COMMUNICATIONS SYSTEMS INC
Form 10-Q
November 08, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
o **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended **September 30, 2013**

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ______________________ to _______________________

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)	(Zip Code)

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

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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO o

Indicate by a check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined by Rule 12b-2 of the Exchange Act).

Large Accelerated Filer o Accelerated Filer x Non-Accelerated Filer o Smaller Reporting Company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act. YES o NO x

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Name of Exchange On Which Registered**	**Outstanding at November 1, 2013**
Common Stock, par value $.05 per share	NASDAQ	8,551,542

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	September 30 2013	December 31 2012
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 8,103,878	$ 17,869,712
Investments	8,113,687	12,701,538
Trade accounts receivable, less allowance for doubtful accounts of $56,000 and $69,000, respectively	36,731,208	14,683,227
Inventories	28,551,690	33,752,710
Prepaid income taxes		2,113,926
Other current assets	693,804	783,352
Deferred income taxes	4,203,426	4,013,628
TOTAL CURRENT ASSETS	86,397,693	85,918,093
PROPERTY, PLANT AND EQUIPMENT, net	14,764,093	14,474,913
OTHER ASSETS:		
Investments	2,976,742	5,376,397
Goodwill		5,956,934
Other assets	712,998	808,308
TOTAL OTHER ASSETS	3,689,740	12,141,639
TOTAL ASSETS	$ 104,851,526	112,534,645
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	$ 481,439	$ 457,464
Accounts payable	4,993,242	9,237,233
Accrued compensation and benefits	3,492,892	3,044,864
Accrued consideration	256,519	770,041
Other accrued liabilities	1,843,606	1,670,009
Income taxes payable	47,061	
Dividends payable	1,442,951	61,833
TOTAL CURRENT LIABILITIES	12,557,710	15,241,444
LONG TERM LIABILITIES:		
Long-term compensation plans		350,457
Uncertain tax positions	233,782	320,426
Deferred income taxes	877,963	1,381,785
Pension liabilities	154,095	127,611
Long-term debt - mortgage payable	753,394	1,117,529
TOTAL LONG-TERM LIABILITIES	2,019,234	3,297,808
COMMITMENTS AND CONTINGENCIES (Footnote 7)		
STOCKHOLDERS EQUITY		
Preferred stock, par value $1.00 per share; 3,000,000 shares authorized; none issued		
Common stock, par value $.05 per share; 30,000,000 shares authorized; 8,548,273 and 8,474,896 shares issued and outstanding, respectively	427,414	423,745
Additional paid-in capital	37,133,171	36,404,518
Retained earnings	53,488,776	57,755,178
Accumulated other comprehensive loss	(774,779)	(588,048)
TOTAL STOCKHOLDERS EQUITY	90,274,582	93,995,393

TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 104,851,526	$ 112,534,645

The accompanying notes are an integral part of the condensed consolidated financial statements.

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF (LOSS) INCOME AND COMPREHENSIVE (LOSS) INCOME
(Unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2013	**2012**	**2013**	**2012**
Sales	$ 44,616,873	$ 28,687,687	$ 104,006,206	$ 78,492,866
Costs and expenses:				
Cost of sales	30,993,686	17,927,814	69,078,776	47,128,483
Selling, general and administrative expenses	9,468,972	9,053,164	27,835,588	28,169,627
Impairment loss	5,849,853		5,849,853	
Total costs and expenses	46,312,511	26,980,978	102,764,217	75,298,110
Operating (loss) income	(1,695,638)	1,706,709	1,241,989	3,194,756
Other (expenses) and income :				
Investment and other income	(72)	(8,342)	122,070	24,830
(Loss)/gain on sale of assets	(33,388)	(1,740)	(78,065)	87,801
Interest and other expense	(26,644)	(33,187)	(82,487)	(104,918)
Other (expense) income, net	(60,104)	(43,269)	(38,482)	7,713
(Loss) income from operations before income taxes	(1,755,742)	1,663,440	1,203,507	3,202,469
Income tax expense	280,191	544,098	1,358,525	1,056,316
Net (loss) income	(2,035,933)	1,119,342	(155,018)	2,146,153
Other comprehensive income (loss), net of tax:				
Additional minimum pension liability adjustments	179,450	4,671	(26,624)	137,397
Unrealized gains/(losses) on available-for-sale securities	12,193	33,855	(18,353)	39,488
Foreign currency translation adjustment	197,918	103,814	(141,754)	143,697
Total other comprehensive income (loss)	389,561	142,340	(186,731)	320,582
Comprehensive (loss) income	$ (1,646,372)	$ 1,261,682	$ (341,749)	$ 2,466,735
Basic net (loss) income per share:	$ (0.24)	$ 0.13	$ (0.02)	$ 0.25
Diluted net (loss) income per share:	$ (0.24)	$ 0.13	$ (0.02)	$ 0.25
Weighted Average Basic Shares Outstanding	8,547,563	8,520,469	8,524,045	8,505,571
Weighted Average Dilutive Shares Outstanding	8,550,227	8,532,534	8,531,017	8,528,523
Dividends declared per share	$ 0.16	$ 0.16	$ 0.48	$ 0.48

The accompanying notes are an integral part of the condensed consolidated financial statements.

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
(Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total
BALANCE AT DECEMBER 31, 2012	8,474,896	$ 423,745	$ 36,404,518	$ 57,755,178	$ (588,048)	$ 93,995,393
Net loss				(155,018)		(155,018)
Issuance of common stock under Employee Stock Purchase Plan	13,708	685	135,545			136,230
Issuance of common stock to Employee Stock Ownership Plan	44,598	2,230	461,589			463,819
Issuance of common stock under Non-Employee Stock Option Plan	15,000	750	109,500			110,250
Issuance of common stock under Executive Stock Plan	71	4	694			698
Tax benefit from non-qualified stock options			13,562			13,562
Share based compensation			7,763			7,763
Shareholder dividends				(4,111,384)		(4,111,384)
Other comprehensive loss					(186,731)	(186,731)
BALANCE AT SEPTEMBER 30, 2013	8,548,273	$ 427,414	$ 37,133,171	$ 53,488,776	$ (774,779)	$ 90,274,582

The accompanying notes are an integral part of the condensed consolidated financial statements.

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30 2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net (loss) income	$ (155,018)	$ 2,146,153
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	1,627,804	1,636,887
Share based compensation	7,763	366,574
Deferred taxes	(693,619)	129,918
Impairment loss	5,849,853	
Change in fair value of acquisition-related contingent consideration	(352,462)	(161,644)
Loss/(gain) on sale of assets	78,065	(87,801)
Excess tax benefit from share-based payments	(13,562)	(67,932)
Changes in assets and liabilities:		
Trade receivables	(22,042,463)	(2,101,517)
Inventories	5,187,881	(2,493,891)
Prepaid income taxes	2,126,683	890,067
Other assets	106,675	(2,815)
Accounts payable	(4,243,547)	(797,081)
Accrued compensation and benefits	560,605	(2,554,475)
Other accrued liabilities	161,650	(109,789)
Income taxes payable	(38,272)	(23,475)
Net cash used in operating activities	(11,831,964)	(3,230,821)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(1,977,058)	(2,047,771)
Purchases of investments	(2,824,848)	(13,599,917)
Proceeds from the sale of fixed assets	56,394	161,663
Proceeds from the sale of investments	9,794,000	15,556,039
Net cash provided by investing activities	5,048,488	70,014
CASH FLOWS FROM FINANCING ACTIVITIES:		
Cash dividends paid	(2,730,265)	(4,005,003)
Mortgage principal payments	(340,161)	(317,765)
Proceeds from issuance of common stock	247,178	249,847
Excess tax benefit from share-based payments	13,562	67,932
Payment of contingent consideration related to acquisition	(161,060)	(357,879)
Purchase of common stock		(252,647)
Net cash used in financing activities	(2,970,746)	(4,615,515)
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	(11,612)	25,011
NET DECREASE IN CASH AND CASH EQUIVALENTS	(9,765,834)	(7,751,311)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	17,869,712	22,515,710
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 8,103,878	$ 14,764,399
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Income taxes (refunded)/paid	$ (85,297)	$ 74,508
Interest paid	79,293	103,945
Dividends declared not paid	1,367,724	1,363,430

The accompanying notes are an integral part of the condensed consolidated financial statements.

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COMMUNICATIONS SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Communications Systems, Inc. (herein collectively called CSI or the Company) is a Minnesota corporation organized in 1969 that operates primarily as a holding company conducting its business through three business units having operations in the United States, Costa Rica, the United Kingdom and China. Through its Suttle business unit, the Company is principally engaged in the manufacture and sale of modular connecting and wiring devices for voice and data communications, digital subscriber line filters, and structured wiring systems. Through its Transition Networks business unit, the Company is engaged in the manufacture of media and rate conversion products for telecommunications networks. Through its JDL Technologies (JDL) business unit, the Company also provides IT solutions including network design, computer infrastructure installations, IT service management, change management, network security and network operations services.

Financial Statement Presentation

The condensed consolidated balance sheets and condensed consolidated statement of changes in stockholders equity as of September 30, 2013 and the related condensed consolidated statements of (loss) income and comprehensive (loss) income, and the condensed consolidated statements of cash flows for the periods ended September 30, 2013 and 2012 have been prepared by Company management. In the opinion of management, all adjustments (which include only normal recurring adjustments, except where noted) necessary to present fairly the financial position, results of operations, and cash flows at September 30, 2013 and 2012 and for the periods then ended have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted. We recommend these condensed consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Company s December 31, 2012 Annual Report to Shareholders on Form 10-K. The results of operations for the periods ended September 30, 2013 are not necessarily indicative of operating results for the entire year.

The presentation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent assets and liabilities at the balance sheet date, and the reported amounts of revenues and expenses during the reporting period. The estimates and assumptions used in the accompanying condensed consolidated financial statements are based upon management s evaluation of the relevant facts and circumstances as of the time of the financial statements. Actual results could differ from those estimates.

Except to the extent updated or described below, the significant accounting policies set forth in Note 1 to the consolidated financial statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2012, appropriately represent, in all material respects, the current status of accounting policies, and are incorporated herein by reference.

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Revenue Recognition

The Company s manufacturing operations (Suttle and Transition Networks) recognize 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. Revenue is recognized for domestic and international sales at the shipping point or delivery to customers, based on the related shipping terms. Risk of loss transfers at the point of shipment or delivery to customers, and the Company has no further obligation after this time. Sales are made directly to customers and through distributors. Payment terms for distributors are consistent with the terms of the Company s direct customers. The Company records a provision for sales returns, sales incentives, and warranty costs at the time of the sale, based on historical experience and current trends.

JDL generally records revenue on hardware, software and related equipment sales and installation contracts when the revenue recognition criteria are met and 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 the revenue is earned in a different pattern. Each contract is individually reviewed to determine when the earnings process is complete.

Accumulated Other Comprehensive (Loss) Income

The components of accumulated other comprehensive income, net of tax, are as follows:

	September 30 2013	December 31 2012
Foreign currency translation	$ (2,512,228)	$ (2,370,474)
Unrealized (loss)/gain on available-for-sale investments	5,237	23,590
Minimum pension liability	1,732,212	1,758,836
	$ (774,779)	$ (588,048)

NOTE 2 CASH EQUIVALENTS AND INVESTMENTS

The following tables show the Company s cash equivalents and available-for-sale securities adjusted cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category recorded as cash and cash equivalents or short and long term investments as of September 30, 2013 and December 31, 2012:

	September 30, 2013						
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash Equivalents	Short-Term Investments	Long-Term Investments
Cash equivalents:							
Money Market funds	$ 1,548,267	$	$	$ 1,548,267	$ 1,548,267	$	$
Subtotal	1,548,267			1,548,267	1,548,267		
Investments:							
Certificates of deposit	2,101,926	785	(2,213)	2,100,498		1,861,509	238,989
Corporate Notes/Bonds	8,966,889	25,977	(2,935)	8,989,931		6,252,178	2,737,753
Subtotal	11,068,815	26,762	(5,148)	11,090,429		8,113,687	2,976,742
Total	$ 12,617,082	$ 26,762	$ (5,148)	$ 12,638,696	$ 1,548,267	$ 8,113,687	$ 2,976,742

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	December 31, 2012						
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash Equivalents	Short-Term Investments	Long-Term Investments
Cash equivalents:							
Money Market funds	$ 5,497,788	$	$	$ 5,497,788	$ 5,497,788	$	$
Subtotal	5,497,788			5,497,788	5,497,788		
Investments:							
Certificates of deposit	8,157,749	3,727	(1,945)	8,159,531		7,258,768	900,763
Corporate Notes/Bonds	8,241,327	35,364	(914)	8,275,777		3,800,143	4,475,634
Commercial Paper	1,638,892	3,735		1,642,627		1,642,627	
Subtotal	18,037,968	42,826	(2,859)	18,077,935		12,701,538	5,376,397
Total	$ 23,535,756	$ 42,826	$ (2,859)	$ 23,575,723	$ 5,497,788	$ 12,701,538	$ 5,376,397

The Company tests for other than temporary losses on a quarterly basis and has considered the unrealized losses indicated above to be temporary in nature. The Company intends to hold the investments until it can recover the full principal amount and has the ability to do so based on other sources of liquidity. The Company expects these recoveries to occur prior to the contractual maturities. All unrealized losses as of September 30, 2013 were in a continuous unrealized loss position for less than twelve months and are not deemed to be other than temporarily impaired as of September 30, 2013.

The following table summarizes the estimated fair value of our investments, designated as available-for-sale and classified by the contractual maturity date of the securities as of September 30, 2013:

	Amortized Cost	Estimated Market Value
Due within one year	$ 8,094,583	$ 8,113,687
Due after one year through five years	2,974,232	2,976,742
	$ 11,068,815	$ 11,090,429

The Company did not recognize any gross realized gains, and gross realized losses were immaterial, during the nine-month periods ending September 30, 2013 and 2012, respectively. If the Company had realized gains or losses, they would be included within investment and other income in the accompanying consolidated results of operations.

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NOTE 3 - STOCK-BASED COMPENSATION

Employee Stock Purchase Plan

Under the Company s Employee Stock Purchase Plan (ESPP), employees are able to acquire shares of common stock at 90% of the price at the end of each current quarterly plan term. The most recent term ended September 30, 2013. The ESPP is considered compensatory under current Internal Revenue Service rules. At September 30, 2013, after giving effect to the shares issued as of that date, 38,856 shares remain available for purchase under the ESPP.

2011 Executive Incentive Compensation Plan

On March 28, 2011 the Board adopted and on May 19, 2011 the Company s shareholders approved the Company s 2011 Executive Incentive Compensation Plan (2011 Incentive Plan). The 2011 Incentive Plan authorizes incentive awards to officers, key employees and non-employee directors in the form of options (incentive and non-qualified), stock appreciation rights, restricted stock, restricted stock units, performance stock units (deferred stock), performance cash units, and other awards in stock, cash, or a combination of stock and cash. Up to 1,000,000 shares of our common stock may be issued pursuant to awards under the 2011 Incentive Plan.

During 2013, stock options covering 169,550 shares were awarded to key executive employees, which options expire seven years from the date of award and vest 25% each year beginning one year after the date of award. The Company also granted deferred stock awards of 202,078 shares to key employees during 2013 under the Company s long-term incentive plan for performance over the 2013 to 2015 period. The actual number of shares of deferred stock, if any, that are earned by the respective employees will be determined based on achievement against cumulative performance goals for the three years ending December 31, 2015 and the shares earned will be issued in the first quarter of 2016 to those key employees still with the Company at that time. The Company also granted deferred stock awards of up to 11,576 shares to executive employees that could be earned under the Company s short-term incentive plan if actual revenue equaled or exceeded 150% of 2013 quarterly or annual revenue targets. The shares earned by the respective executive employees will be issued no later than the first quarter of 2014.

During 2013, the Company granted restricted stock units totaling 28,280 units to the Company s seven non-employee directors with the restricted stock units issued to each director having a value of $40,000 based on the closing price of the Company s stock on May 21, 2013. These restricted stock units vest after one year and are issued as stock after another year.

At September 30, 2013, 568,711 shares remained available for future issuance under the 2011 Incentive Plan.

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Stock Option Plan for Directors

Shares of common stock are reserved for issuance to non-employee directors under options granted by the Company prior to 2011 under its Stock Option Plan for Non-Employee Directors (the Director Plan). Under the Director Plan nonqualified stock options to acquire shares of common stock were automatically granted to each non-employee director concurrent with annual meetings of shareholders in 2010 and earlier years, with the exercise price of options granted being the fair market value of the common stock on the date of the respective shareholder meetings. Options granted under the Director Plan expire 10 years from date of grant.

No options were granted under the Director Plan in 2012 or 2013. The Director Plan was amended as of May 19, 2011 to prohibit option grants in 2011 and future years.

1992 Stock Plan

Under the Company s 1992 Stock Plan (the Stock Plan), shares of common stock may be issued pursuant to stock options, restricted stock or deferred stock grants to officers and key employees. Exercise prices of stock options under the Stock Plan cannot be less than fair market value of the stock on the date of grant. Rules and conditions governing awards of stock options, restricted stock and deferred stock are determined by the Compensation Committee of the Board of Directors, subject to certain limitations in the Stock Plan. When seeking approval of the 2011 Incentive Plan at the 2011 Annual Meeting of Shareholders, the Company committed to amending the Stock Plan to prohibit the issuance of future equity awards if such approval was given. Effective August 11, 2011, the amendment to prohibit future stock options or other equity awards was approved by the Board.

At September 30, 2013, after reserving for stock options and deferred stock awards granted in prior years and adjusting for forfeitures and issuances during the year, there were 136,009 shares reserved for issuance under the Stock Plan. The Company has not awarded stock options or deferred stock under this plan in 2013.

Changes in Stock Options Outstanding

The following table summarizes changes in the number of outstanding stock options under the 2011 Incentive Plan, the Director Plan and Stock Plan over the period December 31, 2012 to September 30, 2013:

	Options		**Weighted average exercise price per share**	**Weighted average remaining contractual term**
Outstanding December 31, 2012	311,153	$	12.05	4.98
Awarded	169,550		10.19	
Exercised	(15,000)		7.35	
Forfeited	(166,155)		11.49	
Outstanding September 30, 2013	299,548		11.54	4.43
Excercisable at September 30, 2013	184,188	$	11.58	4.08
Expected to vest September 30, 2013	299,548		11.54	4.43

The aggregate intrinsic value of all options (the amount by which the market price of the stock on the last day of the period exceeded the market price of the stock on the date of grant) outstanding at September 30, 2013 was $213,000. The intrinsic value of all options exercised during the nine months ended September 30, 2013 was $38,000. Net cash proceeds from the exercise of all stock options were $110,000 and $86,000 for the nine months ended September 30, 2013 and 2012, respectively.

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Changes in Deferred Stock Outstanding

The following table summarizes the changes in the number of deferred stock shares under the Stock Plan and 2011 Incentive Plan over the period December 31, 2012 to September 30, 2013:

		Shares		Weighted Average Grant Date Fair Value
Outstanding	December 31, 2012	160,790	$	14.16
Granted		217,654		10.07
Vested		(71)		9.82
Forfeited		(130,750)		11.35
Outstanding	September 30, 2013	247,623		12.05

Changes in Restricted Stock Units Outstanding

The following table summarizes the changes in the number of restricted stock units under the 2011 Incentive Plan over the period December 31, 2012 to September 30, 2013:

		Shares		Weighted Average Grant Date Fair Value
Outstanding	December 31, 2012	25,879	$	10.82
Granted		29,290		9.97
Vested				
Forfeited		(4,040)		9.90
Outstanding	September 30, 2013	51,129		10.40

Compensation Expense

Share-based compensation expense recognized for the nine-month period ended September 30, 2013 was $8,000 before income taxes and $5,000 after income taxes. Share-based compensation expense recognized for the nine-month period ended September 30, 2012 was $367,000 before income taxes and $238,000 after income taxes. Unrecognized compensation expense for the Company s plans was $621,000 at September 30, 2013. Excess tax benefits from the exercise of stock options and issuance of restricted stock included in financing cash flows for the nine month periods ended September 30, 2013 and 2012 were $14,000 and $68,000, respectively. Share-based compensation expense is recorded as a part of selling, general and administrative expenses.

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NOTE 4 - INVENTORIES

Inventories summarized below are priced at the lower of first-in, first-out cost or market:

	September 30 2013	December 31 2012
Finished goods	$ 18,772,477	$ 21,252,143
Raw and processed materials	9,779,213	12,500,567
	$ 28,551,690	$ 33,752,710

NOTE 5 GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill is required to be evaluated for impairment on an annual basis and between annual tests upon the occurrence of certain events or circumstances. A two-step process is 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. 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.

During the quarter ended September 30, 2013, due to the loss of key personnel and the continued decline in year-over-year revenues due primarily to continued slowdown in domestic government spending as well as a decline in sales of its legacy products, management concluded that these events and circumstances were indicators to require us to perform an interim goodwill impairment analysis of our Transition Networks reporting unit. This analysis included the determination of the reporting unit s fair value primarily using discounted cash flows modeling. Based on the step one and step two analysis, considering Transition Networks reduced earnings and cash flow forecasts, the Company determined that Transition Networks goodwill was fully impaired and recorded a goodwill impairment for this segment of $5,850,000.

The changes in the carrying amount of goodwill for the nine months ended September 30, 2013 and 2012 by segment is as follows:

	Suttle	Transition Networks	Total
January 1, 2012	$	$ 5,990,571	$ 5,990,571
Foreign currency translation		(31,803)	(31,803)
September 30, 2012	$	$ 5,958,768	$ 5,958,768
January 1, 2013	$	$ 5,956,934	$ 5,956,934
Impairment loss		(5,849,853)	(5,849,853)
Foreign currency translation		(107,081)	(107,081)
September 30, 2013	$	$	$
Gross goodwill	1,271,986	$ 5,849,853	$ 7,121,839
Accumulated impairment loss	(1,271,986)	(5,849,853)	(7,121,839)
Balance at September 30, 2013	$	$	$

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The Company s identifiable intangible assets with finite lives are being amortized over their estimated useful lives and were as follows:

	September 30, 2013			
	Gross Carrying Amount	Accumulated Amortization	Foreign Currency Translation	Net
Trademarks	81,785	(24,946)	(1,107)	55,732
Customer relationships	490,707	(104,782)	(6,639)	379,286
Technology	228,996	(97,792)	(3,098)	128,106
	801,488	(227,520)	(10,844)	563,124

	December 31, 2012			
	Gross Carrying Amount	Accumulated Amortization	Foreign Currency Translation	Net
Trademarks	81,785	(16,346)	(1,018)	64,421
Customer relationships	490,707	(68,652)	(6,108)	415,947
Technology	228,996	(64,075)	(2,850)	162,071
	801,488	(149,073)	(9,976)	642,439

Amortization expense on these identifiable intangible assets was $76,000 and $77,000 in 2013 and 2012, respectively. The amortization expense is included in selling, general and administrative expenses.

NOTE 6 WARRANTY

We provide reserves for the estimated cost of product warranties at the time revenue is recognized. We estimate the costs of our warranty obligations based on our warranty policy or applicable contractual warranty, historical experience of known product failure rates, and use of materials and service delivery costs incurred in correcting product failures. Management reviews the estimated warranty liability on a quarterly basis to determine its adequacy. The actual warranty expense could differ from the estimates made by the Company based on product performance.

The following table presents the changes in the Company s warranty liability for the nine-month periods ended September 30, 2013 and 2012, respectively, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

	2013	2012
Beginning balance	$ 590,000	$ 634,000
Amounts charged to expense	185,000	183,000
Actual warranty costs paid	(191,000)	(202,000)
Ending balance	$ 584,000	$ 615,000

NOTE 7 CONTINGENCIES

In the ordinary course of business, the Company is exposed to legal actions and claims and incurs costs to defend against these actions and claims. Company management is not aware of any outstanding or pending legal actions or claims that could materially affect the Company s financial position or results of operations.

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NOTE 8 INCOME TAXES

In the preparation of the Company s consolidated financial statements, management calculates income taxes based upon the estimated effective rate applicable to operating results for the full fiscal year. This includes estimating the current tax liability as well as assessing 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 recovered from future taxable income.

At September 30, 2013 there was $160,000 of net uncertain tax benefit positions that would reduce the effective income tax rate if recognized. The Company records interest and penalties related to income taxes as income tax expense in the Condensed Consolidated Statements of Income.

The Company is subject to U.S. federal income tax as well as income tax of multiple state and foreign jurisdictions. The tax years 2009-2011 remain open to examination by the Internal Revenue Service and the years 2008-2011 remain open to examination by various state tax departments. The tax years from 2009-2011 remain open in Costa Rica.

The Company s effective income tax rate was 112.9% for the first nine months of 2013. The effective tax rate differs from the federal tax rate of 35% due to state income taxes, return to provision adjustments, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges for uncertain income tax positions, the effect of operations conducted in lower foreign tax rate jurisdictions, the release of contingent consideration from the Company s 2011 acquisition and goodwill impairment not deductible for income tax purposes. The effect of the foreign operations is an overall rate decrease of approximately 47.5% for the nine months ended September 30, 2013. There were no additional uncertain tax positions identified in the first nine months of 2013. The Company s effective income tax rate for the nine months ended September 30, 2012 was 33.3%, and differed from the federal tax rate due to state income taxes, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges, the release of valuation allowance placed on foreign net operating losses, and the effect of operations conducted in lower foreign tax rate jurisdictions.

NOTE 9 SEGMENT INFORMATION

The Company classifies its businesses into three segments as follows:

Suttle manufactures and markets copper and fiber connectivity systems, enclosure systems, xDSL filters and splitters, and active technologies for voice, data and video communications;

Transition Networks manufactures network interface devices (NIDs), media converters, network interface cards (NICs), Ethernet switches and other connectivity products that offer the ability to affordably integrate the benefits of fiber optics into any data network; and

JDL Technologies provides technology solutions including virtualization, managed services, wired and wireless network design and implementation services, and converged infrastructure configuration and deployment.

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Our non-allocated corporate general and administrative expenses are categorized as Other in the Company s segment reporting. Management has chosen to organize the enterprise and disclose reportable segments based on our products and services. There are no material inter-segment revenues.

Information concerning the Company s continuing operations in the various segments for the three and nine-month periods ended September 30, 2013 and 2012 is as follows:

	Suttle	**Transition Networks**	**JDL Technologies**	**Other**	**Total**
Three Months Ended September 30, 2013					
Sales	$ 14,838,164	$ 10,881,569	$ 18,897,140	$	$ 44,616,873
Cost of sales	9,861,311	5,716,712	15,415,663		30,993,686
Gross profit	4,976,853	5,164,857	3,481,477		13,623,187
Selling, general and administrative expenses	2,556,650	4,598,906	704,908	1,608,508	9,468,972
Impairment		5,849,853			5,849,853
Operating income (loss)	$ 2,420,203	$ (5,283,902)	$ 2,776,569	$ (1,608,508)	$ (1,695,638)
Depreciation and amortization	$ 213,253	$ 196,631	$ 13,126	$ 146,140	$ 569,150
Capital expenditures	$ 338,414	$ 251,757	$	$ 80,306	$ 670,477
Assets	$ 29,786,727	$ 28,702,749	$ 21,711,436	$ 24,650,614	$ 104,851,526

	Suttle	**Transition Networks**	**JDL Technologies**	**Other**	**Total**
Three Months Ended September 30, 2012					
Sales	$ 12,242,334	$ 13,647,047	$ 2,798,306	$	$ 28,687,687
Cost of sales	8,915,366	6,983,935	2,028,513		17,927,814
Gross profit	3,326,968	6,663,112	769,793		10,759,873
Selling, general and administrative expenses	2,318,165	5,365,325	564,401	805,273	9,053,164
Operating income (loss)	$ 1,008,803	$ 1,297,787	$ 205,392	$ (805,273)	$ 1,706,709
Depreciation and amortization	$ 216,232	$ 198,411	$ 25,798	$ 72,192	$ 512,633
Capital expenditures	$ 292,674	$ 117,695	$ 9,545	$ 414,399	$ 834,313
Assets	$ 28,126,173	$ 36,413,632	$ 2,562,750	$ 44,181,073	$ 111,283,628

	Suttle	**Transition Networks**	**JDL Technologies**	**Other**	**Total**
Nine Months Ended September 30, 2013					
Sales	$ 41,102,681	$ 32,156,461	$ 30,747,064	$	$ 104,006,206
Cost of sales	28,948,153	15,595,728	24,534,895		69,078,776
Gross profit	12,154,528	16,560,733	6,212,169		34,927,430
Selling, general and administrative expenses	7,523,328	15,156,939	1,851,061	3,304,260	27,835,588
Impairment		5,849,853			5,849,853
Operating income (loss)	$ 4,631,200	$ (4,446,059)	$ 4,361,108	$ (3,304,260)	$ 1,241,989
Depreciation and amortization	$ 653,451	$ 564,337	$ 41,618	$ 368,398	$ 1,627,804
Capital expenditures	$ 777,196	$ 752,732	$ 15,361	$ 431,769	$ 1,977,058

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	Suttle	Transition Networks	JDL Technologies	Other	Total
Nine Months Ended September 30, 2012					
Sales	$ 33,167,194	$ 40,614,746	$ 4,710,926	$	$ 78,492,866
Cost of sales	24,441,885	19,340,790	3,345,808		47,128,483
Gross profit	8,725,309	21,273,956	1,365,118		31,364,383
Selling, general and administrative expenses	6,891,833	16,557,399	1,678,516	3,041,879	28,169,627
Operating income (loss)	$ 1,833,476	$ 4,716,557	$ (313,398)	$ (3,041,879)	$ 3,194,756
Depreciation and amortization	$ 699,893	$ 638,907	$ 80,725	$ 217,362	$ 1,636,887
Capital expenditures	$ 958,262	$ 277,340	$ 24,236	$ 787,933	$ 2,047,771

NOTE 10 PENSIONS

The Company s U.K. based subsidiary Austin Taylor maintains defined benefit pension plans. The Company does not provide any other post-retirement benefits to its employees. Components of net periodic benefit cost of the pension plans for the three and nine-months ended September 30, 2013 and 2012 were:

	Three Months Ended September 30		Nine Months Ended September 30	
	2013	2012	2013	2012
Service cost	$ 77,000	$ 10,000	$ 206,000	$ 28,000
Interest cost	68,000	67,000	183,000	188,000
Expected return on assets	(73,000)	(75,000)	(196,000)	(210,000)
Amortization of prior service cost		13,000		36,000
Net periodic pension cost	$ 72,000	$ 15,000	$ 193,000	$ 42,000

NOTE 11 NET INCOME PER SHARE

Basic net income per common share is based on the weighted average number of common shares outstanding during each year. Diluted net income per common share takes into effect the dilutive effect of potential common shares outstanding. The Company s only potential common shares outstanding are stock options and shares associated with the long-term incentive compensation plans, which resulted in a dilutive effect of 2,664 and 6,972 shares for the three and nine-month periods ended September 30, 2013, respectively. The dilutive effect of stock options for the three and nine-month periods ended September 30, 2012 was 12,065 shares and 22,952 shares, respectively. The Company calculates the dilutive effect of outstanding options using the treasury stock method. Options totaling 155,014 were excluded from the calculation of diluted earnings per share for the nine-months ended