WINLAND ELECTRONICS, INC.

2001 ANNUAL REPORT

CONTENTS

CEO's LETTER TO SHAREHOLDERS

Dear Winland Shareholder:

On behalf of Winland Electronics' board of directors, management team, and staff, I welcome this opportunity to bring closure to 2001 and to highlight activities that we believe are the building blocks for your company's future.

Unquestionably, financial results for fiscal 2001 have been the most negative in the company's history. The causes behind these results—the challenges, distractions, and negative economic conditions under which Winland operated during the year—have been thoroughly discussed in SEC disclosure filings, news releases, and proxy statements. These factors, together with audited financial statements, will also be reviewed elsewhere in this 2001 Annual Report to Shareholders.

As troubling as fiscal 2001 has been for our investors, management and staff, today, we believe we are once again at the beginning of a path leading toward profitability and growth. Although it sounds peculiar to talk about a 26-year-old company being at the beginning again, every organization must strategically reinvent itself from time to time. Here are some of the reasons for and the steps toward that process.

When I was appointed CEO of the company in June, your board of directors and senior management team came together to evaluate the company's situation. We looked at the urgency of returning Winland to profitability and the steps we could immediately take to conserve cash. In taking these steps, however, the board was not willing to sacrifice the company's future. From this analysis, we rapidly implemented a series of changes in several areas.

Starting with Cost Analysis and Reduction

First we focused on customers and the process of refining a customer profile that would lead us to profitable relationships and best fit Winland's design and manufacturing expertise. Our people examined various cost centers within the company, looking at those that are central to our business and those that are not. We immediately eliminated expenses that were not essential and moved our attention to other urgent issues. These included the reduction of inventory, aggressive management of accounts receivable, and debt reduction. All of these programs served Winland's planned objectives of reducing operating expenses, increasing operating margins, improving our cash position, and returning to an overhead structure that could allow profitability during 2002.

These programs produced:

- A reduction in debt to $4.9 million at year-end from $7.6 million at year-end 2000
- Reduced inventory to $2.4 million at year-end from $5.3 million at year-end 2000
- Reduced accounts receivable to $2.0 million at year-end from $3.4 million at year-end 2000
- An accumulated cash balance of $400,000 at year-end up from $39,000 at year-end 2000

Building Sales and Market Share

As our people worked to solve immediate challenges, their strategic look at the company also uncovered Winland's strengths and weaknesses in our marketplaces. We developed and implemented new initiatives designed to grow our market share of the "right customers".

CEO’s LETTER TO SHAREHOLDERS (continued)

To maximize our efforts to increase sales and build market share, we reorganized sales and customer service operations to allow our sales executives to identify, bid, and close new business that matched the “right customer” target. Between June and December 2001, we began to see the positive results of these efforts. During one of the most difficult economic periods our country has faced, Winland added four new Electronic Manufacturing Services (EMS) customers and four new distributors for our proprietary products.

This reorganization of sales, marketing, and customer service also allows Winland to better service our valued existing customers and to continue providing them with competitive, reliable products. The newly created Project Operations Group not only manages our customers’ projects and relationships, but is charged with improving the value Winland delivers to customers and ultimately, to our shareholders. Since the inception of these changes, existing customers have rewarded us with new additional orders totaling $10.5 million to be delivered over the next 18 months.

Company Growth

Winland’s growth plan includes initiatives to expand sales and market share in both the manufacturing and the engineering segments that the company serves. We will continue to focus on those EMS customer relationships that fit our customer profile, and also take advantage of additional proprietary product growth by leveraging knowledge and capabilities gained through our work with EMS customers. We believe this approach will allow Winland to provide competitive EMS services and, at the same time, work to enhance profitability with an improved mix of higher margin proprietary products that support but do not compete with our customers’ markets.

Because the company’s primary focus is to return to consistent profitability during a soft economy, achieving growth may be a slow process. We will need to balance the desire for growth with our commitment to profitability. Currently, our staff is tightly focused on marketing and sales growth of "environmental security" products and motor controls within our proprietary product line.

I am confident that what has been achieved and the accomplishments to come in the future will lead the company to profitable growth. Winland’s experienced management team, expanded administrative and operational systems, and collective commitment to continuous improvement are powerful tools for success. The word "focused" is used several times in this letter, because it best describes the skill, effort, commitment, and loyalty of our valued staff. We have the right products and services to offer, the right people, and the right opportunity in an ever-growing marketplace.

Thank you for your support, understanding and encouragement in 2001. We will keep you informed of our progress toward our refocused objectives during fiscal 2002.

Sincerely,

Lorin E. Krueger
Chief Executive Officer

CORPORATE PROFILE

Winland Electronics, Inc. provides:

Electronic Manufacturing Services (EMS)
- Contract Manufacturing of Electronic and Electromechanical Assemblies
- Design Engineering Services
- Manufacturing Engineering Services

DC Motor Control Products:
- Standard and Custom Designed DC Motor Controls
- Custom Manufacturing Services for the Motor Control Industry
- Motor Control Accessories

Environmental Security Products for Home and Business:
- Sensors and Alarms for Temperature, Humidity, Water Leakage and Power-Outage
- Driveway Vehicle Detection

Winland Electronics is ISO 9001 Registered

MARKET FOR THE COMPANY'S COMMON STOCK

Effective January 27, 2000, the Company's Common Stock was listed on the American Stock Exchange ("AMEX") under the symbol WEX. Prior to being listed on AMEX, the Company's Common Stock was traded on Nasdaq SmallCap Market under the symbol WLET. The following table sets forth the high and the low bid quotations, as reported by the Nasdaq SmallCap Market through January 27, 2000 and as reported by AMEX thereafter. The bid quotations represent interdealer prices and do not include retail markets mark-ups, mark-downs or commissions and may not necessarily represent actual transactions.

Fiscal Year Ended December 31, 2001	Low	High
First Quarter	1.250	1.938
Second Quarter	1.150	1.550
Third Quarter	0.800	1.500
Fourth Quarter	0.500	1.180

Fiscal Year Ended December 31, 2000	Low	High
First Quarter	2.250	3.625
Second Quarter	1.875	3.188
Third Quarter	1.875	2.875
Fourth Quarter	1.875	2.500

On March 22, 2002, the fair market value of the Company's Common Stock was $.86, based on the closing sale price quoted by AMEX on that date. As of December 31, 2001, the Company had approximately 465 shareholders of record. The Company has never paid cash dividends on its Common Stock. The Board of Directors presently intends to retain earnings for use in the Company's business and does not anticipate paying cash dividends on Common Stock in the foreseeable future. Any future determinations as to the payment of dividends will depend on the financial condition of the Company and such other factors as are deemed relevant by the Board of Directors.

SELECTED FINANCIAL DATA

The following table sets forth selected financial data for Winland Electronics Inc., which has been derived from the Company's financial statements. The financial data listed below should be read in conjunction with "Management's Discussion and Analysis or Plan of Operations" and the audited financial statements and related notes thereto included elsewhere in this annual report.

	Years Ended December 31, 2001	2000
OPERATIONS DATA:		
Net Sales	$15,394,754	$19,500,336
Cost of Sales	12,795,245	16,533,306
Gross Profit	2,599,509	2,967,030
Operating Expenses	3,164,297	3,074,492
Other Income and Expenses, Net	(437,541)	(367,861)
Income Loss Before Income Taxes	(1,002,329)	(475,323)
Income Tax Benefit	(125,600)	(165,800)
Net Loss	$ (876,729)	$ (309,523)
EARNINGS PER SHARE DATA:		
Diluted Loss Per Share	$ (.30)	$ (.11)
Weighted Average Common Shares Outstanding Including Potentially Dilutive Shares	2,954,128	2,936,033
BALANCE SHEET DATA:		
Working Capital	$ 1,367,666	$ 2,074,820
Total Assets	$ 9,815,151	$14,707,109
Long-Term Debt	$ 2,453,909	$ 2,924,885
Stockholders' Equity	$ 3,431,160	$ 4,300,535

Availability of Form 10-KSB

Shareholders of record may obtain the Company's annual report on Form 10-KSB for the fiscal year ended December 31, 2001, which will be filed with the Securities and Exchange Commission and will be available after April 1, 2002. This report (without exhibits) will be provided without charge upon written request to the Corporate Secretary.

MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

RESULTS OF OPERATIONS – 2001 vs. 2000

Net Sales: The Company recorded net sales of $15,394,754 for the year ended December 31, 2001, a decline of $4,105,582 or 21.1% from $19,500,336 for the year ended December 31, 2000. The reduction in sales is attributed to lower sales to OEM customers, most notably reduced sales to PeopleNet Communications. In mid August of 2001 the Company negotiated a release of its manufacturing agreement with PeopleNet for the production of the customers base unit. The Company continues to supply manufacturing services to PeopleNet, but at a reduced level. Management believes that the reduced PeopleNet sales will permit the company to take advantage of other opportunities at gross margin levels more consistent with its business objectives. In addition, sales to several other OEM customers were lower in 2001. This is attributable to reduced customer demand consistent with the broader slowing of the economy. As a percentage of net sales, sales of Winland's proprietary products increased for the twelve months ended December 31, 2001, compared to 2000.

The Company's OEM customers have given the Company purchase orders and forecasts having an aggregate value of $10.5 million over the next 18 months.

The loss of any significant OEM customer would likely have an adverse effect on the Company's short-term, and potentially long-term, results. Although the loss of a portion of the PeopleNet production has had an effect on the Company's revenues, management believes that this change will allow the organization to take advantage of other opportunities.

Gross Profits: Gross profit was $2,599,509 or 16.9% of net sales for the year ended December 31, 2001, compared to $2,967,030 or 15.2% of net sales for the same period in 2000. As a percentage of net sales, gross profits increased 1.7% for the year ended December 31, 2001 compared to 2000. The increase in gross profit, as a percentage of sales, is attributed to sales mix for the year combined with the Company's ability to reduce direct and variable indirect expenses as sales declined for the period.

Operating Expenses: General and administrative expense was $1,606,663 or 10.4% of net sales for the year ended December 31, 2001, compared to $1,278,698 or 6.6% of net sales for the same period in 2000. More than $277,000 of the increase is attributable to increased professional fees, shareholder communications and board of director expenses related to the August 21, 2001 special shareholders' meeting requested by dissident shareholder, Dyna Technology, Inc., and an annual meeting contested by Dyna Technology, Inc. In addition, the Company incurred a $205,591 expense related to an executive severance package in connection with the May 2001 resignation and release of employment agreement of W. Kirk Hankins, the former Chief Executive Officer.

Research and development expense (including the development of new products, as well as design services and support to the OEM customer base) was $840,813 or 5.5% of net sales for the year ended December 31, 2001, compared to $1,124,714 or 5.8% of net sales for 2000. The decline in research and development expense is primarily attributed to employee attrition and reassignment without replacement, offset in part by increased facility and information technology expenses.

Sales and marketing expense, including project management, was $716,821 or 4.7% of net sales for the year ended December 31, 2001, compared to $671,080 or 3.4% of net sales for the same period in 2000. The increase is primarily due to increased salaries and salary related expenses in connection with the reassignment of certain personnel to project management. In addition, information technology and facility expenses increased, offset in part by decreased trade show and promotional expenses.

Interest Expense: Interest expense was $482,634 or 3.1% of net sales for the year ended December 31, 2001, compared to $485,816 or 2.5% of net sales for the same period in 2000. While, as a percentage of sales, the interest expense increased, the actual expense decreased over $3,000 for 2001 compared to 2000. The decline in interest expense is attributed to a reduction in long-term debt, lower interest rates on short-term borrowing, offset by increased borrowing on the Company's revolving line-of-credit early in the year and increased interest on long–term lease agreements due to a significant lease on capital equipment commenced in December 2000.

Net Loss: The Company reported a net loss of $876,729 or $0.30 per basic and diluted share and a net loss of $309,523 or $0.11 per basic and diluted share for the years ended December 31, 2001 and 2000, respectively. The net loss for 2001 is primarily due to lower sales volumes to OEM customers and additional non-recurring, general and administrative expenses in excess of $482,000 directly associated with the resignation of the company's former Chief Executive Officer, fees and expenses related to the August 21, 2001 special shareholders' meeting and the contested annual meeting in December 2001. In addition, the Company provided for a valuation allowance against its net deferred tax assets of $315,000, which contributed to the net loss.

LIQUIDITY AND CAPITAL RESOURCES

Cash provided by operating activities was $3,040,357 for the year ended December 31, 2001, compared to cash used for operating activities of $1,501,570 for the same period in 2000, an improvement of $4,541,927. Cash provided by operations was used to pay down $1,943,000 of the Company's revolving line-of-credit (a reduction of over 49%), reduce long-term debt and to a lesser degree, for the purchase of equipment. The Company has funded its current operations with working capital provided by operations.

The current ratio at December 31, 2001 was 1.4 to 1, compared to 1.3 to 1 at December 31, 2000. Working capital equaled $1,367,666 on December 31, 2001, compared to $2,074,820 on December 31, 2000. The decrease in working capital is attributed to reductions in accounts receivable, inventory, and deferred taxes, offset, in part, by increased income tax receivable and prepaid expenses and decreased accounts payable and short-term borrowings.

The Company has a $3,500,000 revolving line-of-credit agreement with Wells Fargo Bank, through September 15, 2002. Interest on advances are 2% over the bank's reference rate (6.75 percent at December 31, 2001) and due monthly. Advances outstanding on the revolving line-of-credit at December 31, 2001 and December 31, 2000 were $1,981,501 and $3,924,501, respectively. Advances are due on demand, are secured by substantially all assets of the Company, and are subject to a defined borrowing base equal to 75 percent of qualified accounts receivable and 50 percent of eligible inventory. In addition, the line-of-credit agreement contains certain reporting and operating covenants. One such covenant required the Company to have no more than a $710,000 net loss for 2001. The provision for a valuation allowance against net deferred tax assets of $315,000, although not affecting the net loss before income taxes, created a violation of this covenant at December 31, 2001, which was subsequently waived by the bank.

The Company has maintained financing arrangements with Wells Fargo Bank since February of 1996. In the fall of 2000, the Company increased the maximum loan amount under its line-of-credit agreement with Wells Fargo Bank to $4,500,000 from the $3,500,000 level which had been in place throughout 2000, to address working capital demands largely attributable to increased production for one of the Company's customers. At December 31, 2000, the Company was in violation of certain covenants under the line-of-credit agreement and Wells Fargo Bank waived the covenants through December 31, 2001. The Company and Wells Fargo Bank agreed to extend the original $3,500.000 line of credit from August 31, 2001 through November 30, 2001. In December 2001, the line of credit was extended again through March 1, 2002.

On March 19, 2002, the Company extended the line-of-credit agreement with Wells Fargo through September 15, 2002 under the terms described above. The Company will continue to explore other financing sources, including asset-based lending, to provide financing beyond September 15, 2002. There is no assurance that the Company will be successful in obtaining financing arrangements on terms acceptable to the Company. The Company may find it necessary to accept financing arrangements which limit the Company's ability to achieve growth.

A summary of our contractual cash obligations at December 31, 2001 is as follows:

	Payments due by period					
Contractual Obligations	**Total**	**2002**	**2003**	**2004**	**2005**	**2006 and thereafter**
Long-term debt, including interest	$3,438,800	$662,800	$551,800	$964,300	$1,097,300	$162,600
Operating leases	28,000	18,000	10,000	0	0	0
Purchase agreement for manufacturing equipment	0	0	0	0	0	0
Total contractual cash obligations	$3,466,800	$680,800	$561,800	$964,300	$1,097,300	$162,600

We also have a commercial commitment as described below:

Other Commercial Commitment	**Total Amount Committed**	**Outstanding at 12/31/01**	**Date of Expiration**
Line of credit	$3,500,000	$1,981,501	September 15, 2002

We believe that our cash balance, availability under our line of credit, if needed, and anticipated cash flows from operations will be adequate to fund our cash requirements for fiscal 2002.

CRITICAL ACCOUNTING POLICIES

Our significant accounting policies are summarized in the footnotes to our financial statements. Some of the most critical policies are also discussed below.

As a matter of policy, we review our major assets for impairment. Our major operating assets are accounts receivable, inventory and property and equipment. We have not experienced significant bad debts expense and our reserve for doubtful accounts of $10,000 should be adequate for any exposure to loss in our December 31, 2001 accounts receivable. We have also established reserves for slow moving and obsolete inventories and believe the reserve of $135,000 is adequate. We depreciate our property and equipment over their estimated useful lives. We have identified one piece of equipment that was impaired in 2001 and wrote it down to its lease buy out value.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In July 2001, FAS 141, *Business Combinations*, and FAS 142, *Goodwill and Other Intangible Assets*, were issued. These pronouncements provide that all business combinations initiated after June 30, 2001 be accounted for using the purchase method and that goodwill be reviewed for impairment rather than amortized, beginning on January 1, 2002. The Company does not believe that the adoption of these pronouncements, including the effect on the license agreement disclosed (see Note 12), will have a material effect on its financial statements. Any business combination transactions in the future would be accounted for under this new guidance.

In September 2001, the FASB issued Statement 143, *Asset Retirement Obligations*. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Statement will be effective for the Company's fiscal year ending December 2003. The Company does not believe that the adoption of this pronouncement will have a material effect on its financial statements.

In August 2001, the FASB issued Statement 144, *Accounting for Impairment or Disposal of Long-Lived Assets*. This Statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. The Statement will be effective for the Company's fiscal year ending December 2002. The Company does not believe that the adoption of this pronouncement will have a material effect on its financial statements.

CAUTIONARY STATEMENTS

Certain statements contained in this Annual Report and other written and oral statements made from time to time by the Company do not relate strictly to historical or current facts. As such, they are considered "forward-looking statements" which provide current expectations or forecasts of future events. Such statements can be identified by the use of terminology such as "anticipate," "believe," "estimate," "expect," "intend," "may," "could," "possible," "plan," "project," "should," "will," "forecast" and similar words or expressions. The Company's forward-looking statements generally relate to the Company's growth strategies, financial results, product development and sales efforts. One must carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by inaccurate assumptions, including, among others, those discussed below. Consequently, no forward-looking statement can be guaranteed and actual results may vary materially. As provided for under the Private Securities Litigation Reform Act of 1995, the Company wishes to caution investors that the following important factors, among others, in some cases have affected and in the future could affect the Company's actual results of operations and cause such results to differ materially from those anticipated in forward-looking statements made in this document and elsewhere by or on behalf of the Company.

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

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

The Company's ability to execute its initiatives to increase sales and expand marketshare depends upon its ability to develop additional proprietary products and on the availability of sufficient financing, both equity and debt, to meet fixed and variable costs associated with such growth. In the current economic environment, banks and other sources of financing are becoming increasingly conservative in their lending and investment policies. There is no assurance that the Company will be able to obtain the financing necessary to achieve its goals.

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

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Winland Electronics, Inc.
Mankato, Minnesota

We have audited the accompanying balance sheets of Winland Electronics, Inc., as of December 31, 2001 and 2000, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. 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 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 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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Winland Electronics, Inc., as of December 31, 2001 and 2000, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

McGladrey & Pullen, LLP

Minneapolis, Minnesota
January 25, 2002 (March 19, 2002, as to Note 3)

WINLAND ELECTRONICS, INC.

BALANCE SHEETS
December 31, 2001 and 2000

ASSETS (Note 3)	2001	2000
Current Assets		
Cash	**$ 399,749**	$ 38,961
Accounts receivable, less allowance for doubtful accounts of $10,000 (Note 9)	**1,993,983**	3,435,030
Income tax receivable (Note 6)	**177,000**	127,252
Inventories (Note 2)	**2,439,727**	5,270,029
Prepaid expenses and other assets	**100,191**	56,599
Deferred taxes (Note 6)	**-**	244,100
Total current assets	**5,110,650**	9,171,971
Other Assets		
Patents and trademarks, net of accumulated amortization of $33,212 in 2001; $31,741 in 2000	**1,027**	2,498
Property and Equipment, at cost (Note 4)		
Land and land improvements	**272,901**	272,901
Building	**2,983,586**	2,983,586
Machinery and equipment	**3,675,897**	3,778,392
Data processing equipment	**1,301,598**	1,277,413
Office furniture and equipment	**353,932**	351,960
Total property and equipment	**8,587,914**	8,664,252
Less accumulated depreciation	**3,884,440**	3,131,612
Net property and equipment	**4,703,474**	5,532,640
Total assets	**$ 9,815,151**	$ 14,707,109

See Notes to Financial Statements.

LIABILITIES AND STOCKHOLDERS' EQUITY	**2001**	2000
Current Liabilities		
Note payable to bank (Note 3)	**$ 1,981,501**	$ 3,924,501
Current maturities of long-term debt	**472,325**	713,845
Accounts payable	**931,385**	2,107,319
Accrued expenses:		
Compensation	**289,749**	225,767
Other	**68,024**	125,719
Total current liabilities	**3,742,984**	7,097,151
Long-Term Liabilities		
Deferred revenue (Note 5)	**187,098**	195,238
Long-term debt, less current maturities (Notes 3 and 4)	**2,453,909**	2,924,885
Deferred taxes (Note 6)	**-**	189,300
Total long-term liabilities	**2,641,007**	3,309,423
Total liabilities	**6,383,991**	10,406,574
Commitments and Contingencies (Note 4)		
Stockholders' Equity (Notes 7 and 8)		
Common stock, par value $0.01 per share; authorized 20,000,000 shares; issued and outstanding 2,959,842 shares in 2001 and 2,952,313 shares in 2000	**29,598**	29,523
Additional paid-in capital	**2,249,702**	2,242,423
Retained earnings	**1,151,860**	2,028,589
Total stockholders' equity	**3,431,160**	4,300,535
Total liabilities and stockholders' equity	**$ 9,815,151**	$ 14,707,109

WINLAND ELECTRONICS, INC.

STATEMENTS OF INCOME
Years Ended December 31, 2001 and 2000

	2001	2000
Net sales (Note 9)	**$ 15,394,754**	$ 19,500,336
Cost of sales	**12,795,245**	16,533,306
Gross profit	**2,599,509**	2,967,030
Operating expenses:		
General and administrative	**1,606,663**	1,278,698
Research and development	**840,813**	1,124,714
Sales and marketing	**716,821**	671,080
	3,164,297	3,074,492
Operating loss	**(564,788)**	(107,462)
Other income (expenses):		
Interest expense	**(482,634)**	(485,816)
Interest income	**25,552**	75,352
Other, net	**19,541**	42,603
	(437,541)	(367,861)
Loss before income taxes	**(1,002,329)**	(475,323)
Income tax benefit (Note 6)	**(125,600)**	(165,800)
Net loss	**$ (876,729)**	$ (309,523)
Earnings (loss) per share data:		
Basic	**$ (0.30)**	$ (0.11)
Diluted	**(0.30)**	(0.11)
Weighted-average number of common shares outstanding:		
Basic	**2,954,128**	2,936,033
Diluted	**2,954,128**	2,936,033

See Notes to Financial Statements.

WINLAND ELECTRONICS, INC.

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
Years Ended December 31, 2001 and 2000

	Common Stock		Additional Paid-In	Retained	
	Shares	Amount	Capital	Earnings	Total
Balance on December 31, 1999	2,901,620	$ 29,016	$ 2,169,750	$ 2,338,112	$ 4,536,878
Issuance of common stock in accordance with employee stock option and purchase plans and warrants exercised (Notes 7 and 8)	50,693	507	72,673	-	73,180
Net loss	-	-	-	(309,523)	(309,523)
Balance on December 31, 2000	2,952,313	29,523	2,242,423	2,028,589	4,300,535
Issuance of common stock in accordance with employee stock purchase plan (Note 8)	7,529	75	7,279	-	7,354
Net loss	-	-	-	(876,729)	(876,729)
Balance on December 31, 2001	**2,959,842**	**$ 29,598**	**$ 2,249,702**	**$ 1,151,860**	**$ 3,431,160**

See Notes to Financial Statements.

WINLAND ELECTRONICS, INC.

STATEMENTS OF CASH FLOWS
Years Ended December 31, 2001 and 2000

	2001	2000
Cash Flows From Operating Activities		
Net loss	$ (876,729)	$ (309,523)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	851,061	814,147
Loss on disposal of equipment	11,003	14,986
Deferred taxes	54,800	(108,000)
Changes in assets and liabilities:		
Accounts receivable	1,441,047	(903,158)
Income tax receivable	(49,748)	(108,252)
Inventories	2,830,302	(1,816,251)
Prepaid expenses and other assets	(43,592)	1,992
Accounts payable	(1,175,934)	1,015,355
Accrued expenses, including deferred revenue	(1,853)	(102,866)
Net cash provided by (used in) operating activities	3,040,357	(1,501,570)
Cash Flows From Investing Activities		
Proceeds from disposal of equipment	18,150	3,285
Purchases of property and equipment	(49,577)	(283,417)
Net cash used in investing activities	(31,427)	(280,132)
Cash Flows From Financing Activities		
Net borrowings (payments) on revolving credit agreement	(1,943,000)	2,406,000
Principal payments on long-term borrowings, including capital lease obligations	(712,496)	(698,534)
Proceeds from issuance of common stock	7,354	73,180
Net cash provided by (used in) financing activities	(2,648,142)	1,780,646
Net increase (decrease) in cash	360,788	(1,056)
Cash		
Beginning of year	38,961	40,017
End of year	$ 399,749	$ 38,961
Supplemental Disclosures of Cash Flow Information		
Cash payments for (receipts of):		
Interest	$ 482,818	$ 482,996
Income taxes	(130,815)	98,852
Supplemental Schedule of Noncash Investing and Financing Activities		
Capital lease obligations incurred for the use of equipment	$ -	$ 441,598

See Notes to Financial Statements.

Note 1. Nature of Business and Significant Accounting Policies

Nature of business: The Company operates in one business segment, which includes the design and manufacture of electronic control devices. Sales are to customers located primarily in the upper Midwest, and credit is granted based upon the credit policies of the Company.

A summary of the Company's significant accounting policies follows:

Use of estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from such estimates.

Revenue recognition: Revenue from product sales is recognized when shipped, FOB shipping point. Shipping and handling charges billed to customers are included in net sales, and shipping and handling costs incurred by the Company are included in cost of goods sold.

Cash: The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

Inventories: Inventories are stated at the lower of cost (first-in, first-out method) or market.

Patents and trademarks: Patents and trademarks are stated at cost and are being amortized using the straight-line method over their economic useful lives.

Depreciation: It is the Company's policy to include depreciation expense on assets acquired under capital leases with depreciation expense on owned assets. Depreciation is computed using the straight-line method based on the estimated useful lives of the various assets or capital lease term, as follows:

	Years
Land improvements	17–20
Building	39–40
Machinery and equipment	5–7
Data processing equipment	3–7
Office furniture and equipment	3–7

Long-lived assets: The Company reviews its long-lived assets and intangibles periodically to determine potential impairment by comparing the carrying value of the long-lived assets with the estimated future cash flows expected to result from the use of the assets, including cash flows from disposition. Should the sum of the expected future cash flows be less than the carrying value, the Company would recognize an impairment loss. An impairment loss would be measured by comparing the amount by which the carrying value exceeds the fair value of the long-lived assets and intangibles. In 2000, management has determined that no impairment of long-lived assets exists. In 2001, the Company recognized an impairment charge on certain equipment of approximately $63,000.

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Income taxes: Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit 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.

Investment tax credits, research and development credits, and job credits are accounted for by the flow-through method, whereby they reduce income taxes currently payable and the provision for income taxes in the period the assets giving rise to the credits are placed in service. To the extent such credits are not currently utilized on the Company’s tax return, deferred tax assets, subject to considerations about the need for a valuation allowance, are recognized for the carryforward amount.

Fair value of financial instruments: In accordance with the requirements of Statement of Financial Accounting Standards (SFAS) No. 107, *Disclosures About Fair Value of Financial Instruments*, management estimates that the carrying value of long-term debt approximates fair value, estimated based on interest rates for the same or similar debt offered to the Company having the same or similar remaining maturities and collateral requirements. The carrying value of all other financial instruments approximates fair value due to the short-term nature of the instruments.

Earnings (loss) per share: Basic earnings (loss) per share is computed by dividing net earnings (loss) by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed by dividing net earnings by the weighted-average number of common shares outstanding during the period, including potentially dilutive shares.

The Company has granted options and warrants to purchase shares of common stock at various amounts per share (see Note 7). For 2001 and 2000, these options and warrants were not included in the computation of diluted earnings per share because the Company has incurred a loss for the period. The inclusion of potential common shares in the calculation of diluted loss per share would have an antidilutive effect. Therefore, basic and diluted loss per share amounts are the same for 2001 and 2000.

Research and development expense: The Company expenses research and development costs as incurred. Research and development expenses of $840,813 and $1,124,714 were charged to operations during the years ended December 31, 2001 and 2000, respectively.

Emerging accounting standards: The FASB has issued SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* which the Company adopted in the fiscal year ended December 31, 2001. Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires than an entity recognize all derivatives as either assets or liabilities in the balance sheet and measure those instruments at fair value. SFAS No. 133 did not have any effect on the Company’s financial statements.

Note 1. Nature of Business and Significant Accounting Policies (Continued)

In July 2001, the Financial Accounting Standards Board issued two statements—Statement No. 141, *Business Combinations,* and Statement No. 142, *Goodwill and Other Intangible Assets,* which will potentially impact the Company's accounting for its reported intangible assets. The standards generally are required to be implemented by the Company in its 2002 financial statements. The adoption of these standards is not expected to have a material impact on the Company's financial statements.

In September 2001, the FASB issued Statement No. 143, *Asset Retirement Obligations.* This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The statement will be effective for the Company's fiscal year ending 2003. Management does not expect the adoption of this standard to have a material impact on the Company's financial statements.

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* replaces Statement No. 121—an earlier pronouncement on this topic. The new statement establishes a single accounting model for long-lived assets to be disposed of by sale. Statement No. 144 will be effective for the Company's fiscal year ending 2002. Management does not expect the adoption of this standard to have a material impact on the Company's financial statements.

Reclassifications: Certain 2000 costs of sales and operating expenses have been reclassified to be in conformity with the 2001 presentation. These reclassifications have had no effect on previously reported net loss or net loss per share data.

Note 2. Inventories

The components of inventories at December 31, 2001 and 2000, are as follows:

	December 31	
	2001	2000
Raw materials	$ 2,006,461	$ 4,713,476
Work in progress	138,859	288,991
Finished goods	429,407	319,562
Obsolescence reserve	(135,000)	(52,000)
Total	$ 2,439,727	$ 5,270,029

Note 3. Financing Arrangement and Long-Term Debt

Financing arrangement: The Company has a $3,500,000 revolving line-of-credit agreement through March 1, 2002. Advances are due on demand, are secured by substantially all assets of the Company, and are subject to a defined borrowing base equal to 80 percent of qualified accounts receivable and 50 percent of eligible inventories plus 25 percent of work in process. Interest on advances is at the prime rate plus 2.0 percent (6.75 percent at December 31, 2001) and is due monthly. Advances outstanding on the revolving line-of-credit agreement at December 31, 2001 and 2000, were $1,981,501 and $3,924,501, respectively. On March 19, 2002, the line-of-credit agreement was extended through September 15, 2002.

Note 3. Financing Arrangement and Long-Term Debt (Continued)

Long-term debt: The following is a summary of long-term debt:

	December 31	
	2001	2000
6.941% note payable, due in monthly installments of $15,221, including interest, to January 1, 2005, when the remaining balance is payable, secured by property and equipment (a)	$ 1,127,505	$ 1,228,072
4% note payable, due in monthly installments of $3,698, including interest, to January 1, 2005, when the remaining balance is payable, secured by property and equipment	306,096	337,547
8.25% note payable, due in monthly installments of $5,150, including interest, to September 2004, secured by equipment	486,890	507,051
6% note payable, due in monthly installments of $1,665, including interest, to November 2009, secured by building	124,653	136,761
Capital lease obligations, due in various monthly installments, with interest ranging from 7.24% to 10.04%, to November 2006, secured by equipment (Note 4)	881,090	1,346,013
Other	-	83,286
	2,926,234	3,638,730
Less current maturities	472,325	713,845
Total long-term debt	$ 2,453,909	$ 2,924,885

Approximate maturities of long-term debt for years subsequent to December 31, 2001, are as follows:

2002	$ 472,000
2003	393,000
2004	814,000
2005	1,096,000
2006	99,000
Thereafter	52,000
Total	$ 2,926,000

(a) These agreements contain certain reporting and operating covenants. The Company was in violation of certain covenants at December 31, 2001, which were subsequently waived by the bank.

Note 4. Commitments and Contingencies

Capital leases: The Company is leasing certain equipment under capital leases. The cost and accumulated depreciation of assets acquired under capital leases at December 31, 2001 and 2000, are as follows:

	2001	2000
Cost	$ 2,070,802	$ 2,898,400
Accumulated depreciation	1,105,106	1,397,125
Net leased property under capital leases	$ 965,696	$ 1,501,275

The future minimum lease payments under capital leases and the aggregate present value of the net minimum lease payments at December 31, 2001, are approximately as follows:

2002	$ 562,000
2003	355,000
2004	244,000
2005	250,000
2006	93,000
Thereafter	86,000
Total minimum lease payments	1,590,000
Less amount representing interest	709,000
Present value of net minimum lease payments (included in long-term debt)	$ 881,000

Operating leases: The Company leases certain equipment and vehicles under noncancelable operating leases through September 2003. The Company is responsible for all repairs and maintenance, insurance, and other related expenses in connection with these leases.

Rental and other related expenses for the above leases for the years ended December 31, 2001 and 2000, were approximately $103,000 and $150,000, respectively.

Approximate future minimum annual lease payments under these leases as of December 31, 2001, are as follows:

Years ending December 31:	
2002	$ 23,000
2003	12,000
	$ 35,000

Note 5. Deferred Revenue

During 1994, the Company and the city of Mankato entered into a tax increment financing agreement for the construction of the Company's operating facility. In connection with this agreement, the city donated land improvements with a fair value of $270,009. The fair value of land improvements donated was accounted for as deferred revenue and is being amortized over 39 years, which is the life of the building.

Note 6. Income Taxes

Components of the provision for (benefits of) income taxes are as follows:

	December 31	
	2001	2000
Currently (refundable) payable	$ (180,400)	$ (57,800)
Deferred	54,800	(108,000)
	$ (125,600)	$ (165,800)

The statutory income tax rate reconciliation to the effective rate is as follows:

	December 31	
	2001	2000
Statutory U.S. income tax rate	(35) %	(35) %
State taxes, net of federal tax effect	(1) %	(1) %
Tax benefit of NOL and credit carryforwards	(7) %	(6) %
Research and development tax credit	(7) %	(9) %
Utilization of federal NOL carryback	6 %	15 %
Valuation allowance	31 %	- %
Other	- %	1 %
Effective income tax rate	(13) %	(35) %

Net deferred tax assets (liabilities) consist of the following components as of December 31, 2001 and 2000:

	December 31	
	2001	2000
Deferred tax assets:		
Inventory	$ 79,800	$ 82,600
Allowance for doubtful accounts	3,700	3,700
NOL carryforwards and tax credits	313,000	89,100
Other	72,300	68,700
	468,800	244,100
Deferred tax liabilities:		
Property and equipment	153,600	189,300
	315,200	54,800
Valuation allowance	(315,200)	-
Net deferred tax assets	$ -	$ 54,800

Note 6. Income Taxes (Continued)

During the year ended December 31, 2001, the Company recorded a valuation allowance of $315,200. The valuation allowance was established by management due to the difficulties in predicting when the net deferred tax assets would be utilized and the amount of future taxable income that may be generated. Realization of deferred tax assets is dependent on future taxable income during the period that deductible temporary differences and carryforwards are to be available to reduce taxable income. There was no other activity in the valuation allowance account during 2001 and 2000.

The components giving rise to the net deferred tax assets and liabilities described above have been included in the accompanying balance sheets at December 31, 2001 and 2000, as follows:

	December 31	
	2001	2000
Current assets	$ -	$ 244,100
Noncurrent liabilities	-	189,300

At December 31, 2001, the Company has federal and state net operating loss carryforwards of approximately $174,000 and $1,080,000, respectively. These carryforwards expire in 2021 and 2016, respectively. In addition, the Company has approximately $146,000 of tax credits that expire in 2021.

Note 7. Stock-Based Compensation Plans

Stock option plan: The Company has reserved 750,000 common shares for issuance under qualified and nonqualified stock options for its key employees and directors. Option prices are the respective market values of the stock at the time the options were granted. Options become exercisable as determined at the date of grant by a committee of the Board of Directors. Options generally expire five years after the date of grant, unless an earlier expiration date is set at the time of grant.

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*. Accordingly, no compensation cost has been recognized for the stock option plan. Had compensation cost for the Company's stock option plan been determined based on the fair value at the grant date for awards consistent with the provisions of SFAS No. 123, the Company's earnings and earnings per share would have changed to the pro forma amounts indicated below:

	December 31	
	2001	2000
Net loss—as reported	$ (876,729)	$ (309,523)
Net loss—pro forma	(915,882)	(359,096)
Net loss per share, basic—as reported	(0.30)	(0.11)
Net loss per share, diluted—as reported	(0.30)	(0.11)
Net loss per share, basic—pro forma	(0.31)	(0.12)
Net loss per share, diluted—pro forma	(0.31)	(0.12)

Note 7. Stock-Based Compensation Plans (Continued)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 2001 and 2000:

	December 31	
	2001	2000
Expected life of options	3 years	3 years
Expected dividend yield	0.0%	0.0%
Expected stock price volatility	61.6%	60.9%
Risk-free interest rate	6.5%	5.2%

The pro forma effect on earnings in 2001 and 2000 is not representative of the pro forma effect in future years because it does not take into consideration pro forma compensation expense related to grants made prior to 1995.

Additional information relating to all outstanding options as of December 31, 2001 and 2000, is as follows:

	2001			2000		
	Shares		Weighted-Average Exercise Price	Shares		Weighted-Average Exercise Price
Options outstanding, beginning of year	405,000	$	2.10	427,000	$	1.98
Exercised	-		-	(62,000)		1.84
Expired	(103,400)		2.13	(80,000)		2.00
Granted	74,000		0.72	120,000		2.26
Options outstanding, end of year	375,600	$	1.80	405,000	$	2.08
Weighted-average fair value of options granted during the year, computed using the Black-Scholes option pricing model		$	0.42		$	1.02

Options exercised in 2000 were on a cashless basis, resulting in the issuance of only 13,955 shares of common stock.

Note 7. Stock-Based Compensation Plans (Continued)

The following table summarizes information about stock options outstanding at December 31, 2001:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
$0.53 to $0.92	74,000	5.4	$ 0.72	20,000	$ 0.84
$1.75	141,600	1.1	1.75	122,700	1.75
$1.88 to $2.00	63,000	3.2	1.98	30,600	1.97
$2.25 to $2.94	97,000	2.9	2.59	64,600	2.63
	375,600		$ 1.80	237,900	$ 1.94

At December 31, 2000, there were 226,100 options exercisable at a weighted-average exercise price of $2.07.

Note 8. Employee Benefit Plans

Pension plan: The Company has a qualified defined contribution 401(k) profit-sharing plan for its employees who meet certain age and service requirements. Employees are allowed to make contributions up to 15 percent of their eligible compensation. The plan also provides for a company-sponsored match to be determined each year by the Board of Directors. The Company contributed approximately $71,200 and $79,400 to the plan for the years ended December 31, 2001 and 2000, respectively. In addition, the Company may make additional discretionary contributions to the plan to the extent authorized by the Board of Directors. There were no discretionary contributions to the plan for the years ended December 31, 2001 and 2000.

Stock purchase plan: The Company has adopted an employee stock purchase plan to provide substantially all employees an opportunity to purchase shares of its common stock through payroll deductions of up to 15 percent of eligible compensation. The plan provides for two annual six-month phases beginning January 1 and July 1, the grant dates. On June 30 and December 31, the exercise dates, participant account balances are used to purchase shares of stock at the lesser of 85 percent of the fair value of shares on the grant date or the exercise date. The employee stock purchase plan expires December 31, 2002. A total of 100,000 shares were originally available for purchase under the plan. There were 7,529 and 8,526 shares purchased under the plan for the years ended December 31, 2001 and 2000, respectively.

Note 9. Major Customers, International Sales, and Enterprisewide Disclosures

Major customers: The Company has customers which accounted for more than 10 percent of net sales for the years ended December 31, 2001 and 2000, as follows:

	2001	2000
Sales percentage:		
Customer A	35%	32%
Customer B	16%	17%
Customer C	15%	23%
Accounts receivable percentage at December 31:		
Customer A	38%	21%
Customer B	19%	10%
Customer C	2%	35%

International sales: Export sales to international customers for 2001 and 2000 were approximately $290,000 and $256,000, respectively. Accounts receivable from international customers were approximately $27,000 and $20,000 at December 31, 2001 and 2000, respectively.

Enterprisewide disclosures: The following table presents revenue from external customers for each of the Company's groups of products and services:

	2001	2000
Proprietary products and services, primarily for the security/industrial, motor control, and GPS market	$ 2,777,400	$ 2,934,700
Electronic controls and assemblies for OEM customers	12,617,300	16,565,600
	$ 15,394,700	$ 19,500,300

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Self-Employed Business Consultant

Thomas J. de Petra
Director of the Company
Management Consultant

R. Terren Dunlap
Director of the Company
Chief Executive Officer of Ultra-Scan Corporation

James L. Reissner
Director of the Company
President of Activar, Inc.

Lorin E. Krueger
Chief Executive Officer & President
Secretary and Director of the Company

Jennifer Thompson
Chief Financial Officer

Kirk Hankins
Vice President of Sales EMS Eastern Region

Steven Vogel
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