COMMUNICATIONS SYSTEMS INC
Form 10-K
March 24, 2009

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

FORM 10-K

(Mark One)
x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

Commission File Number: 001-31588

COMMUNICATIONS SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Minnesota	**41-0957999**
(State or other jurisdiction of incorporation or organization)	(Federal Employer Identification No.)

10900 Red Circle Drive, Minnetonka, MN 55343
(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: (952) 996-1674

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

Title of each class	**Name of each exchange on which registered**
Common Stock, $.05 par value	**NASDAQ**

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
YES o NO x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. YES o
NO x

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company.
See definition of accelerated filer , large accelerated filer and smaller reporting company in Rule 12b-2 of the Act.
Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer o Smaller Report Company x
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). YES o NO x

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant was approximately $65,076,000 based upon the closing sale price of the Company s common stock on the NASDAQ on June 30, 2008.

As of March 15, 2009 there were outstanding 8,282,348 shares of the Registrant s common stock.

Documents Incorporated by Reference:	Portions of the Company s Proxy Statement for its Annual Meeting of Shareholders to be held on May 21, 2009 are incorporated by reference into Part III of this Form 10-K.

PART I

ITEM 1. BUSINESS
(a) GENERAL DEVELOPMENT OF BUSINESS

Communications Systems, Inc. (herein collectively referred to as CSI , our , we or the Company) is a Minnesota corporation organized in 1969 which operates directly and through its subsidiaries located in the United States, Costa Rica, the United Kingdom and China. CSI is principally engaged through its Suttle and Austin Taylor business units in the manufacture and sale of modular connecting and wiring devices for voice and data communications, digital subscriber line filters, and structured wiring systems and through its Transition Networks business unit in the manufacture and sale of media and rate conversion products for telecommunications networks. CSI also provides IT solutions through its JDL Technologies business unit including network design, computer infrastructure installations, IT service management, change management, network security, and network operation services.

The Company maintains a website at *www.commsystems.com*. Our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our periodic reports on Form 8-K (and any amendments to these reports) are available free of charge by linking from our website to the Securities & Exchange Commission website.

(b) FINANCIAL INFORMATION ABOUT INDUSTRY SEGMENTS

The Company classifies its businesses into four segments: *Suttle*, which manufactures U.S. standard modular connecting and wiring devices for voice and data communications; *Transition Networks,* which designs and markets data transmission, computer network and media conversion products and print servers; *Austin Taylor,* which manufactures British standard line jacks, patch panels, metal boxes, distribution and central office frames; and *JDL Technologies, (JDL*), provides IT solutions. Non-allocated general and administrative expenses are separately accounted for as Other in the Company s segment reporting. There are no material intersegment revenues. Further information regarding the various segments is set forth in Note 9 of the Notes to Consolidated Financial Statements under Item 8, herein.

(c) NARRATIVE DESCRIPTION OF BUSINESS

(1) Information Regarding Business Segments

(i) Suttle

Suttle manufactures and markets connectors and wiring devices for voice, data and video communications under the Suttle brand name in the United States (U.S.) and internationally. Suttle also manufactures and markets a line of residential structured wiring products under the SOHO (Small Office Home Office) Access brand name. Suttle also markets a line of DSL (Digital Subscriber Line) filters for the telecommunications market. Approximately 63% of Suttle s products are manufactured at its plants in Hector, Minnesota (Suttle Apparatus Minnesota Division), and San Jose, Costa Rica (Suttle Costa Rica, S.A.). The other 37% are purchased from offshore contract manufacturers. Segment sales were $44,421,000 (36% of consolidated revenues) in 2008 and $48,135,000 (40% of consolidated revenues) in 2007.

Products

Suttle s products are used in on-premise connection of voice, data, and video devices. The core product line consists primarily of modular connecting devices and includes numerous types of jacks, connecting blocks and assemblies, adapters, cords and related equipment, which are offered in a variety of colors, styles and wiring configurations. Many of the products are used in voice applications but Suttle continues to develop an expanding line of products for full communications and entertainment connectivity. A significant portion of Suttle s revenue is derived from sales of a line of corrosion-resistant connectors, which utilize a water-resistant gel to offer superior performance in harsh environments. Station apparatus products generally range in price from $0.30 to $30.00 per unit. A majority of Suttle s sales volume, both in units and revenues, is derived from products selling for under $5.00 per unit.

Suttle produces a full product line of residential structured wiring equipment used for customer premise applications for voice, data, video, and entertainment distribution. This line of products consists of structured wiring enclosures which are recessed or surface mounted in a residence or small business, and a series of plug-and-play modules which snap into the enclosures to complete the system. The modules selected determine the application of service and the number of ports or connections can be scaled up by adding more modules. These products are marketed under the SOHO Access™ line of products. Suttle s residential wiring systems range in price from $5.42 to $95.00.

Suttle also sells DSL filters for home and business applications that are procured from offshore sources. These filters permit the user to receive both analog and digital signals simultaneously and allow a single telephone line to support uninterrupted voice, fax and internet capabilities.

Markets and Marketing

Suttle competes in all major areas of the telecommunications connector market utilizing traditional modular jacks as well as dual provider switch jacks. Switch jacks enable the user to switch between two competing telephone service providers without the expense of rewiring.

Suttle markets DSL filtering devices to telephone companies for use with their DSL home install kits. The products include both inline filters for deployment in the home and DSL splitters which are typically mounted outside the home near the telephone demarcation point.

Suttle markets residential structured cabling system products which are an increasingly important part of its product line. Service providers such as the telephone and cable companies have extended their traditional services to include comprehensive communications and entertainment offerings which require enhanced premise cabling. Suttle markets its products to service providers, residential builders, and low voltage installers through distributors, and through the Company s sales staff.

Suttle s customers include the major communication companies including both telephone and cable service provider companies. The Company s major telephone company customers include Verizon, ATT (formerly Bell South and SBC Communications), and Qwest. Major telephone companies are served directly by Suttle s sales staff and through a select group of distributors. As a group, sales to the major telephone companies (including DSL), both directly and through distribution, represented 46% of Suttle s sales in 2008 and 43% in 2007. The Company s cable company customers include Comcast, Time Warner, Cox Communications, and Charter as well as other cable companies. Other customers include smaller telephone companies, electrical/low voltage contractors, home builders, original equipment manufacturers, and retailers. These customers are served primarily through distributors but are also served directly by Suttle s sales staff. Sales to cable customers and original equipment manufacturers (OEM) are made through a nationwide network of distributors and through the Suttle sales staff. Sales to cable television distributors represented 9% of Suttle s sales in 2008 and 11% in 2007. Sales to OEMS and other distributors were 28% of Suttle s sales in 2008 and 27% in 2007. Sales to international customers and other customers represented 17% of Suttle s sales in 2008 and 19% in 2007.

The Company s Suttle brand name is important to its business. Suttle regularly supports this name by trade advertising and believes it is well known in the marketplace.

Competition

Suttle encounters strong competition in all its product lines and competes primarily on the basis of the broad lines of products offered, product performance, quality, price and delivery. In addition, distributors of Suttle s products also market products for one or more of these competitors.

Order Book

Suttle manufactures its products on the basis of estimated customer requirements. Outstanding customer orders at March 1, 2009 were approximately $3,333,000 compared to approximately $1,972,000 at March 1, 2008. New orders are generally filled within 30 days. Suttle does not believe its order book is a significant indicator of future results.

Manufacturing and Sources of Supply

Suttle s products are manufactured using plastic parts, wire sub-assemblies, fasteners, brackets, electronic circuit boards and other components, most of which are fabricated by Suttle. There are multiple sources of supply for the materials and parts required and the Company is not dependent upon any single supplier, except that Suttle s corrosion-resistant products utilize a moisture-resistant gel-filled fig available only from Tyco Electronics. Suttle has not generally experienced significant problems in obtaining its required supplies, although from time to time spot shortages are experienced and additional order lead times are required from the offshore suppliers.

Research and Development; Patents

Suttle continually monitors industry requirements and creates new products to improve its existing product line. Historically, Suttle has generally not relied on patents to protect its competitive position in its market. However, duplication of its designs by foreign apparatus manufacturers has caused Suttle to apply for design patents on a number of products.

(ii) Transition Networks

Transition Networks, Inc. (Transition Networks) is based in Minnetonka, Minnesota and also maintains an engineering center and sales office in Shanghai, China. Transition designs, assembles and markets media converters, transceivers, network interface cards, Ethernet switches, Small Form factor Pluggable modules (SFP)s, and other connectivity products under the Transition Networks and MILAN brand names. Transition sells its product through distributors, resellers, integrators, and OEMs. These media converter and Ethernet Switch products permit voice and data networks to move information between copper-wired equipment and fiber-optic cable. Sales by Transition Networks were $62,924,000 (51% of consolidated sales) in 2008 compared to $53,063,000 (44% of consolidated sales) in 2007. International sales accounted for 27% of Transition s sales or $17,061,000 in 2008, compared to $14,937,000 or 28% of Transition s sales in 2007.

Products

Transition Networks designs, assembles and sells media converter devices, Ethernet switches and other connectivity products that make it possible to transmit telecommunications signals between systems using different types of media (for example, between copper and fiber optic networks). These products assist customers to integrate fiber optics into their existing network infrastructure as their networks grow, and extend data services to customers or remote locations. Protocols supported include Gigabit Ethernet, Fast Ethernet, Ethernet, T1/E1, DS3, RS232, RS485, OC3, OC12, and more. The company uses proprietary Application Specific Integrated Circuits (ASIC) for development of some products, as well as ASICs from IC manufacturers such as Marvell® and Broadcomm® for the development of new products. Product hardware and software development is done internally and is expensed when incurred. The software that Transition Networks utilizes to manage its products is provided free with the product. Transition Networks product development is focused on hardware, with software developed to support hardware sales. The Company has been developing and marketing Ethernet based networking products for approximately 20 years. Transition Networks continues to develop products that address the enterprise, service provider, industrial markets, security and, in addition, targets the specific vertical markets of government and education.

Manufacturing and Sources of Supply

Transition Networks outsources most of its manufacturing operations. In 2008, approximately 49% of its products were manufactured offshore, principally in Asia. The offshore sources of supply are subject to certain risks, including foreign currency fluctuations and interference from political sources. The balance of its product is manufactured in the United States. The Company has alternate sources of supply for its products and to date has not had problems obtaining necessary product.

Markets and Marketing

Transition Networks   products are used in a broad array of markets including enterprise networks, service providers   networks, security and industrial environments such as in manufacturing processes. Transition Networks has a broad customer base and applications for its products.

The media conversion product line addresses and is utilized in a variety of applications. The chassis based system, the Point System , is used primarily in telecommunication closets for high-density applications and when multiple protocols need to be supported. Stand alone media converters are used typically at a workstation or for lower density applications. The line of Ethernet switches is used in both the central closet and at the end user station.

Marketing primarily consists of direct marketing utilizing a telesales force, tradeshows, trade magazine advertising, on-line advertising, web site and public relations activities. Transition Networks also provides and participates in advertising and cooperative marketing campaigns with distribution partners.

The Company s   Transition Networks   and   MILAN   brand names are important to its business. The Company regularly supports these names by trade advertising and believes them to be well known in the marketplace.

Research and Development

Transition Networks continues to develop products that address the enterprise, service provider, security and industrial markets. This includes developing converters for emerging protocols and existing protocols in new markets, as well as new industry standards. Some of these products include remote management devices built on the IEEE® 802.3AH standard, Metro Ethernet Forum (MEF)® standards and Power Over Ethernet based on the IEEE® 802.3AF standard. Some design efforts are paced by the development of critical components such as integrated circuits and optical transceivers.

Research and development consists primarily of testing, equipment and supplies associated with enhancing existing products and developing new products. Research and development costs are expensed when incurred and were $1,792,000 in 2008 compared to $592,000 in 2007.

Transition Network s research and development operations are conducted in the United States and China. Transition opened an engineering and sales office in China (Transition Networks Shanghai) in the third quarter of 2007. The Company expects its China operation will focus primarily on engineering including hardware and software development and testing. Additional operations will include marketing, purchasing, and potentially sales support.

Competition

Transition Networks faces strong competition across its entire product line. A large number of competitors exist for the highest volume products in the Fast Ethernet and Gigabit Ethernet family. Low cost competitors from China and Taiwan are strongest in the developing Asian markets, but have had limited success in the North American market for the media converter products. A deeper penetration of these competitors poses a potential threat to sales and profit margins. Competition also exists from substitutes such as lower cost fiber switches. The Fast Ethernet and Gigabit Ethernet switch market is filled with a large number of domestic and Asian competitors. Transition Networks also faces new competitors as it enters new markets for industrial products, security market, and higher performance devices for the service provider market.

Order Book

Outstanding customer orders for Transition Networks products were approximately $2,000,000 at March 1, 2009 and $5,544,000 at March 1, 2008. Transition Networks orders are fulfilled on a relatively short-term basis and therefore the order book is not considered a significant indicator of future results.

(iii) JDL Technologies, Inc.

JDL Technologies, Inc., located in Minnetonka Minnesota (JDL), provides IT solutions including network design, computer infrastructure installations, IT service management, change management, network security and network operation services. JDL s 2008 sales were $9,838,000 (8% of consolidated sales) compared to 2007 sales of $13,219,000 (11% of consolidated sales). Sales of hardware, software and related equipment totaled $3,621,000 in 2008 or 37% of JDL sales compared to $6,009,000 in 2007 or 45% of JDL sales. Training, support, consulting and connectivity revenues were $6,217,000 and $7,210,000 in 2008 and 2007, respectively.

During the past several years JDL derived most of its revenues from two major customers, the Broward County, Florida school district and the U.S. Virgin Islands Department of Education (VIDE), and sales to these two customers provided 100% of 2008 revenue. However, as discussed below, VIDE ceased being a customer after June 2008.

Impairment of VIDE Assets

On January 17, 2008 the Company was notified that JDL was not selected as a vendor to provide services to VIDE for the 2008 2009 school year. As a result, the Company determined that assets, including goodwill, related to its VIDE operations were impaired. See Management s Discussion and Analysis in Item 7 herein for further information.

Department of Justice Investigation

In Note 5 of the Notes to Consolidated Financial Statements of the Company presented in Item 8 of the Company s Annual Report on Form 10-K for the period ended December 31, 2007 (the 2007 10-K), the Company reported, under the caption Department of Justice Investigation , a matter which involved a potential claim against the Company. To date, however, no claim has been asserted and, otherwise, there has been no change in the status of this matters as reported in the 2007 10-K.

Order Book

Outstanding customer orders and contracts for JDL products and services were approximately $4,400,000 at March 1, 2009 and $6,330,000 at March 1, 2008. Approved amounts could vary from the original contracts.

(iv) Austin Taylor

Austin Taylor Communications, Ltd. is located in Bethesda, North Wales, United Kingdom. Austin Taylor is a provider of telephony and data networking products to leading telecommunications companies, distributors and installers throughout the U.K., Europe and the Middle East. Austin Taylor sales were $5,516,000 (5% of consolidated revenues) in 2008 and $6,826,000 (6% of consolidated revenues) in 2007.

Austin Taylor has a strong supply chain product development relationship with its Chinese supplier which has been established over a number of years. At the plant in Bethesda the company designs and manufactures external metal cabinets and internal metal boxes to industry standards and to customer specifications. All manufacturing and supply line products are supported to ISO: 9001:2000 approved standards to guarantee customer quality, consistency and reliability. Approximately 59% and 61% of Austin Taylor sales were to U.K. customers in 2008 and 2007.

Outstanding customer orders for Austin Taylor products were approximately $193,000 at March 1, 2009 compared to $438,000 at March 1, 2008. Because Austin Taylor fills new orders on a relatively short timetable, the Company does not believe its order book is a significant indicator of future results.

(2) Employment Levels

As of March 1, 2009 the Company employed 462 people. Of this number, 260 were employed by Suttle (including 110 in Hector, Minnesota and 150 in Costa Rica), 130 by Transition Networks, Inc. (115 in Minnetonka, MN and 15 in China), 22 by JDL Technologies, Inc., 32 by Austin Taylor Communications, Ltd and 18 corporate general and administrative positions. None of the Company s employees are represented under collective bargaining agreements. The Company considers its employee relations to be good.

(3) Executive Officers of Registrant

The executive officers of the Company and their ages at March 1, 2009 were as follows:

Name	Age	Position[1]
Jeffrey K. Berg	66	President and Chief Executive Officer [2007][2]
David T. McGraw	57	Vice President, Treasurer and Chief Financial Officer [2008][3]
William G. Schultz	40	Vice President and General Manager, Transition Networks, Inc. [2007] [5]
Bruce Blackwood	46	Vice President and General Manager, Suttle [2007][6]
Michael J. Skucius	55	Vice President and General Manager JDL Technologies, Inc. [2007][7]
Karen Nesburg Bleick	44	Vice President, Human Resources[8]

1 Dates in brackets indicate period during which officers began serving in such capacity. Executive officers serve at the pleasure of the Board of Directors and are elected annually for one-year terms.

2 Mr. Berg was appointed Chief Executive Officer of the Company in June 2007. From November 2000 to June 2007 he served as the Company s Chief Operating Officer and was named President of the Company in March 2002. Prior to November 2000, Mr. Berg served as President of the Company s Suttle operations.

3 Mr. McGraw was appointed Chief Financial Officer in January 2008. From September 2002 to December 2007 he served as President of Suttle. From May 2001 to August 2002, he served as Chief Operating Officer of JDL Technologies, Inc. Prior to May 2001, he was Vice President-General Manager of Precision Diversified Industries in Plymouth, MN.

5 Mr. Schultz was appointed Vice President and General Manager of Transition Networks, Inc. in October 2007. From May 2000 to September 2007, he served as Transition Networks Vice President of Marketing. Prior to May 2000, he was Distribution Business Manager for AMP Division of Tyco International, Ltd.

6 Mr. Blackwood was appointed Vice President and General Manager of Suttle in December 2007. From July 2001 to November 2007 he served as Suttle s Vice President of Sales. Prior to July 2001 he was Vice President of Sales for Americable.

7 Mr. Skucius was appointed Vice President and General Manager of JDL Technologies in July 2007. From 1980 to 2007 he was the Company s Director of Management Information Services.

8 Ms. Nesburg Bleick was appointed Vice President, Human Resources in January 2009. From October 2002 to December 2008, she served as Director of Human Resources.

(d) FINANCIAL INFORMATION ABOUT FOREIGN AND DOMESTIC OPERATIONS AND EXPORT SALES
Financial information about domestic and foreign operations and export sales may be obtained by reference to Note 9 of the Notes to Consolidated Financial Statements under Item 8 herein.

ITEM 1A. RISK FACTORS
Forward Looking Statements

Certain statements contained in this Annual Report on Form 10-K are forward-looking statements within the meaning of and in reliance on the Private Securities Litigation Reform Act of 1995, which provides certain safe harbor provisions for forward-looking statements. Actual events and results may differ materially from those expressed or forecasted in forward-looking statements due to a number of factors. The principal important risk factors that could cause our actual performance and future events and actions to differ materially from such forward-looking statements include, but are not limited to, the risk factors discussed below.

Risks Related to Our Business

The primary markets we serve are highly competitive, and our ability to compete requires continual focus on delivering high quality, competitively priced products and the regular introduction of new products that meet evolving customer requirements.

Competition in the markets for voice and data communications products is intense. We believe our ability to compete with other manufacturers of these products depends primarily on our engineering, manufacturing and marketing skills; the price, quality and reliability of our products; our delivery and service capabilities; and our control of operating expenses. We have experienced, and anticipate continuing to experience, pricing pressures from our customers as well as our competitors. The markets we serve are characterized by rapid technological advances and evolving industry standards. These markets can be significantly affected by new product introductions and marketing activities of industry participants. Certain of our competitors and potential competitors may have greater financial, technological, manufacturing, marketing, and personnel resources than us. Present and future competitors may be able to identify new markets and develop products more quickly, which are superior to those developed by us. They may also adapt new technologies faster, devote greater resources to research and development, promote products more aggressively, and price products more competitively than us. There are no assurances that competition will not intensify or that we will be able to compete effectively in the markets in which we compete.

We face many challenges in maintaining acceptable margins, and our level of gross margin may not be sustainable.

Gross margins among our products vary and are subject to fluctuation from quarter to quarter. The factors that may impact our gross margins adversely are numerous and include:

Changes in customer, geographic, or product mix;

Our ability to reduce product costs;

Increases in material or labor costs;

Expediting costs incurred to meet customer delivery requirements;

Excess inventory and inventory carrying charges;

Obsolescence charges;

Changes in shipment volume;

Changes in component pricing;

Increased price competition;

Changes in distribution channels;

Increased warranty cost; and

Our ability to manage the impact of foreign currency exchange rate fluctuations.

Consolidation among our customers has occurred and further consolidation may occur and result in the loss of some customers and may reduce revenue during the pendency of business combinations and related integration activities.

We believe consolidation among our customers in the future may occur in order for them to increase market share and achieve greater economies of scale. Consolidation has impacted our business as our customers focus on completing business combinations and integrating their operations. In certain instances, customers integrating large-scale acquisitions have reduced their purchases of our products during the integration period.

The impact of significant mergers among our customers on our business is likely to be unclear until sometime after such transactions are completed. After a consolidation occurs, a customer may choose to reduce the number of vendors from which it purchases equipment and may choose one of our competitors as its preferred vendor. There can be no assurance that we will continue to supply equipment to the surviving communications service provider after a business combination is completed.

Our profitability could be impacted negatively if one or more of our key customers substantially reduces orders for our products and/or transitions their purchases towards lower gross margin products.

Our customer base is somewhat concentrated, with our top ten customers accounting for 60%, 54% and 54% of net sales for fiscal 2008, 2007 and 2006, respectively. One of our largest customers, Verizon, accounted for 5%, of our net sales in each of the fiscal years 2008, 2007 and 2006. The merger of AT&T and BellSouth in our fiscal 2007 created another large customer for us. In fiscal 2008 and 2007, this combined company accounted for approximately 12% and 10% of our sales, respectively. If we lose a significant customer for any reason, our sales and gross profit will be impacted negatively.

Our market is subject to rapid technological change and, to compete effectively, we must continually introduce new products that achieve market acceptance.

The communications equipment industry is characterized by rapid technological changes, evolving industry standards, changing market conditions and frequent new product and service introductions and enhancements. The introduction of products using new technologies or the adoption of new industry standards can make our existing products, or products under development, obsolete or unmarketable. In order to remain competitive and increase sales, we will need to adapt to these rapidly changing technologies, enhance our existing products and introduce new products to address the changing demands of our customers.

We may not predict technological trends or the success of new products in the communications equipment market accurately. New product development often requires forecasting of market trends, development and implementation of new technologies and processes and substantial capital commitments. We do not know whether other new products we develop will gain market acceptance or result in profitable sales.

Certain of our competitors have greater engineering and product development resources than we have. Although we expect to continue to invest significant resources in product development activities, our efforts to achieve and maintain profitability will require us to be selective and focused with our research and development expenditures. If we fail to anticipate or respond in a cost-effective and timely manner to technological developments, changes in industry standards or customer requirements, or if we experience any significant delays in product development or introduction, our business, operating results and financial condition could be affected adversely.

The communications technology industry is characterized by rapidly changing technologies, evolving industry standards, frequent new product introductions, short product life cycles and rapidly changing customer requirements. The introduction of products embodying new technologies and the emergence of new industry standards can render existing products obsolete and unmarketable. Our future success will depend on our ability to enhance our existing products, to introduce new products to meet changing customer requirements and emerging technologies, and to demonstrate the performance advantages and cost-effectiveness of our products over competing products. Failure by us to modify our products to support new alternative technologies or failure to achieve widespread customer acceptance of such modified products could cause us to lose market share and cause our revenues to decline.

We may experience delays in developing and marketing product enhancements or new products that respond to technological change, evolving industry standards and changing customer requirements. There can be no assurance that we will not experience difficulties that could delay or prevent the successful development, introduction, and marketing of these products or product enhancements, or that our new products and product enhancements will adequately meet the requirements of the marketplace and achieve any significant or sustainable degree of market acceptance in existing or additional markets. In addition, the future introductions or announcements of products by us or one of our competitors embodying new technologies or changes in industry standards or customer requirements could render our then-existing products obsolete or unmarketable. There can be no assurance that the introduction or announcement of new product offerings by us or one or more of our competitors will not cause customers to defer their purchase of our existing products, which could cause our revenues to decline

We expect to actively pursue strategic acquisitions, but we may not successfully close the acquisitions and, if these acquisitions are completed, we may have difficulty integrating the acquired businesses with our existing operations.

We regularly consider the acquisition of complementary companies and/or product lines. We cannot provide assurances that we will be able to find appropriate candidates for acquisitions, reach agreement to acquire them, or obtain requisite shareholder or regulatory approvals needed to close strategic acquisitions. The significant effort and management attention invested in a strategic acquisition may not result in a completed transaction.

The impact of future acquisitions on our business, operating results and financial condition are not known at this time. In the case of businesses we may acquire in the future, we may have difficulty assimilating these businesses and their products, services, technologies and personnel into our operations. These difficulties could disrupt our ongoing business, distract our management and workforce, increase our expenses and materially adversely affect our operating results and financial condition. Also, we may not be able to retain key management and other critical employees after an acquisition. We may also acquire unanticipated liabilities. In addition to these risks, we may not realize all of the anticipated benefits of these acquisitions.

Our operating results fluctuate from quarter to quarter.

Our operating results are difficult to predict and may fluctuate significantly from quarter to quarter. Fluctuations in our quarterly operating results may be caused by many factors, including the following:

- the volume and timing of orders from shipments to our customers;
- the overall level of capital expenditures by our customers;
- work stoppages and other developments affecting the operations of our customers;
- the timing of and our ability to obtain new customer contracts and the timing of revenue recognition;
- the timing of new product and service announcements;
- the availability of products and services;
- market acceptance of new and enhanced versions of our products and services;
- variations in the mix of products and services we sell;
- the location and utilization of our production capacity and employees; and
- the availability and cost of key components of our products.

Our expense levels are based in part on expectations of future revenues. If revenue levels in a particular quarter are lower than expected, our operating results will be affected adversely.

We depend on manufacturing relationships and on limited-source suppliers, and any disruptions in these relationships may cause damage to our customer relationships.

We procure all parts and certain services involved in the production of our products and subcontract much of our product manufacturing to outside firms that specialize in such services. Although most of the components of our products are available from multiple vendors, we have several single-source supplier relationships, either because alternative sources are not available or because the relationship is advantageous to us. There can be no assurance that our suppliers will be able to meet our future requirements for products and components in a timely fashion. In addition, the availability of many of these components to us is dependent in part on our ability to provide our suppliers with accurate forecasts of our future requirements. Delays or lost sales could be caused by other factors beyond our control, including defects in the quality of components or products supplied by others.

We are dependent upon our senior management and other critical employees.

Like all communications technology companies, our success is dependent on the efforts and abilities of our senior management personnel and other critical employees, including those in sales, marketing and product development functions. Our ability to attract, retain and motivate these employees is critical to our success. In addition, because we may acquire one or more businesses in the future, our success will depend, in part, upon our ability to retain and integrate our own personnel with personnel from acquired entities that are necessary to the continued success or the successful integration of the acquired businesses.

Managing our inventory is complex and may include write-downs of excess or obsolete inventory.

Managing our inventory of components and finished products is complicated by a number of factors, including the need to maintain a significant inventory of finished goods for orders we anticipate but may not be received. These issues may cause us to purchase and maintain significant amounts of inventory. If this inventory is not used as expected based on anticipated requirements, it may become excess or obsolete. The existence of excess or obsolete inventory can result in sales price reductions and/or inventory write-downs, which could adversely affect our business and results of operations.

We face risks associated with our expanding our sales outside of the United States.

We believe that our future growth is dependent in part upon our ability to increase sales in international markets. These sales are subject to a variety of risks, including fluctuations in currency exchange rates, tariffs, import restrictions and other trade barriers, unexpected changes in regulatory requirements, longer accounts receivable payment cycles and potentially adverse tax consequences, and export license requirements. In addition, we are subject to the risks inherent in conducting business internationally, including political and economic instability and unexpected changes in diplomatic and trade relationships. There can be no assurance that one or more of these factors will not have a material adverse effect on our business strategy and financial condition.

Compliance with internal control requirements is expensive and poses certain risks.

We expect to incur significant continuing costs, including accounting fees and staffing costs, in order to maintain compliance with the internal control requirements of the Sarbanes-Oxley Act of 2002. Expansion of our business, particularly internationally, will necessitate ongoing changes to our internal control systems, processes and information systems. In addition, if we complete acquisitions in the future, our ability to integrate operations of the acquired company could impact our compliance with Section 404 of the Sarbanes-Oxley Act. We cannot be certain that as our business changes, our current design for internal control over financial reporting will be sufficient to enable management to determine that our internal controls are effective for any period, or on an ongoing basis.

In the future, if we fail to complete the annual Section 404 evaluation in a timely manner, we could be subject to regulatory scrutiny and a loss of public confidence in our internal controls. In addition, any failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations.

Product defects or the failure of our products to meet specifications could cause us to lose customers and revenue or to incur unexpected expenses.

If our products do not meet our customers performance requirements, our customer relationships may suffer. Also, our products may contain defects or fail to meet product specifications. Any failure or poor performance of our products could result in:

- delayed market acceptance of our products;

- delayed product shipments;
- unexpected expenses and diversion of resources to replace defective products or identify and correct the source of errors;
- damage to our reputation and our customer relationships;
- delayed recognition of sales or reduced sales; and
- product liability claims or other claims for damages that may be caused by any product defects or performance failures.

Risks Related to Our Common Stock

Our stock price has been volatile historically and the price of our common stock may fluctuate significantly in the future.

The trading price of our common stock has been and may continue to be subject to wide fluctuations. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results, announcements of technological innovations or new products by us or our competitors, the operating and stock price performance of other companies that investors may deem comparable to us, and new reports relating to trends in our markets or general economic conditions.

In addition, the stock market in general, and prices for companies in our industry in particular, have experienced extreme volatility that often has been unrelated to the operating performance of such companies. These broad market and industry fluctuations may adversely affect the price of our common stock, regardless of our operating performance.

Anti-takeover provisions in our charter documents, our shareholder rights agreement and Minnesota law could prevent or delay a change in control of our company.

Provisions of our articles of incorporation and bylaws, our shareholder rights agreement (also known as a poison pill) and Minnesota law may discourage, delay or prevent a merger or acquisition that a shareholder may consider favorable, and could limit the price that investors are willing to pay for our common stock. These provisions include the following:

- advance notice requirements for shareholder proposals;
- authorization for our board of directors to issue preferred stock without shareholder approval;
- authorization for our board of directors to issue preferred stock purchase rights upon a third party s acquisition of 16.5% or more of our outstanding shares of common stock; and
- limitations on business combinations with interested shareholders.

Some of these provisions may discourage a future acquisition of our company even though our shareholders would receive an attractive value for their shares, or a significant number of our shareholders believe such a proposed transaction would be in their best interest.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The administrative and manufacturing functions of CSI are conducted at the following facilities:

- In Minnetonka, Minnesota the Company owns a 105,000 square foot building where its executive and administrative offices are located. In addition, Transition Networks uses this facility for its warehouse, assembly, engineering and administrative operations, JDL Technologies, Inc. uses this facility for its executive and administrative operations, and Suttle uses this facility for its sales, marketing and product development.

- Suttle s manufacturing is conducted at two locations. At Hector, Minnesota, the Company owns three plants totaling 68,000 feet of manufacturing space. The Company leases 40,000 square feet of manufacturing space in San Jose, Costa Rica.

- Austin Taylor Communications, Ltd. owns a 40,000 square foot facility in Bethesda, Wales, U.K.

CSI believes these facilities will be adequate to accommodate its administrative, manufacturing and distribution needs for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

No material litigation or other material claim is presently pending against the Company.

In its report on Form 10-K for its fiscal year ended December 31, 2007 (the 2007 10-K), the Company reported under Item 3 regarding (i) a claim asserted by a former officer of one of the Company s subsidiaries seeking substantial additional retirement benefits, and (ii) an investigation by the Department of Justice (DOJ) related to products and services provided to the U.S. Virgin Islands Department of Education by the Company s JDL Technologies subsidiary. Since the date of the 2007 10-K, the Company has not received any further communication from either the former officer or the DOJ in respect of these matters, nor any notice from a court or public official regarding the initiation of court or administrative proceedings related to either matter.

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

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

(a) MARKET INFORMATION

The Company s common stock trades on the NASDAQ under the trading symbol JCS.

The table below presents the price range of high and low trades of the Company s common stock for each quarterly period indicated as reported by NASDAQ for 2008 and 2007.

	2008		2007	
	High	Low	High	Low
First	$ 12.15	$ 9.75	$ 11.33	$ 9.51
Second	11.75	10.02	11.47	9.41
Third	11.62	9.61	11.65	9.79
Fourth	11.00	6.93	12.02	9.50

(b) HOLDERS

At March 15, 2009 there were approximately 830 registered holders of record of Communications Systems, Inc. common stock.

(c) DIVIDENDS

Communications Systems, Inc. paid regular quarterly dividends to its shareholders on the dates and at the rates indicated below:

Payment Date	Dividend per Share
January 1, 2009	$ .12
October 1, 2008	.12
July 1, 2008	.12
April 1, 2008	.12
January 1, 2008	.12
October 1, 2007	.12
July 1, 2007	.10
April 1, 2007	.10
January 1, 2007	.10

The payment of future dividends will be determined at the discretion of the Board of Directors.

(d) INFORMATION REGARDING EQUITY COMPENSATION PLANS

The following table presents information about the Company s equity compensation plans, under which equity securities of the Company are authorized for issuance, as of December 31, 2008:

Securities Authorized for Issuance Under Equity Compensation Plans

Plan Category (1)	Number of shares of common stock to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options warrants and rights	Number of shares of common stock remaining available for future issuance under equity compensation plans (excluding shares in column (a))
Equity compensation plans approved by security holders:			
1992 Stock Plan-Employee Plan	159,350	$ 9.88	970,789
1992 Stock Plan-Nonemployee Director Plan	192,000	$ 10.08	28,000
1990 Employee Stock Purchase Plan	6,657	$ 7.41	155
Equity compensation plans not approved by security holders:			
None			

(1) The Company does not have individual compensation arrangements involving the grant of options, warrants and rights.

(e) REGULATION S-K, ITEM 201 (e) INFORMATION

The following graph presents, at the end of each of the Company s last five fiscal years, the cumulative total return on the common stock of the Company as compared to the cumulative total return reported for the NASDAQ (U.S.), and the NASDAQ Telecommunications Index. Company information and each index assume the investment of $100 on the last business day before January 1, 2003 and the reinvestment of all dividends.

Comparison of Five-Year Cumulative Total Return

Company or Index	2003	2004	2005	2006	2007	2008
Communications Systems, Inc.	$ 100.000	$ 152.777	$ 160.065	$ 136.660	$ 164.165	$ 114.642
NASDAQ U.S.	100.000	108.835	111.155	122.109	132.420	63.801
NASDAQ Telecommunications	100.000	106.629	101.332	133.247	118.520	68.095

(f) RECENT SALES OF UNREGISTERED SECURITIES

Not applicable.

(g) REPURCHASES OF ISSUER S EQUITY SECURITIES

The Company has repurchased a total of 343,889 shares of common stock since January 1, 2008 pursuant to Rule 10b-18 under the Exchange Act. The following table presents the repurchases for the three months ending December 31, 2008:

ISSUER PURCHASES OF EQUITY SECURITIES (1) (2)

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
October 2008	190,643	$ 9.73	190,643	96,602
November 2008	105,609	$ 8.25	105,609	490,993
December 2008	3,930	$ 7.63	3,930	487,063
Total	300,182		300,182	

(1) Shares repurchased in 2008 prior to November 2008 were repurchased pursuant to a Board approved program to repurchase a total of 500,000 shares that was publicly announced in September 2007. All but 9,007 of the shares repurchased in November 2008 were repurchased pursuant to this authorization and in compliance with Rule 10b-18.

(2) On November 13, 2008 the Company publicly announced that its Board of Directors had authorized a new program to repurchase up to an additional 500,000 shares of the Company s common stock. Based on this authorization, during November and December 2008, a total of 12,937 shares were repurchased in open market, or privately negotiated or block trade transactions pursuant to Rule 10b-18.

ITEM 6. SELECTED FINANCIAL DATA

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
SELECTED FINANCIAL INFORMATION
(in thousands except per share amounts)

	Year Ended December 31				
	2008	**2007**	**2006**	**2005**	**2004**
Selected Income Statement Data	(1)	(1)			
Sales from Continuing Operations	$ 122,700	$ 121,243	$ 115,440	$ 115,382	$ 108,555
Costs and Expenses:					
Cost of Sales	76,008	78,357	76,853	77,861	72,947
Selling, General and Administrative Expenses	33,109	32,623	33,562	31,651	27,979
Impairment Loss	2,999				
Total Costs and Expenses	112,116	110,980	110,415	109,512	100,926
Operating Income from Continuing Operations	10,584	10,263	5,025	5,870	7,629
Other income (expense), Net	597	1,760	698	448	167
Income from Continuing Operations Before Income Taxes	11,181	12,023	5,723	6,318	7,796
Income Tax Expense	4,570	4,512	1,228	1,728	2,865
Income from Continuing Operations	6,611	7,511	4,495	4,590	4,931
Net Loss from Discontinued Operations				(120)	(168)
Net Income	$ 6,611	$ 7,511	$ 4,495	$ 4,470	$ 4,763
Basic Net Income (loss) Per Share					
Continuing Operations	$ .77	$ .86	$ .52	$ .53	$ .60
Discontinued Operations				(.01)	(.02)
	$ .77	$ .86	$ .52	$ .52	$ .58
Diluted Net Income (loss) Per Share					
Continuing Operations	$ .77	$ .85	$ .51	$ .52	$ .59
Discontinued Operations				(.01)	(.02)
	$ .77	$ .85	$ .51	$ .51	$ .57
Cash Dividends Per Share	$ .48	$ .42	$ .34	$ .27	$ .17
Average Dilutive Shares Outstanding	8,563	8,831	8,807	8,716	8,321
Selected Balance Sheet Data					
Total Assets	$ 98,738	$ 100,760	$ 92,723	$ 92,883	$ 89,481
Property, Plant and Equipment, Net	12,015	13,945	8,580	8,300	7,040

Long-term liabilities	4,919	4,045	724	1,332	406
Stockholders Equity	83,728	84,931	82,545	79,851	77,051

(1) During the first and third quarters of fiscal 2008, the Company recognized approximately $2.0 million of revenue related to services that were invoiced and expensed in fiscal 2007

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Communications Systems, Inc

Communications Systems, Inc. is a global company with design, production and distribution facilities around the world. We provide a growing family of physical and electronic connectivity infrastructure and IT services for voice, video and data communications. Our product families include a broad range of passive and active products which include copper-based and fiber optic connection devices, digital subscriber line filters and connection devices, structured wiring systems that support Local Area Networks, media conversion devices and switches.

Austin Taylor

Located in Bethesda, Wales, United Kingdom, Austin Taylor is a leading UK manufacturer of cabling installation products for copper and fiber optics. Austin Taylor serves the government and commercial markets throughout Europe, the Middle East and Hong Kong with British standard products. Austin Taylor s broad catalogue of products ranges from telephony linejacks to structured cabling and from plastic connection boxes to metal cabinets.

JDL Technologies

JDL Technologies is an IT Services Company that provides outsourced technical services in the education and business market segments. JDL provides studies and analysis, design, installation, maintenance and operational support for increasingly network based, server centered systems. JDL s largest customer is the School Board of Broward Co. FL. We run the Network Operation Center which monitors all network elements (servers, switches, routers) including over 60,000 computers in 265 buildings for the nations 6th largest school district.

Suttle

Founded in 1910, Suttle is one of the world s largest suppliers of high-volume copper connection products used by North America s largest telcos. Suttle designs, manufactures and markets a full line of structured wiring components for small office, home office (SOHO) components for voice, video and high-speed data communications convergent solutions. Suttle s products are used throughout the Telco, multi-service cable operators (MSOs), and Installer/Contractor markets.

Transition Networks

Transition Networks offers a full suite of networking connectivity solutions including media converters, network interface cards, switches, and coarse-wave division multiplexing (CWDM). Utilizing its Product Design and Development Facility in Shanghai, China, Transition Networks designs and markets these technologies across a broad spectrum of protocols including Ethernet, Fast Ethernet, Gigabit Ethernet, T1/E1, DS3, and serial. Transition Networks distributes these hardware-based connectivity solutions exclusively through a network of resellers in 90 countries and is the preferred choice among industry IT professionals for high-end media conversion devices.

Forward Looking Statements

In this report and from time to time, in reports filed with the Securities and Exchange Commission, in press releases, and in other communications to shareholders or the investing public, there may be forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The Company may make forward-looking statements concerning possible or anticipated future financial performance, business activities, plans, pending claims, investigations or litigation which are typically preceded by the words believes , expects , anticipates , intends or similar expressions. For such forward-looking statements, the Company claims the protection of the safe harbor for forward-looking statements contained in federal securities laws. Shareholders and the investing public should understand that such forward looking statements are subject to risks and uncertainties which could cause actual performance, activities, anticipated results, outcomes or plans to differ significantly from those indicated in the forward-looking statements. For a detailed discussion of a number of such risk factors, please see Item 1A above.

Critical Accounting Policies

Allowance for Doubtful Accounts: The Company records a provision for doubtful accounts receivable based on an individual analysis and specific identification problem accounts. This involves a degree of judgment based on discussions with our internal sales and marketing groups and examinations of the financial stability of our customers. There can be no assurance that our estimates will match actual amounts ultimately collected. During periods of downturn in the market for our products or economic recession, a greater degree of risk exists concerning the ultimate collectability of our accounts receivable due to the impact that these conditions might have on our customer base.

Sales Returns: An allowance is established for possible return of products, rebates and advertising allowances. The amount of the allowance is an estimate, which is based on historical ratios of returns to sales, the historical average length of time between the sale and the return and other factors. Though management considers these allowances adequate and proper, changes in customers behavior versus historical experience or changes in the Company s return policies are among the factors that could affect the adequacy of this allowance.

Inventory Valuation: The Company s inventories are valued at the lower of cost or market. Reserves for overstock and obsolescence are estimated and recorded to reduce the carrying value to estimated net realizable value. The amount of the reserve is determined based on projected sales information, plans for discontinued products and other factors. Though management considers these reserves adequate and proper, changes in sales volumes due to unexpected economic or competitive conditions are among the factors that could materially affect the adequacy of this reserve.

Income Taxes: We account for income taxes in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 109, Accounting for Income Taxes. In the preparation of the Company s consolidated financial statements, management calculates income taxes. This includes estimating the Company s current tax liability as well as assessing temporary differences resulting from different treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. These assets and liabilities are analyzed regularly and management assesses the likelihood that deferred tax assets will be realized from future taxable income. The valuation allowance for deferred income tax benefits is determined based upon the expectation of whether the benefits are more likely than not to be realized. We adopted the provisions of Financial Standards Accounting Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 , (FIN 48) an interpretation of FASB Statement No. 109 (SFAS 109) on January 1, 2007 Note 8 to the consolidated financial statements in Item 8 herein. Consistent with prior periods and upon adoption of FIN 48 the Company records interest and penalties related to income taxes as income tax expense in the Consolidated Statements of Income.

Warranty: The Company s warranty programs vary by business groups and by product lines. Reserves for the estimated cost of product warranties are established at the time revenue is recognized. The costs of our warranty obligations are estimated based on warranty policy and the applicable contractual warranty, our historical experience of known product failure rates, our vendors experience and material and service delivery costs incurred in correcting product failures. Management reviews the estimated warranty liability on a quarterly basis to determine its adequacy. Though management considers these balances adequate and proper, changes in the Company s warranty policy or a significant change in product defects versus historical experience are among the factors that could affect the adequacy of this reserve.

Asset Impairment

We are required to test for asset impairment relating to property and equipment whenever events or changes in circumstances indicate that the carrying value of an asset might not be recoverable. We apply SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in order to determine whether or not an asset is impaired. This standard requires an impairment analysis when indicators of impairment are present. If such indicators are present, the standard requires that if the sum of the future expected cash flows from a company s asset, undiscounted and without interest charges, is less than the carrying value, an asset impairment must be recognized in the financial statements. The amount of the impairment is the difference between the fair value of the asset and the carrying value of the asset.

We believe the accounting estimates related to potential asset impairments are critical as they require management to make assumptions about future cash flows and the impact of recognizing an impairment could have a significant effect on operations.

On January 17, 2008 the Company was notified by the United States Virgin Island Department of Education (VIDE), a customer of JDL Technologies since 1998, that the Company was not selected as a vendor to provide services for the period from July 1, 2008 to June 30, 2009. This notification was completely unexpected by the Company. The loss of the VIDE contract for 2008 - 2009 represented an event that required the related asset group to be tested for impairment in accordance with SFAS 144 Accounting for Impairment or Disposal of Long-Lived Assets and the related goodwill in accordance with SFAS 142 Goodwill and Other Intangible Assets . The Company completed this evaluation in the first quarter of fiscal 2008 and identified an impairment of the network infrastructure supporting services provided to VIDE to the extent of its total net book value of $2,295,000.

Goodwill Impairment: Goodwill is required to be evaluated for impairment on an annual basis and between annual tests upon the occurrence of certain events or circumstances, according to SFAS No. 142, Goodwill and Other Intangible Assets. The standard requires a two-step process be performed to analyze whether or not goodwill has been impaired. Step one is to test for potential impairment, and requires that the fair value of the reporting unit be compared to its book value including goodwill. If the fair value is higher than the book value, no impairment is recognized. The Company estimates the fair value of each reporting unit based on a discounted cash flow analysis. If the fair value is lower than the book value, a second step must be performed. The second step is to measure the amount of impairment loss, if any, and requires that a hypothetical purchase price allocation be done to determine the implied fair value of goodwill. This fair value is then compared to the carrying value of goodwill. If the implied fair value is lower than the carrying value, an impairment adjustment must be recorded.

On January 17, 2008, a major customer of the JDL Technologies segment for the last several years, VIDE notified the Company that JDL was not selected as a vendor to provide services to VIDE for the 2008-2009 school year. The loss of the VIDE contract for 2008 - 2009 represented an event that required goodwill be tested for impairment in accordance with SFAS 142. The Company completed the SFAS No. 142 evaluation at March 31, 2008 and recorded a goodwill impairment for the JDL Technologies segment of $704,000.

The carrying amounts of the remaining goodwill by segment as of December 31, 2008 are as follows: Suttle $1,272,000 and Transition Networks $3,288,000.

The Company believes that accounting estimates related to goodwill impairment are critical because the underlying assumptions used for the discounted cash flow can change from period to period and could potentially cause a material impact to the income statement. Management s assumptions about inflation rates and other internal and external economic conditions, such as earnings growth rate, require significant judgment based on fluctuating rates and expected revenues.

Revenue Recognition: The Company recognizes revenue when the earnings process is complete, evidenced by persuasive evidence of an agreement, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectability is reasonably assured. In the Suttle, Transition Networks and Austin Taylor segments, the earning process completion is evidenced through the shipment of goods, based on the sales terms of these segments, the risk of loss is transferred upon shipment or delivery to customers and there are no significant obligations subsequent to that point. Other than the sales returns as discussed above, there are not significant estimates related to revenue recognition for these segments.

JDL Technologies records revenue on hardware, software and related equipment sales and installation contracts when the revenue recognition criteria are met and the products are installed and accepted by the customer.

JDL records revenue on service contracts on a straight-line basis over the contract period, unless evidence suggests that the revenue is earned in a different pattern. Each contract is individually reviewed to determine when the earnings process is complete. Contracts with the Virgin Islands Department of Education (VIDE) are funded by the federal government s E-RATE program and must be approved by the Schools and Libraries Division (SLD) of the Universal Service Administration Company before payment can be received. Our policy is not to recognize E-RATE revenue on our VIDE contracts until they are approved by the SLD, because, based on our experience in 2007, we concluded there was more than a remote chance that funding would not be approved.

Foreign Currency Translation: Assets and liabilities of the foreign subsidiary are translated to U.S. dollars at year-end rates, and the statements of operations are translated at average exchange rates during the year. Translation adjustments arising from the translation of the foreign affiliates net assets into U.S dollars are recorded in other comprehensive income.

Results of Operations

2008 Compared to 2007

Sales were $122,700,000 in 2008, a 1% increase from sales of $121,243,000 in 2007. Operating income increased 3% to $10,584,000 in 2008 as compared to $10,263,000 in 2007. Income before income taxes decreased 7% to $11,181,000 from $12,023,000 in 2007. Net income decreased 12% to $6,611,000 in 2008 compared to $7,511,000 in 2007.

Suttle

Suttle sales decreased 8% to $44,421,000 in 2008 compared to $48,135,000 in 2007. Sales by product groups in 2008 and 2007 were:

	Suttle Sales by Product Group	
	2008	2007
Modular connecting products	$ 18,834,000	$ 24,146,000
DSL products	10,270,000	12,278,000
Structured cabling products	14,445,000	10,866,000
Other products	872,000	845,000
	$ 44,421,000	$ 48,135,000

Suttle s sales by customer groups in 2008 and 2007 were:

	Suttle Sales by Customer Group	
	2008	2007
Major telephone companies	$ 20,624,000	$ 20,581,000
Distributors/OEM	16,367,000	18,482,000
International	2,474,000	3,940,000
Other	4,956,000	5,132,000
	$ 44,421,000	$ 48,135,000

The decrease in sales was due primarily to the accelerated land-line loss by the major telephone customers, the severe downturn in the domestic housing market, and the loss of the Bellsouth DSL contract during the course of the acquisition by ATT. Sales to the major telephone companies remained stable at $20,624,000 in 2008 compared to $20,581,000 in 2007. Sales to these customers accounted for 46% of Suttle s sales in 2008 compared to 43% of sales in 2007. The land-line loss in the major telephone companies forced a faster than expected decline in the traditional and Corroshield product lines. Additionally, the lost DSL contract at Bellsouth was valued at $2.9 million in 2007. However, sales of structured cabling products to these same customers increased as investment remained strong into FTTP networks. Sales to distributors, original equipment manufacturers (OEMs), and electrical contractors decreased 28% and accounted for 37% of sales in 2008 compared to 38% in 2007. The decline in this segment is a direct result of reduced opportunities in the domestic market for new single-family unit (SFU) construction and multi-dwelling unit (MDU) construction. International sales decreased 37% and accounted for 6% of Suttle s 2008 sales. International telephone customers also faced land-line loss causing decreased sales of voice products. DSL product sales into this segment did increase as customers increased investment into broadband.

Suttle s gross margins decreased 17% to $10,778,000 in 2008 compared to $13,030,000 in 2007. The gross margin percentage was 24% in 2008 compared to 27% in 2007. This decrease in gross margin was due to a change in product mix attributed to declining sales in higher margin product, such as the traditional and Corroshield product lines.

Selling, general and administrative expenses decreased 16% to $6,045,000 in 2008 from $7,202,000 in 2007. This decrease was due to reduction in staff, lower commissions and bonus expense.

Suttle s operating income declined 19% to $4,733,000 in 2008 from $5,828,000 in 2007 due to the decreased revenues and margins noted above.

Transition Networks

Transition Networks is a provider of active networking hardware devices. Characteristics of the business include a rapid pace of change in technologies and alternative solutions to our products. Transition Networks derives revenues from one time product sales and not reoccurring revenue streams from service contracts. The majority of the business is derived from one time network projects that do not repeat. The core markets for the products are enterprise, service provider, and industrial. Roughly 73% of Transition Networks revenue comes from North America, but we continue to see opportunity for long term growth outside of North America and we will invest resources in sales, marketing, and infrastructure to grow that business.

Transition Networks sales increased 19% to $62,924,000 compared to $53,063,000 in 2007. Transition Networks organizes its sales force and segments its customers geographically. Sales by customer groups in 2008 and 2007 were:

	Transition Networks Sales by Region			
	2008		2007	
North America	$	45,863,000	$	38,126,000
Europe, Middle East, Asia (EMEA)		8,352,000		6,890,000
Rest of world		8,709,000		8,047,000
	$	62,924,000	$	53,063,000

Sales in North America increased 20% compared to 2007. Sales in Europe, Middle East and Asia grew approximately 21% and all other sales increased 8% compared to 2007. A large portion of the growth in North America sales came from the U.S. Federal Government which accounted for the majority of the increase in our Ethernet adapter sales. Transition also experienced good growth in sales to the service provider space and traditional enterprise also grew. There is inherent risk in the federal government of projects reaching completion and thereby no longer requiring our product, funding can be cut, or the technology platform can change eliminating the need for our products.

Growth outside the North America region came mostly from the service provider space which is traditionally a larger portion of sales outside of North America.

The following table summarizes Transition Networks 2008 and 2007 sales by product group:

	Transition Networks Sales by Product Group			
	2008		2007	
Media converters	$	47,196,000	$	44,500,000
Ethernet switches		5,809,000		5,720,000
Ethernet adapters		7,220,000		2,516,000
Other products		2,699,000		327,000
	$	62,924,000	$	53,063,000

Gross margin increased 28% to $30,972,000 in 2008 compared to $24,211,000 in 2007 due to increase in revenues and lower cost of goods sold. Gross margin as a percentage of sales increased to 49% in 2008 compared to 46% in 2007 due to additional outsourcing of production to lower cost offshore suppliers through an inventory cost reduction plan of $1.2 million in 2008 and an increase in sales of higher margin products (such as converters and adapters). Selling, general and administrative expenses increased 11% to $20,673,000 in 2008 from $18,608,000 in 2007 due to increases in the sales force headcount and marketing program incentives and expenses. While overall SG&A costs increased over 2007, there was a decrease as a percentage of sales down to 33% in 2008 versus 35% in 2007. Operating income for the combined units increased 84% to $10,299,000 in 2008 compared to $5,603,000 in 2007.

Transition Networks will continue to develop product based on market needs as well as following industry standards set by such organizations as the Institute of Electrical and Electronics Engineers (IEEE) and the Metro Ethernet Forum (MEF). We will also continue to invest in sales and marketing to grow revenues in our target markets and expand sales outside of North America.

JDL Technologies, Inc.

Sales by JDL Technologies, Inc. (the Company s IT services business unit) decreased 26% to $9,838,000 in 2008 compared to $13,219,000 in 2007. The following table summarizes JDL s revenues by customer group in 2008 and 2007:

	JDL Revenue by Customer Group	
	2008	**2007**
Broward County FL schools	$ 5,186,000	$ 5,716,000
U.S. Virgin Islands Dept. of Education (VIDE)	4,649,000	6,223,000
All other	3,000	1,280,000
	$ 9,838,000	$ 13,219,000

In 2007, funding commitments for several contracts were received for work performed in earlier periods. As a result, the Company recognized $2,555,000 of revenue for services performed in 2006. Revenue in 2008 includes $2.0 million for contracts of services provided to the VIDE in 2007 that were not approved until 2008. JDL does not expect any material revenue from the VIDE after December 31, 2008.

Revenues earned in Broward County FL declined $530,000 or 9% in 2008. The decline was the result of a delay in network refresh work due to customer budget limitations. The revenue decline does not represent a loss of business as the work was merely delayed into 2009. The decrease in other revenues from 2007 to 2008 was due to the sale of certain lines of business to a former officer in 2007.

Gross margins earned by JDL in 2008 increased to $4,212,000 compared to $4,033,000 in 2007. Gross margins in 2008 and 2007 were significantly impacted by the timing of the recognition of E-RATE revenues from JDL s VIDE contracts. Costs of $1.4 million were recorded in 2007, when the services were provided, however, the $2.0 million revenue related to these costs was recognized in 2008 when the E-Rate funding was approved. Similarly, the Company s 2007 margins include $2,555,000 for services provided to the VIDE in 2006. The impact on 2007 gross margins in 2007 due to timing of revenue recognition was partially offset by increased depreciation charges due to higher levels of plant investments in the U.S. Virgin Islands and reduced volumes of equipment sales to Broward County. VIDE s decision to select another vendor for the 2008-2009 contract year (discussed below) resulted in reduced selling, general and administrative expenses. These costs decreased 55% in 2008 to $1,105,000 from $2,466,000 in 2007. The decrease was due to lower legal and professional fees, staff reductions and cuts in marketing and administrative costs.

JDL had operating income of $108,000 in 2008 compared to $1,567,000 in 2007. The sharp decline in operating income for JDL stems from the decision of the VIDE, to select another vendor to provide wireless network services for the contract year beginning July 1, 2008. JDL had supplied network services to VIDE under one year contracts since 2002. Notification of this decision by VIDE, which was totally unexpected by the Company, was given to JDL on January 17, 2008, and after unsuccessful attempts to reverse VIDE s decision, the Company decided to terminate its operations in the Virgin Islands effective July 1, 2008. In accordance with generally accepted accounting principles, the Company conducted an evaluation of this event for impairment, and identified an impairment of goodwill of $704,000 and impairment of the network infrastructure with a total net book value of $2,295,000. The process of winding up JDL s Virgin Islands operations is complete.

Austin Taylor

Austin Taylor s revenues decreased 19% in 2008 to $5,516,000 from $6,826,000 in 2007, due to decreased order activity from its two major customers. Gross margin decreased to $730,000 in 2008 from $1,611,000 in 2007. Gross margin as a percentage of sales decreased to 13% in 2008 from 24% in 2007. This decrease was due to greatly increased material costs during 2008 and certain quality issues with two of its major vendors. Austin Taylor reported an operating loss in 2008 of $85,000 compared to operating income of $479,000 in 2007.

Other

Net investment and other income decreased to $597,000 in 2008 compared to $1,760,000 in 2007 due to an increase in interest expense on the Company s mortgage and a decrease in earnings on cash investments. The Company paid a full year in interest expense on the mortgage in 2008 while only a few months in 2007. The Company generally invested its excess cash in money market funds and certificates of deposit in 2008, which had lower rates than in the prior year. The combination of the state and foreign income taxes increased the Company s 2008 tax rate to 41% compared to a normal U.S. rate of 35%.

2007 Compared to 2006

Sales from continuing operations were $121,243,000 in 2007, a 5% increase from sales of $115,440,000 in 2006. Operating income from continuing operations increased 104% to $10,263,000 from $5,025,000 in 2006. Income from continuing operations before income taxes increased 110% to $12,023,000 from $5,723,000 in 2006. Income from continuing operations increased 67% to $7,511,000 in 2007 compared to $4,495,000 in 2006. The sale of one of the Company s buildings in Minnetonka in December 2007 resulted in a gain on sale of assets of approximately $834,000.

Suttle

Suttle sales increased 13% to $48,135,000 in 2007 compared to $42,690,000 in 2006. Sales to the major telephone companies increased 15% to $20,581,000 in 2006 compared to $17,893,000 in 2006. Sales to these customers accounted for 43% of Suttle s sales in 2007 compared to 42% of sales in 2006. Sales to distributors, original equipment manufacturers (OEMs), and electrical contractors increased 12% to $18,482,000 in 2007 compared to $16,443,000 in 2006. This customer segment accounted for 38% of sales in 2007 compared to 39% in 2006. International sales increased 47% to $3,940,000 and accounted for 8% of Suttle s 2007 sales. Sales to other customers decreased 10% to $5,108,000. Suttle s inventory increased by $2,951,000 to $18,360,000. This increase was due to a buildup for a new marketing focus of the small office and home office product line for expected 2008 sales. It is expected that this level will decrease in the first half of 2008.

The following table summarizes Suttle s 2007 and 2006 sales by product group:

Suttle Sales by Product Group