

COMMUNICATIONS SYSTEMS INC
Form 10-Q
May 10, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2011

OR

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
(State or other jurisdiction of
incorporation or organization)

41-0957999
(Federal Employer
Identification No.)

10900 Red Circle Drive, Minnetonka, MN
(Address of principal executive offices)

55343
(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 NO

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 NO

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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 Accelerated Filer Non-Accelerated Filer Smaller Reporting Company

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

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 May 1, 2011 |
|--|---|----------------------------|
| Common Stock, par value \$.05 per share | NASDAQ | 8,432,658 |

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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

| | March 31 2011 | December 31 2010 |
|--|-----------------------|-----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 15,625,165 | \$ 16,787,558 |
| Investments | 19,938,475 | 21,698,905 |
| Trade accounts receivable, less allowance for doubtful accounts of \$577,000 and \$500,000, respectively | 19,425,433 | 17,544,136 |
| Inventories | 25,009,349 | 24,498,935 |
| Prepaid income taxes | | 296,586 |
| Other current assets | 1,595,313 | 908,102 |
| Deferred income taxes | 4,398,934 | 4,469,941 |
| TOTAL CURRENT ASSETS | 85,992,669 | 86,204,163 |
| PROPERTY, PLANT AND EQUIPMENT, net | 13,153,360 | 13,214,067 |
| OTHER ASSETS: | | |
| Investments | 6,109,116 | 4,588,267 |
| Goodwill | 4,560,217 | 4,560,217 |
| Prepaid pensions | 353,094 | 349,575 |
| Other assets | 149,517 | 153,938 |
| TOTAL OTHER ASSETS | 11,171,944 | 9,651,997 |
| TOTAL ASSETS | \$ 110,317,973 | \$ 109,070,227 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| CURRENT LIABILITIES: | | |
| Current portion of long-term debt | \$ 406,065 | \$ 399,209 |
| Accounts payable | 5,141,953 | 5,385,558 |
| Accrued compensation and benefits | 4,710,713 | 3,951,401 |
| Other accrued liabilities | 1,558,909 | 1,669,776 |
| Income taxes payable | 854,511 | 0 |
| Dividends payable | 1,264,122 | 1,263,434 |
| TOTAL CURRENT LIABILITIES | 13,936,273 | 12,669,378 |
| LONG TERM LIABILITIES: | | |
| Long-term compensation plans | 163,057 | 1,738,105 |
| Income taxes payable | 704,213 | 678,395 |
| Deferred income taxes | 657,191 | 585,317 |
| Long term debt - mortgage payable | 1,898,215 | 2,002,339 |
| TOTAL LONG-TERM LIABILITIES | 3,422,676 | 5,004,156 |
| COMMITMENTS AND CONTINGENCIES | | |
| 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; 8,427,480 and 8,422,890 shares issued and outstanding, respectively | | |
| | 421,374 | 421,144 |
| Additional paid-in capital | 34,716,244 | 34,491,370 |
| Retained earnings | 58,063,532 | 56,769,816 |
| Accumulated other comprehensive loss, net of tax | (242,126) | (285,637) |
| TOTAL STOCKHOLDERS EQUITY | 92,959,024 | 91,396,693 |
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 110,317,973 | \$ 109,070,227 |

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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
INCOME AND COMPREHENSIVE INCOME (LOSS)
(Unaudited)

| | Three Months Ended March 31 | |
|--|------------------------------------|---------------|
| | 2011 | 2010 |
| Sales from operations | \$ 31,022,802 | \$ 25,882,011 |
| Costs and expenses: | | |
| Cost of sales | 17,694,313 | 15,366,950 |
| Selling, general and administrative expenses | 9,187,210 | 8,394,796 |
| Total costs and expenses | 26,881,523 | 23,761,746 |
| Operating income | 4,141,279 | 2,120,265 |
| Other income and (expenses): | | |
| Investment and other income | 79,422 | 38,622 |
| Gain on sale of assets | (12,220) | 6,420 |
| Interest and other expense | (48,043) | (52,489) |
| Other income (loss), net | 19,159 | (7,447) |
| Income before income taxes | 4,160,438 | 2,112,818 |
| Income tax expense | 1,602,600 | 781,894 |
| Net income | 2,557,838 | 1,330,924 |
| Other comprehensive income (loss), net of tax: | | |
| Additional minimum pension liability adjustments | (9,218) | (102,462) |
| Unrealized gains (losses) on available-for-sale securities | (15,328) | 18,000 |
| Foreign currency translation adjustment | 68,057 | (208,232) |
| Total other comprehensive income (loss), net of tax | 43,511 | (292,694) |
| Comprehensive net income | \$ 2,601,349 | \$ 1,038,230 |
| Basic net income per share: | \$ 0.30 | \$ 0.16 |
| Diluted net income per share: | \$ 0.30 | \$ 0.16 |
| Average Basic Shares Outstanding | 8,425,003 | 8,356,873 |
| Average Dilutive Shares Outstanding | 8,469,845 | 8,388,478 |
| Dividends per share | \$ 0.15 | \$ 0.14 |

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

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

| | Common Stock | | Additional | Retained | Cumulative | |
|---|--------------|------------|---------------|---------------|---------------|---------------|
| | Shares | Amount | Paid-in | Earnings | Other | Total |
| | | | Capital | | Comprehensive | |
| | | | | | Income (Loss) | |
| BALANCE AT DECEMBER 31, 2010 | 8,422,890 | \$ 421,144 | \$ 34,491,370 | \$ 56,769,816 | \$ (285,637) | \$ 91,396,693 |
| Net income | | | | 2,557,838 | | 2,557,838 |
| Issuance of common stock under Employee Stock Purchase Plan | 1,590 | 80 | 21,131 | | | 21,211 |
| Issuance of common stock under Non-Employee Stock Option Plan | 3,000 | 150 | 24,150 | | | 24,300 |
| Tax benefit from non-qualified stock options | | | 7,280 | | | 7,280 |
| Share based compensation | | | 172,313 | | | 172,313 |
| Shareholder dividends | | | | (1,264,122) | | (1,264,122) |
| Other comprehensive income | | | | | 43,511 | 43,511 |
| BALANCE AT MARCH 31, 2011 | 8,427,480 | \$ 421,374 | \$ 34,716,244 | \$ 58,063,532 | \$ (242,126) | \$ 92,959,024 |

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)

| | Three Months Ended March 31 | |
|---|------------------------------------|---------------|
| | 2011 | 2010 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 2,557,838 | \$ 1,330,924 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 499,221 | 486,692 |
| Share based compensation | 80,173 | |
| Deferred income taxes | 142,881 | (131,091) |
| Loss (gain) on sale of assets | 12,220 | (6,420) |
| Excess tax benefit from stock based payments | (7,280) | |
| Changes in assets and liabilities: | | |
| Trade receivables | (1,853,282) | (2,085,915) |
| Inventories | (482,030) | (204,684) |
| Prepaid income taxes | 296,586 | 337,274 |
| Other assets | (681,740) | 76,721 |
| Accounts payable | (254,581) | 255,857 |
| Accrued compensation and benefits | (723,597) | (1,463,591) |
| Other accrued expenses | (115,352) | (36,744) |
| Income taxes payable | 887,609 | 313,773 |
| Net cash provided by (used in) operating activities | 358,666 | (1,127,204) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Capital expenditures | (443,602) | (555,608) |
| Purchases of investments | (7,125,746) | (9,698,600) |
| Proceeds from the sale of fixed assets | | 7,524 |
| Proceeds from the sale of investments | 7,350,000 | 3,268,023 |
| Net cash used in investing activities | (219,348) | (6,978,661) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Cash dividends paid | (1,263,434) | (1,169,040) |
| Mortgage principal payments | (97,268) | (90,864) |
| Proceeds from issuance of common stock | 45,511 | 55,212 |
| Excess tax benefit from stock based payments | 7,280 | |
| Purchase of common stock | | |
| Net cash used in financing activities | (1,307,911) | (1,204,692) |
| EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH | 6,200 | (98,177) |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (1,162,393) | (9,408,734) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 16,787,558 | 21,293,448 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 15,625,165 | \$ 11,884,714 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Income taxes paid | \$ 275,522 | \$ 260,893 |
| Interest paid | 46,290 | 52,731 |
| Dividends declared not paid | 1,264,122 | 1,170,058 |

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 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 of media and rate conversion products for telecommunications networks. CSI also provides through its JDL Technologies ("JDL") business unit 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 consolidated statement of changes in stockholders' equity as of March 31, 2011 and 2010 and the related consolidated statements of income and comprehensive income (loss), and the condensed consolidated statements of cash flows for the periods ended March 31, 2011 and 2010 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 March 31, 2011 and 2010 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, 2010 Annual Report to Shareholders on Form 10-K. The results of operations for the periods ended March 31 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, 2010, appropriately represent, in all material respects, the current status of accounting policies, and are incorporated herein by reference.

Table of ContentsCash equivalents and investments

For purposes of the condensed consolidated balance sheet and statements of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less at the time of purchase to be cash equivalents. As of March 31, 2011, the Company had \$15.6 million in cash and cash equivalents. Of this amount, \$8.9 million was invested in short-term money market funds that are not considered to be bank deposits and are not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or other government agency. These money market funds seek to preserve the value of the investment at \$1.00 per share; however, it is possible to lose money investing in these funds.

The remainder of the Company's cash and cash equivalents is deposited at banks. The FDIC insures deposits at banks up to \$250,000 per account. The Company's cash and cash equivalents are held at large, well-established financial institutions and the Company believes any risk associated with uninsured balances is remote.

The Company had \$26.0 million in investments, which consist of certificates of deposit that were purchased in the public markets and are classified as available-for-sale at March 31, 2011. Of the \$26.0 million in investments, \$19.9 million mature in 12 months or less and are classified as current assets. Available-for-sale investments are reported at fair value with unrealized gains and losses net of tax excluded from operations and reported as a separate component of stockholders' equity (See Comprehensive income below).

Revenue Recognition

The Company's manufacturing operations (Suttle, Transition Networks and Austin Taylor) 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 income (loss)

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

| | March 31 2011 | December 31 2010 |
|--|------------------|---------------------|
| Foreign currency translation | \$ (1,204,473) | \$ (1,272,530) |
| Unrealized gain (loss) on available-for-sale investments | (1,270) | 14,058 |
| Minimum pension liability | 963,617 | 972,835 |
| | \$ (242,126) | \$ (285,637) |
| | 8 | |

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NOTE 2 - 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 95% of the price at the end of the current quarterly plan term, which is March 31, 2011. The ESPP is non-compensatory under current rules and does not give rise to compensation cost. At March 31, 2011, 75,131 shares remain available for purchase under the ESPP.

Stock Option Plan for Directors

Shares of common stock are also reserved for issuance in connection with a nonqualified stock option plan under which shares may be issued to nonemployee directors (the Director Plan). The Director Plan provides for the automatic grant of nonqualified options for 3,000 shares of common stock annually to each nonemployee director concurrent with the annual shareholders' meeting. Exercise price is the fair market value of the stock at the date of grant. Options granted under the Director Plan vest when issued and expire 10 years from date of grant. At March 31, 2011, 37,000 shares are available to be issued under the Director Plan.

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.

During the quarter ending March 31, 2011 stock options were awarded covering 89,610 shares 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.

During the quarter ended March 31, 2011, key employees were granted 16,092 shares of deferred stock based on achievement against performance goals in 2010 under the Company's performance unit plan. The deferred stock will be paid out in the first quarter of 2014 to key employees still with the Company at that time. The Company also granted deferred stock awards of 73,972 shares to key employees under the Company's performance unit plan for performance over the 2011 to 2013 period. The actual number of shares of deferred stock earned by the respective employees, if any, will be determined based on achievement against cumulative performance goals for the three years ending December 31, 2013 and the number of shares earned will be paid in the first quarter of 2014 to those key employees still with the Company at that time. During the first quarter, the Company also granted deferred stock awards of up to 11,618 shares to executive employees that will be earned under the Company's short-term incentive plan if actual revenue growth equals or exceeds 150% of the revenue growth target for 2011. The number of shares earned by the respective executive employees, if any, will be paid out in the first quarter of 2012.

At March 31, 2011, 933,981 shares remained available to be issued under the Stock Plan.

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Changes in Stock Options Outstanding

The following table summarizes changes in the number of outstanding stock options under the Director Plan and Stock Plan over the period December 31, 2010 to March 31, 2011. All stock options outstanding at December 31, 2010 are exercisable and none of the options awarded during the period ended March 31, 2011 are exercisable.

| | Options | Weighted average exercise price per share | Weighted average remaining contractual term |
|-------------------------------|---------|---|---|
| Outstanding December 31, 2010 | 162,000 | \$ 9.49 | 5.33 years |
| Awarded | 89,610 | 14.15 | |
| Exercised | (3,000) | 8.10 | |
| Canceled | | | |
| Outstanding March 31, 2011 | 248,610 | 11.19 | 5.65 years |

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 March 31, 2011 was \$1,045,000. The intrinsic value of all options exercised during the three months ended March 31, 2011 was \$19,000. Net cash proceeds from the exercise of all stock options were \$24,000 and \$0 for the three months ended March 31, 2011 and 2010, respectively.

Compensation Expense

Share based compensation expense recognized for the three month period ended March 31, 2011 was \$80,000 before income taxes and \$52,000 after income taxes. No stock compensation expense was recognized for the three month period ended March 31, 2010. Unrecognized compensation expense for the Company's plans was \$857,000 at March 31, 2011. Excess tax benefits from the exercise of stock options included in financing cash flows for the three month periods ended March 31, 2011 and 2010 were \$7,000 and \$0, respectively.

NOTE 3 - INVENTORIES

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

| | March 31 2011 | December 31 2010 |
|-----------------------------|------------------|---------------------|
| Finished goods | \$ 13,616,894 | \$ 13,684,884 |
| Raw and processed materials | 11,392,455 | 10,814,051 |
| Total | \$ 25,009,349 | \$ 24,498,935 |

NOTE 4 - 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.

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The following table presents the changes in the Company's warranty liability for the three month periods ended March 31, 2011 and 2010, respectively, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

| | 2011 | 2010 |
|----------------------------|-------------|-------------|
| Beginning Balance | \$ 616,000 | \$ 648,000 |
| Actual warranty costs paid | (89,000) | (18,000) |
| Amounts charged to expense | 105,000 | (50,000) |
| Ending balance | \$ 632,000 | \$ 580,000 |

NOTE 5 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 would materially affect the Company's financial position or results of operations.

NOTE 6 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 March 31, 2011 there was \$546,000 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 2007-2009 remain open to examination by the Internal Revenue Service and the years 2006-2009 remain open to examination by various state tax departments. The tax years from 2008-2009 remain open in Costa Rica.

The Company's effective income tax rate was 38.5% for the first three months of 2011. The effective tax rate differs from the federal tax rate of 35% due to state income taxes, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges and settlement of uncertain income tax positions. The foreign operating losses may ultimately be deductible in the countries in which they have occurred; however the Company has not recorded a deferred tax asset for these losses due to uncertainty regarding the eventual realization of the benefit. The effect of the foreign operations is an overall rate increase of approximately 0.4% for the three months ended March 31, 2011. There were no additional uncertain tax positions identified in the first quarter of 2011. The Company's effective income tax rate for the three months ended March 31, 2010 was 37%, 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, and settlement of uncertain tax positions.

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NOTE 7 SEGMENT INFORMATION

The Company classifies its businesses into four segments as follows:

Suttle manufactures and sells U.S. standard modular connecting and wiring devices for voice and data communications, digital subscriber line filters, and structured wiring systems;

Transition Networks designs and markets data transmission, computer network and media conversion products;

JDL Technologies, Inc. provides IT services including network design, computer infrastructure installations, IT service management, change management, network security and network operations services;

Austin Taylor Communications LTD manufactures British-standard telephone equipment and equipment enclosures for the U.K and international markets.

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.

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Information concerning the Company's continuing operations in the various segments for the three month periods ended March 31, 2011 and 2010 is as follows:

SEGMENT INFORMATION

| | Suttle | Transition Networks | JDL Technologies | Austin Taylor | Other | Total |
|--|---------------|---------------------|------------------|---------------|----------------|----------------|
| Three months ended March 31, 2011: | | | | | | |
| Sales | \$ 9,659,974 | \$ 16,555,896 | \$ 3,779,724 | \$ 1,027,208 | | \$ 31,022,802 |
| Cost of sales | 7,126,170 | 7,579,227 | 2,152,368 | 836,548 | | \$ 17,694,313 |
| Gross profit | 2,533,804 | 8,976,669 | 1,627,356 | 190,660 | | 13,328,489 |
| Selling, general and administrative expenses | 1,816,945 | 5,332,393 | 512,820 | 303,246 | 1,221,806 | \$ 9,187,210 |
| Operating income (loss) | \$ 716,859 | \$ 3,644,276 | \$ 1,114,536 | \$ (112,586) | \$ (1,221,806) | \$ 4,141,279 |
| Depreciation and amortization | \$ 217,016 | \$ 167,154 | \$ 28,488 | \$ 11,898 | \$ 74,665 | \$ 499,221 |
| Capital expenditures | \$ 232,625 | \$ 191,550 | \$ 10,051 | \$ 9,376 | \$ | \$ 443,602 |
| Assets at March 31, 2011 | \$ 20,424,181 | \$ 32,125,732 | \$ 3,668,604 | \$ 2,732,972 | \$ 51,366,484 | \$ 110,317,973 |
| | Suttle | Transition Networks | JDL Technologies | Austin Taylor | Other | Total |
| Three months ended March 31, 2010: | | | | | | |
| Sales | \$ 9,927,105 | \$ 13,753,196 | \$ 1,295,719 | \$ 905,991 | \$ | \$ 25,882,011 |
| Cost of sales | 7,276,458 | 6,330,882 | 934,898 | 824,712 | | \$ 15,366,950 |
| Gross profit | 2,650,647 | 7,422,314 | 360,821 | 81,279 | | 10,515,061 |
| Selling, general and administrative expenses | 1,787,899 | 4,893,304 | 387,196 | 248,554 | 1,077,843 | \$ 8,394,796 |
| Operating income (loss) | \$ 862,748 | \$ 2,529,010 | \$ (26,375) | \$ (167,275) | \$ (1,077,843) | \$ 2,120,265 |
| Depreciation and amortization | \$ 217,037 | \$ 147,023 | \$ 37,919 | \$ 12,202 | \$ 72,510 | \$ 486,692 |
| Capital expenditures | \$ 463,796 | \$ 26,590 | \$ 11,787 | \$ 14,648 | \$ 38,787 | \$ 555,608 |
| Assets at March 31, 2010 | \$ 20,160,161 | \$ 30,071,446 | \$ 2,540,094 | \$ 3,890,113 | \$ 45,177,607 | \$ 101,839,421 |

NOTE 8 PENSIONS

The Company's U.K. based subsidiary Austin Taylor maintains defined benefit pension plans that cover approximately seven active employees. The Company does not provide any other post-retirement benefits to its employees. Components of net periodic benefit cost of the pension plans were:

| | Three months Ended March 31 | |
|--------------------------------|-----------------------------|-----------|
| | 2011 | 2010 |
| Service cost | \$ 12,000 | 9,000 |
| Interest cost | 67,000 | 62,000 |
| Expected return on plan assets | (63,000) | (54,000) |
| | \$ 16,000 | \$ 17,000 |

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NOTE 9 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 44,841 shares and 31,605 shares for the respective three month periods ended March 31, 2011 and 2010. The Company calculates the dilutive effect of outstanding options using the treasury stock method. The number of shares not included in the computation of diluted earnings per share was 0 and 24,000 at March 31, 2011 and 2010, respectively. Certain options were not included because the exercise price was greater than the average market price of common stock during the period and certain deferred stock awards were not included because of unmet performance conditions.

NOTE 10 FAIR VALUE MEASUREMENTS

The accounting guidance establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1 Observable inputs that reflect unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access at the measurement date.

Level 2 Observable inputs such as quoted prices for similar instruments and quoted prices in markets that are not active, and inputs that are directly observable or can be corroborated by observable market data. The types of assets and liabilities included in Level 2 are typically either comparable to actively traded securities or contracts, such as treasury securities with pricing interpolated from recent trades of similar securities, or priced with models using highly observable inputs, such as commodity options priced using observable forward prices and volatilities.

Level 3 Significant inputs to pricing have little or no observability as of the reporting date. The types of assets and liabilities included in Level 3 are those with inputs requiring significant management judgment or estimation, such as the complex and subjective models and forecasts used to determine the fair value of financial instruments.

The Company's assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2011 and December 31, 2010, respectively, include money market funds within cash and cash equivalents of \$8,901,000 and \$9,624,000 classified as Level 1 within the hierarchy and certificate of deposits within investments of \$26,048,000 and \$26,287,000 classified as Level 2. The Company does not have any assets or liabilities classified as Level 3 within the hierarchy. There were no transfers between levels during the three months ended March 31, 2011.

NOTE 11 SUBSEQUENT EVENTS

The Company has evaluated subsequent events through the date of this filing. We do not believe there are any material subsequent events that would require further disclosure.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

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, the Company may make forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 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 these 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 these forward looking statements are subject to risks and uncertainties that could cause actual performance, activities, anticipated results, outcomes or plans to differ significantly from those indicated in the forward-looking statements. These risks and uncertainties include, but are not limited to:

- our ability to manufacture and deliver our products to customers in the time frame these customers have specified;
- lower sales to major telephone companies and other major customers;
- the introduction of competitive products and technologies;
- our ability to successfully reduce operating expenses at certain business units;
- the general health of the telecom sector;
- the continuing economic downturn and the fact that conditions outside the United States are recovering more slowly than within the United States;
- successful integration and profitability of acquisitions;
- delays in new product introductions;
- higher than expected expense related to new sales and marketing initiatives;
- unfavorable resolution of claims and litigation;
- availability of adequate supplies of raw materials and components;
- fuel prices;
- government funding of education technology spending; and
- other factors discussed from time to time in the Company's filings with the Securities and Exchange Commission, including risk factors presented under Item 1A of the Company's most recently filed annual report on Form 10-K.

Three Months Ended March 31, 2011 Compared to
Three Months Ended March 31, 2010

Consolidated sales increased 20% in 2011 to \$31,023,000 compared to \$25,882,000 in 2010. Consolidated operating income in 2011 increased to \$4,141,000 compared to \$2,120,000 in the first quarter of 2010.

Net income in 2011 increased to \$2,558,000 compared to \$1,331,000 in the first quarter of 2010.

Table of Contents**Suttle**

Suttle sales decreased 3% in the first quarter of 2011 to \$9,660,000 compared to \$9,927,000 in the same period of 2010 due to a continued decline in the voice markets. Sales by customer groups in the first quarter of 2011 and 2010 were:

| | Suttle Sales by Customer Group | |
|---------------------------|---------------------------------------|---------------------|
| | 2011 | 2010 |
| Major telephone companies | \$ 6,875,000 | \$ 6,751,000 |
| Distributors | 1,149,000 | 1,458,000 |
| International | 1,391,000 | 1,682,000 |
| Other | 245,000 | 36,000 |
| | \$ 9,660,000 | \$ 9,927,000 |

Suttle s sales by product groups in first quarter of 2011 and 2010 were:

| | Suttle Sales by Product Group | |
|-----------------------------|--------------------------------------|---------------------|
| | 2011 | 2010 |
| Modular connecting products | \$ 3,551,000 | \$ 4,213,000 |
| DSL products | 2,959,000 | 3,070,000 |
| Structured cabling products | 2,918,000 | 2,490,000 |
| Other products | 232,000 | 154,000 |
| | \$ 9,660,000 | \$ 9,927,000 |

Sales to the major telephone companies increased 2% in 2011 due to an increase in new multi-dwelling unit construction within the US housing market, which is offset by declines in sales of DSL products and a continued decline in voice markets. Sales to these customers accounted for 71% of Suttle s sales in the first quarter of 2011 compared to 68% of sales in 2010. Sales to distributors decreased 21% in 2011 due to continued declines in voice markets, and continued challenges in the single family unit construction within the US housing market. This customer segment accounted for 12% and 15% of sales in the first quarters of 2011 and 2010, respectively. International sales decreased 17% and accounted for 14% of Suttle s first quarter 2011 sales. Suttle s products do not have a large international market due to different product specifications in non-U.S. markets.

Modular connecting products sales have decreased 16% due to continued decline in the voice market. Sales of DSL products decreased 4% due to the maturation of the U.S. DSL market and the order cycle of major customers. Sales of structured cabling products increased 17% due to an increase in new multi-dwelling unit construction market.

Suttle s gross margin decreased 4% in the first quarter of 2011 to \$2,534,000 compared to \$2,651,000 in the same period of 2010. Gross margin as a percentage of sales decreased to 26% in 2011 from 27% in 2010 due to product mix changes. Selling, general and administrative expenses increased \$29,000 or 2% in the first quarter of 2011 compared to the same period in 2010, due to increased spending in the Company s technology development initiative. Suttle s operating income was \$717,000 in the first quarter of 2011 compared to operating income of \$863,000 in 2010.

Table of Contents**Transition Networks**

Transition Networks sales increased 20% to \$16,556,000 in the first quarter of 2011 compared to \$13,753,000 in 2010.

First quarter sales by region are presented in the following table:

| | Transition Networks Sales by Region | |
|--------------------------------------|--|---------------|
| | 2011 | 2010 |
| North America | \$ 13,218,000 | \$ 11,095,000 |
| Europe, Middle East, Africa (EMEA) | 1,832,000 | 1,080,000 |
| Rest of world | 1,506,000 | 1,578,000 |
| | \$ 16,556,000 | \$ 13,753,000 |

The following table summarizes Transition Networks 2011 and 2010 first quarter sales by its major product groups:

| | Transition Networks Sales by Product Group | |
|-------------------|---|---------------|
| | 2011 | 2010 |
| Media converters | \$ 11,629,000 | \$ 10,426,000 |
| Ethernet switches | 1,036,000 | 870,000 |
| Ethernet adapters | 2,296,000 | 1,602,000 |
| Other products | 1,595,000 | 855,000 |
| | \$ 16,556,000 | \$ 13,753,000 |

Sales in North America increased 19% or \$2,123,000 due to an improving economic situation in the United States and Canada and increased activity in target vertical market segments. International sales increased \$680,000, or 26%, primarily due to improved economic activity in EMEA.

Gross margin on first quarter Transition Networks sales increased 21% to \$8,977,000 in 2011 from \$7,422,000 in 2010. Gross margin as a percentage of sales remained stable at 54% in 2011 and 2010. Selling, general and administrative expenses increased 9% to \$5,332,000 in 2011 compared to \$4,893,000 in 2010 due to the hiring of new employees and an increase in marketing and research and development expenses. Operating income increased to \$3,644,000 in 2011 compared to \$2,529,000 in 2010.

JDL Technologies, Inc.

JDL Technologies, Inc. sales increased 192% to \$3,780,000 in the first quarter of 2011 compared to \$1,296,000 in 2010.

JDL's revenues by customer group were as follows:

| | JDL Revenue by Customer Group | |
|---------------------------|--------------------------------------|--------------|
| | 2011 | 2010 |
| Broward County FL schools | \$ 3,737,000 | \$ 1,200,000 |
| All other | 43,000 | 96,000 |
| | \$ 3,780,000 | \$ 1,296,000 |

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Revenues earned in Broward County, Florida increased \$2,537,000 or 212% in the first quarter 2011. The increase was the result of higher funding from the federal government for LAN/WAN/Wire work in the first quarter of 2011 than in the same period of 2010 from an order that the Company disclosed in the first quarter of 2010.

JDL gross margin increased 351% to \$1,627,000 in the first quarter of 2011 compared to \$361,000 in the same period in 2010. Gross margin as a percentage of sales increased to 43% in 2011 from 28% in 2010 due to purchasing discounts and rebates the Company was able to take advantage of during the quarter. Selling, general and administrative expenses increased in 2011 to \$513,000 compared to \$387,000 in 2010 due to headcount increases, specifically within the sales function as JDL has expanded its market focus. JDL reported operating income of \$1,115,000 in the first quarter of 2011 compared to an operating loss of \$26,000 in the same period of 2010.

Austin Taylor

Austin Taylor's revenues increased 13% to \$1,027,000 for the first quarter of 2011, compared to \$906,000 in 2010. This revenue increase is due to increased product penetration into a major frame and cabinet original equipment manufacturer (OEM). In addition, the Company received adjusted OEM pricing on a renewed three year supplier contract. Gross margin increased to \$191,000 in 2011 from \$81,000 in 2010. Gross margin as a percentage of sales was 19% in 2011 compared to 9% in 2010. This margin increase is a result of increased volume of customized OEM product sales and improved efficiencies of the internal manufacturing processes. Austin Taylor reported an operating loss in 2011 of \$113,000 compared to \$167,000 in 2010.

Other

Net investment income increased to \$19,000 in 2011 as compared to a loss of \$7,000 in 2010. This increase is due to favorable unrealized gains due to the improvement of the Euro, offset by continued decreases in interest expense. The Company's income before income taxes increased to \$4,160,000 in 2011 compared to \$2,113,000 in 2010. The Company's effective income tax rate was 39% in 2011 and 37% in 2010. This effective rate was higher than the standard rate of 35% due to state income taxes, foreign losses not deductible for U.S. income tax purposes, income tax return to provision adjustments, provisions for interest charges and settlement of uncertain income tax positions.

Liquidity and Capital Resources

At March 31, 2011, the Company had approximately \$41,673,000 of cash equivalents and investments compared to \$43,075,000 of cash equivalents and investments at December 31, 2010. The Company had current assets of approximately \$85,993,000 and current liabilities of \$13,936,000 at March 31, 2011 compared to current assets of \$86,204,000 and current liabilities of \$12,669,000 at December 31, 2010.

Net cash provided by operating activities was \$359,000 in the first three months of 2011 compared to \$1,127,000 used in the same period in 2010. Significant working capital changes from December 31, 2010 to March 31, 2011 included an increase in accounts receivable of \$1,853,000 due to an overall increase in sales in the first quarter of 2011 as compared to the fourth quarter of 2010 and an increase in income taxes payable due to higher taxable income and timing of tax payments.

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Net cash used in investing activities was \$219,000 in the first three months in 2011 compared to cash used of \$6,979,000 in the same period in 2010. During the first three months of 2011, the Company continued to purchase certificates of deposit with maturities of greater than 90 days.

Net cash used in financing activities was \$1,308,000 and \$1,205,000 in the first three months of 2011 and 2010, respectively. Cash dividends paid in the first three months of 2011 were \$1,263,000 (\$0.15 per common share) compared to \$1,169,000 (\$0.14 per common share) in the same period in 2010. Proceeds from common stock issuances, principally issued under the Company's Employee Stock Purchase Plan, totaled approximately \$46,000 in the first three months of 2011 and \$55,000 in the same period in 2010. In the first three months of 2011, the Company did not purchase any of its outstanding common shares. At March 31, 2011, 481,938 additional shares could be repurchased under outstanding Board authorizations. The Company has a \$10,000,000 line of credit from U.S. Bank. Interest on borrowings on the credit line is at the LIBOR rate plus 1.5% (1.8% at March 31, 2011). There were no borrowings on the line of credit during the first three months of 2011 or 2010. The credit agreement expires September 30, 2011 and is secured by assets of the Company. As part of the acquisition of the new Minnetonka headquarters building in July 2007, the Company assumed an outstanding mortgage of \$4,380,000. The mortgage is payable in monthly installments and carries an interest rate of 6.83%. The mortgage matures on March 1, 2016. Mortgage payments on principal totaled \$97,000 during the first quarter of 2011. The outstanding balance on the mortgage was \$2,304,000 at March 31, 2011.

In the opinion of management, based on the Company's current financial and operating position and projected future expenditures, sufficient funds are available to meet the Company's anticipated operating and capital expenditure needs.

Critical Accounting Policies

Our critical accounting policies, including the assumptions and judgments underlying them, are discussed in our 2010 Form 10-K in Note 1 Summary of Significant Accounting Policies included in our Consolidated Financial Statements. There were no significant changes to our critical accounting policies during the three months ended March 31, 2011.

The Company's accounting policies have been consistently applied in all material respects and disclose such matters as allowance for doubtful accounts, sales returns, inventory valuation, warranty expense, income taxes, revenue recognition, asset and goodwill impairment recognition and foreign currency translation. On an ongoing basis, we evaluate our estimates based on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the result of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Results may differ from these estimates due to actual outcomes being different from those on which we based our assumptions. Management reviews these estimates and judgments on an ongoing basis.

Recently Issued Accounting Pronouncements

We do not believe there are any recently issued accounting standards that have not yet been adopted that will have a material impact on the Company's financial statements.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk.

The Company has no freestanding or embedded derivatives. The Company's policy is to not use freestanding derivatives and to not enter into contracts with terms that cannot be designated as normal purchases or sales.

The vast majority of our transactions are denominated in U.S. dollars; as such, fluctuations in foreign currency exchange rates have historically not been material to the Company. At March 31, 2011 our bank line of credit carried a variable interest rate based on the London Interbank Offered Rate (LIBOR) plus 1.5%. The Company's investments are either money market type of investments that earn interest at prevailing market rates or certificates of deposits insured through the FDIC and as such do not have material risk exposure.

Based on the Company's operations, in the opinion of management, no material future losses or exposure exist relative to market risk.

Item 4. Controls and Procedures

The Company carried out an evaluation, under the supervision and with the participation of its management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in the Exchange Act Rule 13a-15(e)) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective.

There was no change in the Company's internal control over financial reporting that occurred during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Not Applicable.

Item 1A. Risk Factors

Not Applicable.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable.

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. [Removed and Reserved]

Item 5. Other Information

Not Applicable

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Item 6 Exhibits.

The following exhibits are included herein:

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rules 13a-14 and 15d-14 of the Exchange Act).
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rules 13a-14 and 15d-14 of the Exchange Act).
- 32. Certifications pursuant Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350).

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Signatures

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

Communications Systems, Inc.

By /s/ Jeffrey K. Berg
Jeffrey K. Berg
President and Chief Executive Officer

Date: May 10, 2011

/s/ David T. McGraw
David T. McGraw
Chief Financial Officer

Date: May 10, 2011