>\$ 5,672,622</u> |

The approximate annual requirements for principal payments on long-term debt for the next four years and thereafter are as follows:

| | |
|-----------------------|---------------------|
| Years ending July 31: | |
| 2018 | \$ 596,000 |
| 2019 | 1,619,000 |
| 2020 | 2,678,000 |
| 2021 | 213,000 |
| Thereafter | 688,000 |
| | <u>\$ 5,794,000</u> |

Substantially all assets of the Company are pledged as security for the long-term debt with Security First Bank.

The Security First Bank credit facility is subject to a security and loan agreement, which contains certain restrictions on dividends to stockholders, capital improvement limitations, and a provision such that the Company shall not incur or contract any new debt. Such agreement also discloses the Company shall maintain a maximum total bank debt-to-equity ratio of 1.0 and a debt service coverage ratio of not less than 1.75-to-1, and is subject to various nonfinancial covenants. The Company received a waiver from the bank for all covenants that were not in compliance as of July 31, 2017. The renewed line of credit removed the requirement to meet the debt-to equity ratio covenant of 1.0 as well as the debt service coverage ratio of not less than 1.75-to-1.

Universal Mfg. Co. and Subsidiaries

Notes to Consolidated Financial Statements

Note 6. Income Taxes

The net deferred tax assets (liabilities) consist of the following components as of July 31:

| | 2017 | 2016 |
|---------------------------------|--------------------|---------------------|
| Deferred tax liabilities: | | |
| Property, plant and equipment | \$ (635,896) | \$ (574,845) |
| Intangible assets | (452,456) | (308,986) |
| | <u>(1,088,352)</u> | <u>(883,831)</u> |
| Deferred tax assets: | | |
| Allowance for doubtful accounts | 42,555 | 37,414 |
| Inventory reserve | 231,827 | 162,699 |
| Warranty reserve | 174,236 | 176,462 |
| Inventory capitalization | 67,940 | 70,095 |
| Accrued vacation | 43,123 | 46,925 |
| Self-funded insurance | 140,400 | 88,439 |
| Accrued rent expense | 9,857 | 23,006 |
| Accrued audit fees | 23,607 | 23,886 |
| Charitable contributions | 4,370 | 3,587 |
| Net operating loss | 1,326,926 | - |
| Valuation allowance | (976,489) | - |
| | <u>1,088,352</u> | <u>632,513</u> |
| | <u>\$ -</u> | <u>\$ (251,318)</u> |

The deferred tax amounts mentioned above have been classified in the accompanying consolidated balance sheets as of July 31 as follows:

| | 2017 | 2016 |
|-----------------------|--------------|---------------------|
| Long-term liabilities | \$ (737,915) | \$ (883,831) |
| Current assets | 737,915 | 632,513 |
| | <u>\$ -</u> | <u>\$ (251,318)</u> |

The provision for income taxes charged to operations for the years ended July 31 consists of the following:

| | 2017 | 2016 |
|----------------------------|-------------------|---------------------|
| Current benefit (expense): | | |
| Federal | \$ (35,959) | \$ 164,796 |
| State | (8,000) | (15,000) |
| Deferred benefit (expense) | 251,318 | (420,299) |
| | <u>\$ 207,359</u> | <u>\$ (270,503)</u> |

Universal Mfg. Co. and Subsidiaries

Notes to Consolidated Financial Statements

Note 6. Income Taxes (Continued)

A reconciliation of the provision for income taxes and the amount computed by applying the federal statutory rate to (loss) income before income tax benefit (expense) for the years ended July 31 is as follows:

| | 2017 | 2016 |
|------------------------------------------------------------------------|-------------------|---------------------|
| Computed income tax benefit (expense) at federal statutory rate of 34% | \$ 1,181,872 | \$ (201,574) |
| Meals and entertainment expense | (13,099) | (13,667) |
| Domestic production activities deduction | - | (16,354) |
| Impact of net operating loss | (976,489) | - |
| Other, net | 15,075 | (38,908) |
| | <u>\$ 207,359</u> | <u>\$ (270,503)</u> |

The Company files income tax returns in the U.S. federal jurisdiction and other state jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, or state and local income tax examinations by tax authorities for years before 2012.

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expenses. During the years ended July 31, 2017 and 2016, the Company did not recognize any interest or penalties. As of July 31, 2017 and 2016, the Company did not have any balances accrued for interest or penalties.

Note 7. Employee Benefits

401(k) plan: The Company sponsors a 401(k) plan, which is available to all employees who are at least 21 years of age and have completed one year of service. Employees can contribute up to 15 percent of their compensation to the plan. The Company will provide a matching contribution equal to employee contributions up to a maximum of 3 percent. The 401(k) plan was amended in January 2017 to allow for a safe harbor match. Beginning in January 2017, the Company matches dollar for dollar on the first 3 percent and then 50 cents on the dollar on the next 2 percent. Total expenses for the Company under the plan were approximately \$160,000 for each year ended July 31, 2017 and 2016.

Individual retirement account (IRA) plan: The Company maintains an IRA retirement plan for employees employed by the Company as of May 6, 2007. The Company will make a matching contribution to the IRA. The Company's total matching contribution to hourly employees is \$0.40 per hour to a maximum of 40 hours per week. This plan ceased in May 2016. Total expenses for the Company under the plan were approximately \$-0- and \$8,000 for the years ended July 31, 2017 and 2016, respectively.

Note 8. Union Agreement

The Company entered into an agreement with the United Automobile, Aerospace and Agricultural Implement Workers of America (UAW)'s Amalgamated Local 838 International Union (Union). The Union agreement shall remain in full force and is effective from May 6, 2016 until and including May 5, 2019, and from year to year thereafter unless either party desiring to amend or terminate the Union agreement shall serve upon the other written notice.

Universal Mfg. Co. and Subsidiaries

Notes to Consolidated Financial Statements

Note 9. Commitments and Contingencies

The Company is obligated under certain noncancelable operating leases. Assets held under these leases include the land, building and telephone system for the Company’s operating locations. The Company is also responsible for all taxes, insurance, utilities and repairs. All leases provide for renewal periods. Lease expense for the years ended July 31, 2017 and 2016, was approximately \$960,860 and \$730,000, respectively.

Minimum payments for operating leases having initial or remaining noncancelable terms in excess of one year are as follows:

| | |
|-----------------------|------------|
| Years ending July 31: | |
| 2018 | \$ 996,000 |
| 2019 | 856,000 |
| 2020 | 767,000 |
| 2021 | 767,000 |
| 2022 | 447,000 |

The Company is periodically associated with claims and pending legal proceedings that occur in the normal course of business. These proceedings are, in the opinion of management, ordinary routine matters incidental to the normal business conducted by the Company. In the opinion of management, the ultimate disposition of such proceedings are not expected to have a material adverse effect on the Company’s consolidated financial position, results of operations or cash flows.

Note 10. Concentrations of Credit Risk

The Company performs ongoing credit evaluations of its customers’ financial condition and generally does not require collateral for accounts receivable arising from the normal course of business. The Company maintains allowances for potential credit losses that, when realized, have been within the range of management’s expectations.

In addition, a material portion of the Company’s business is with major customers. For the year ended July 31, 2017, the Company had two customers that accounted for 41 percent of consolidated net sales. There was \$757,000 due from these major customers at July 31, 2017. For the year ended July 31, 2016, the Company had one customer that accounted for 47 percent of consolidated net sales. There were no amounts due from this major customer at July 31, 2016.

The Company maintains its cash in bank deposit accounts that, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

Note 11. Related-Party Transactions

An employee and director of the Company is a director in the institution in which the Company has depository funds and debt financing. This individual is also associated with a legal firm for which the Company incurred expense of \$44,983 and \$59,459 in 2017 and 2016, respectively.

EXECUTIVE OFFICERS

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Chairman of the Board

Thomas C. Hance
President & CEO

Dawn M. Sutter
Secretary/Treasurer

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Kinport Corporation
Lincoln, Nebraska

Donald L. Dunn
Universal Mfg. Co.
Lincoln, Nebraska

Jeff A. Einfalt
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