COMMUNICATIONS SYSTEMS INC
Form 10-K
March 12, 2015

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

FORM 10-K

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

For the fiscal year ended December 31, 2014

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 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
Preferred Stock Purchase Rights	

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 NO

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

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

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.

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 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 Act). YES NO

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant was approximately $84,159,000 based upon the closing sale price of the Company's common stock on the NASDAQ on June 30, 2014.

As of March 1, 2015 there were outstanding 8,658,784 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, 2015 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 that operates directly and through its subsidiaries located in the United States (U.S.), Costa Rica, and the United Kingdom (U.K.). CSI is principally engaged through its Suttle, Inc. subsidiary and business unit 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, Inc. subsidiary and business unit in the manufacture and sale of core media conversion products for telecommunications networks. Through its JDL Technologies, Inc. subsidiary and business unit, CSI provides IT solutions 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 and Exchange Commission website.

(b) FINANCIAL INFORMATION ABOUT INDUSTRY SEGMENTS

The Company classifies its businesses into three segments: Suttle, which manufactures U.S. standard modular connecting and wiring devices for voice and data communications; Transition Networks, which designs and markets media conversion products, Ethernet switches, and other connectivity and data transmission products; and JDL Technologies, (JDL), which provides IT solutions. Effective January 1, 2014, the Company realigned the financial reporting for its business units. As a result of this realignment, all corporate general and administrative expenses that were previously categorized as “Other” are now included within the three business units as fully allocated costs. There are no material intersegment revenues. Further information regarding these segments, including customer and industry concentration, is set forth in Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and in Note 11 of the Notes to Consolidated Financial Statements under Item 8.

(c) NARRATIVE DESCRIPTION OF BUSINESS

(1) Information Regarding Business Segments

(i) Suttle, Inc.

Suttle manufactures and markets a variety of telecommunication products for outside plant, connectivity and premise distribution under the Suttle brand name in the United States and internationally. Suttle’s new FutureLinkTM brand includes solutions for higher speeds, tool-less connectivity and lower cost of ownership, such as copper and fiber connectivity systems, enclosure systems, network interface devices (NIDs), splitters, and active technologies for voice, data and video communications. The new plastic MediaMAXTM brand is optimized for wired and wireless gigabit connectivity to all areas of the home and small office and rounds out Suttle’s premise distribution portfolio, which also includes the traditional metal SOHO Access ™ , and passive lines, such as xDSL filters, under the SpeedStarTM brand. The Company manufactures 70% of its products at its plants in Hector, Minnesota (Suttle, Inc.)

and San Jose, Costa Rica (Suttle Costa Rica, S.A.). The other 30% are purchased from offshore contract manufacturers. Segment sales were $67,330,000 (57% of consolidated revenues) in 2014 and $54,346,000 (41% of consolidated revenues) in 2013.

Products

Suttle offers a broad range of critical components for premise, connectivity and outside plant networking. The Company's customer-oriented approach provides right-sized solutions that leverage existing infrastructure and protect investments as markets and technologies grow and change. With over 100 years of knowledge and experience, Suttle is a reliable partner, delivering innovative, flexible, easy-to-use solutions, lower cost of ownership, and solid customer support.

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Outside Plant:

Suttle’s outside plant products (OSP) are designed to operate in challenging environments yet be easily accessible, extend the life of the existing network, enhance data speeds, and prevent loss.

Suttle OSP systems are designed for flexibility and scalability in real world applications for both copper and fiber networks. Suttle's FutureLinkTM OSP Fiber solutions offer a range of products including terminals, patch-and-splice and splitter enclosures. For copper networks, Suttle’s FutureLinkTM OSP Copper solutions include building entrance terminals and enclosures.

Premise Distribution:

Suttle provides service distribution products for cost-effective solutions using existing wiring. These products reduce installation time and labor costs, and increase the provider’s return on investment. In addition to reducing a service provider’s up-front costs, Suttle’s high throughput solutions help eliminate potential bottlenecks to “future-proof” the installation, reducing future costs.

Suttle’s new MediaMAXTM brand for reliable brownfield and greenfield premise connectivity meets the increasing demand for wired and wireless high-speed connectivity throughout the home and small office. Designed to optimize installation cost and practices while maximizing coverage and bandwidth at the point of use for multiple deployment topologies, this brand includes a premise connectivity and distribution system, featuring plastic modular enclosures and tool-less, snap-in modules to minimize wireless interference.

Suttle’s fiber solutions help providers in the deployment of fiber to the premise (FTTP) service under the FutureLink™ brand. These products feature higher speed connections, tool-less connectivity and lower cost of ownership. Our popular SOHO Access™ enclosures and modules provide flexibility and versatility for the termination and management of voice, data, and video connections.

Active solutions distribute service inside the premise through electronic devices. Suttle’s active service solutions allow the distribution of service at higher speeds regardless of media, using technologies under FutureLink™ brand products. Passive solutions provide traditional telephony and broadband technology deployments. Through our highly recognized brands — SpeedStar™ and Corroshield® as well as our new brand for higher speeds FutureLink™ — Suttle provides the right solution for wired distribution.

Markets and Marketing

Suttle markets its outside plant and premise distribution products globally to telecommunications companies. Suttle has a solid history of offering long-term solutions to some of the largest global providers by understanding the customer’s needs and providing innovative solutions coupled with strong customer support. Suttle also markets its products to service providers, residential builders, and low-voltage installers through distributors and the Company’s sales staff. Suttle reaches its targeted customers through a variety of marketing media including trade shows, associations, advertising, social media and the Suttle website.

Suttle recently changed its domain name for electronic communications to SuttleSolutions.com to emphasize our focus on end-to-end customer oriented solutions for communication service providers.

Customers

Suttle's customers include the major communication companies globally, including both telephone and cable service provider companies. The Company's major telephone company customers include Verizon, ATT, and CenturyLink. Suttle serves these major telephone companies directly by Suttle's sales staff and through a select group of distributors. Sales (including DSL) to the major telephone companies, as a group, both directly and through distribution, represented 84% of Suttle's sales in 2014 and 80% in 2013.

Other customers include smaller telephone companies, electrical/low-voltage contractors, home builders, and a nationwide network of distributors. Suttle serves these customers primarily through distributors, but also directly through its sales staff. Sales to cable customers and original equipment manufacturers (OEMs) are made through the nationwide network of distributors and through the Suttle sales staff. Sales to OEMs and other distributors were 9% of Suttle's sales in 2014 and 11% in 2013. Sales to international customers and other customers represented 7% of Suttle's sales in 2014 and 9% in 2013.

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, delivery, and customer support. In addition, distributors of Suttle's products also market products for one or more of its competitors.

Order Book

Suttle manufactures its products on the basis of estimated customer requirements. Outstanding customer orders at March 1, 2015 were approximately $2,356,000 compared to approximately $2,008,000 at March 1, 2014. New orders are generally filled within 60 days. Suttle does not believe its order book is a significant indicator of longer term future results.

Manufacturing and Sources of Supply

Suttle manufactures its products using plastic or metal 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 use a moisture-resistant gel-filled fig available only from Tyco Electronics Connectivity. Although Suttle has not generally experienced significant problems in obtaining its required supplies, from time to time it experiences spot shortages and additional order lead times are required from its offshore suppliers.

Research and Development: Patents

Suttle continually monitors industry requirements and creates new products to improve its existing product line. Although Suttle has historically not relied significantly on patents to protect its competitive position, as a result of duplication of its designs by foreign apparatus manufacturers, Suttle has begun to apply for design patents on a number of its new products.

Research and development consists primarily of designing, prototyping, and testing of equipment and supplies associated with enhancing existing products and developing new products. Research and development costs are expensed when incurred and were $3,670,000 in 2014 compared to $483,000 in 2013.

Intellectual Property

The Suttle brand name is a trademark important to its business. Suttle regularly supports this name by trade advertising and believes it is well known in the marketplace. Other important trademarks include FutureLinkTM brand umbrella for end-to-end products for outside plant, connectivity and premise distribution; plastic MediaMAXTM and metal SOHO Access™ for small office and home office enclosures and modules; SpeedStarTM for passive premise connectivity; and CorroShield® brand gel that prevents network corrosion.

(ii) Transition Networks, Inc.

Transition Networks, Inc. (“Transition” or “Transition Networks”) is based in Minnetonka, Minnesota and also maintains operations in the U.K. Transition designs, assembles and markets media converters, NIDs, network interface cards (NICs), Ethernet switches, Small Form Factor Pluggable modules (SFP), and other connectivity products under the Transition Networks and MILAN brand names. Transition sells its products through distributors, resellers, integrators, and OEMs. These media converters, NIDs, and Ethernet Switch products allow network operators to transmit voice and data across networks and between copper-wired and fiber-optic equipment. Sales by Transition Networks were $43,174,000 (36% of consolidated sales) in 2014 compared to $43,857,000 (33% of consolidated sales) in 2013. International sales accounted for 27% of Transition’s sales, or $11,645,000 in 2014, compared to $13,196,000, or 30% of Transition’s sales in 2013.

Products

Transition Networks designs, assembles and sells media converter devices, NIDs, Ethernet switches and other connectivity products that make it possible to transmit telecommunications signals across networks and between systems using different types of media (for example, between copper and fiber optic networks). These products enable customers to integrate fiber optics into their existing network infrastructure as their networks grow, and extend data services to customers at remote locations. Protocols supported include: 10 Gigabit Ethernet, Gigabit Ethernet, Fast Ethernet, Ethernet, T1/E1, DS3, Circuit Emulation Services (TDM or ISDN over Ethernet or IP), RS232, RS485, OC3, OC12, and more. Transition Networks develops product hardware and software internally, and expenses the related costs as they are incurred. In connection with the sale of its hardware products, Transition Networks provides its customers with a variety of software management options including powerful Orchestration and Element Management System (EMS) software for providing superior service provisioning and monitoring of next-generation Carrier Ethernet 2.0 Services. The Company has been developing and marketing Ethernet-based networking products for approximately 28 years. Transition Networks continues to develop products that address the enterprise, service provider, industrial, government, and security markets.

Manufacturing and Sources of Supply

Transition Networks uses contract manufacturers to manufacture its products in different geographical locations. In 2014, 53% of the total value of its products was manufactured in Asia while the remaining 47% was manufactured in the US. Offshore sources of supply are subject to certain risks, including political risk. The Company has alternate sources of supply for its products in different geographical locations 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 the federal government, enterprise, service provider, industrial, and surveillance markets. Transition Networks has a broad customer base and its products are used in a variety of applications.

The media conversion product line is used in several applications. The ION and Point System™ chassis-based modular systems are used primarily in telecommunications 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 last mile access, backhaul, central closet and at the end user stations. The Carrier Ethernet NID line of products addresses the high quality access requirements for both business services and wireless backhaul data communications and telecommunications applications.

Marketing primarily consists of direct marketing using a sales force, tradeshows, trade magazine advertising, on-line advertising, website, email, social media 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 develops products for the federal government, 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, 802.3AG, ITU-T Y.1731 standards, Metro Ethernet Forum (MEF)® and MEF 2.0 standards, and Power Over Ethernet devices based on the IEEE® 802.3AF and IEEE® 802.3AT standards. Some design efforts are paced by the development of critical components such as integrated circuits and optical transceivers.

Research and development consists primarily of designing, prototyping, and testing of equipment and supplies associated with enhancing existing products and developing new products. Research and development costs are expensed when incurred and were $4,166,000 in 2014 compared to $2,277,000 in 2013. Transition Networks significantly accelerated its research and development activities in 2014 to improve its product portfolio.

Transition Networks' conducts its research and development operations in the United States and the United Kingdom. The US location has a global engineering and product development leadership responsibility. The UK facility was added in 2011 as a result of the Patapsco acquisition. The UK location focuses on engineering and support for Circuit Emulation Products as well as logistics and sales activities.

Competition

Transition Networks faces strong competition across its entire product line. A large number of competitors exist for high volume products in the Fast Ethernet and Gigabit Ethernet families, as well as the NIDs. Low cost competitors from China and Taiwan are strongest in Asian, Europe, Middle East, and Africa (EMEA) and South American markets, but have had limited success in the North American market for the media converter products. 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 $1,683,000 at March 1, 2015 and $2,389,000 at March 1, 2014. Transition Networks orders are fulfilled on a relatively short-term basis and therefore the Company does not consider the order book as a significant indicator of longer term future results.

(iii) JDL Technologies, Inc.

JDL Technologies, Inc. ("JDL Technologies" or "JDL"), based in Fort Lauderdale, Florida, is a managed service provider and value-added reseller, supplying information technology (IT) solutions focused on IT service and support management; network design, deployment and integration; cloud and virtualization services; and network operations center management. JDL's 2014 sales were $8,567,000 (7% of consolidated sales) compared to 2013 sales of $33,116,000 (25% of consolidated sales). Project revenue totaled $6,836,000 in 2014 or 80% of JDL sales compared to $31,698,000 in 2013 or 96% of JDL sales. Managed services revenues grew to $1,731,000 in 2014 from $1,418,000 in 2013.

Competitive Strategy

While the Florida information technology market includes a number of other managed service providers (MSPs) and value-added resellers (VARs), JDL has differentiated itself in several strategic ways during more than 15 years of operations, and is well qualified to help organizations optimize their information technology.

JDL is committed to helping IT professionals keep their technology up and running, fix problems quickly, support their user communities, and regularly add new value to their organizations. Key avenues for delivering on this commitment—and distinct competitive advantages—are JDL's secure, on-premise, state-of-the-art redundant datacenter and managed services operations center. JDL Technologies was recently named to the Elite 150 Managed Service Providers in North America, part of The Channel Company's 2015 MSP 500 list. JDL also holds the MSP Trustmark credential from CompTIA and is a member of the MSP Alliance.

JDL's portfolio of technology solutions continues to expand to reflect the constant introduction of new technologies and growing demand among businesses for current solutions to strengthen their competitive edge and continuity. With its team of professionally certified engineers, more than 300 years of technical experience, and talented leadership, JDL Technologies develops best-of-breed IT solutions that effectively meet these demands. JDL was named to the 2014 CRN Solution Provider 500.

Augmenting its own exceptional bench strength, JDL maintains active partnerships with industry leaders such as Cisco, Citrix, EMC, HP, Sophos and VMware, as well as younger technology innovators like Aerohive, All Medical Solutions, Bradford Networks, Nutanix and RingCentral. These strategic partnerships enable JDL to leverage a comprehensive array of proven technologies to provide solutions that meet each client's specific needs.

As a result of these combined factors, JDL Technologies has become a trusted advisor to a wide range of clients throughout Florida, earning important incremental business and solid references. In particular, JDL continues to grow its managed services base, successfully attracting enterprise clients with multiple locations in Florida and throughout the U.S. and generating steadily increasing recurring monthly revenues.

Targeted Vertical Markets

Looking beyond its deep roots in the public education sector, in 2012 JDL began to aggressively expand into select other verticals, including the healthcare and general commercial enterprise markets.

Education:
Since JDL Technologies was formed, its largest client has been the School Board of Broward County, Florida (SBBC), the sixth largest public school system in the United States. JDL staffs and manages the SBBC network operations center, which monitors all network elements (servers, switches, routers) and more than 60,000 computers in 265 buildings. In 2014, Broward chose JDL to install wireless networks for its schools, with wireless access points being installed in every classroom as funding becomes available. Currently, more than 5,523 access points are installed and in service,

JDL monitors Florida's public school districts for requests for proposals, and actively bids on all work for which it is qualified. As a result, JDL won bids to perform wireless infrastructure projects for Monroe County and DeSoto County Public Schools in 2014.

Healthcare:
JDL continues to aggressively pursue the $1.3 billion healthcare market in Florida, using HIPAA compliance training seminars and HIPAA-required security risk assessments to acquire clients and position for additional IT services sales, including managed services. More than 30 security risk assessments were completed in 2014, and the company will hire an additional HIPAA Security Analyst to support sales growth in 2015. Strategically, JDL is beginning to segment its training and solutions for small practices, larger providers including medical centers and regional hospitals, and suppliers (known as Business Associates in HIPAA parlance) who are also bound by HIPAA requirements. The company has a robust managed services practice in the healthcare market, with clients ranging from small single-office practices to multi-location regional specialists to medical insurance providers.

Commercial:
Among commercial enterprises, JDL Technologies continues to build a solid roster of diverse clients that include the following examples, along with incremental revenues from additional projects:

- A 60-year-old Florida financial institution with two dozen branches and more than $4 billion in assets;
- A global fitness program whose 14 million followers take weekly classes in over 100,000 locations;
- The largest private international bank in South America;
- Several of the largest construction firms in Florida; and
- A well-funded non-profit organization with 19 locations in the continental U.S.

Technology Solutions

As a managed service provider and value-added reseller, JDL Technologies specializes in delivering information technology solutions that enable organizations to focus on the mission-critical activities that drive their success. JDL's IT solutions encompass an extensive range of networking, virtualization, cloud and infrastructure services, many of which are available under ongoing JDL management to conserve client IT resources and generate monthly recurring revenues for JDL. As information technology continues to evolve, JDL is committed to retaining its position on the leading edge by ensuring its engineers are trained and certified in the newest technology solutions.

Managed Services:
JDL Technologies continues to expand its reach as a Managed Service Provider, growing its client base beyond South Florida to achieve a greater nationwide presence in just two years. The company offers a managed service program designed specifically for the healthcare market, and others for the commercial and education markets. Programs offer network management, availability assurance, event alerting and incident management; server, workstation, mobile device and other asset management; software patching and other security services; help desk support for client users; SIP trunking; migration, conversion and vendor management, as well as technical consulting services and training.

Network Services:
The JDL team has extensive experience in assessing, designing and implementing wired and wireless networks, as well as entire IT infrastructures. Networking services also include MPLS, private line and IP, network and endpoint security, network tuning and cabling/wiring services. Public school districts and healthcare offices, in particular, are actively leveraging wireless networks to simplify their communications systems, reduce their technology footprint in confined spaces, and lower maintenance costs. Wireless networking deployments will be increasingly demanded by school systems as the modernized E-Rate program enables funding for managed wireless networks, or wireless as a service, in addition to more traditional wireless projects.

Cloud Solutions:
JDL cloud services range from storage, backup and recovery to hosted PBX, hosted contact center services and hosted email services, all billable as monthly recurring revenue. Many clients are opting to move elements of their infrastructures to the cloud for the benefits of vertical and horizontal scalability, internal bandwidth conservation and other advantages. Cloud services are also attractive for simplifying IT management for staffs with limited or overtaxed IT resources.

Virtualization:
JDL's talented virtualization engineers assess, design, deploy, and manage virtualization programs that ensure client access to any workload, anytime, anywhere, on any device. Virtualization may encompass desktops, servers, applications, storage or any combination, including connectivity and software licensing. Businesses gain the advantages of economies of scale, enhanced security, and disaster recovery protections that are inherent in virtualized environments.

Order Book and Recent Orders

Outstanding customer orders and contracts for JDL products and services were approximately $3,448,000 at March 1, 2015 and $1,501,000 at March 1, 2014. The Company does not consider current outstanding orders and contracts as a significant indicator of longer term future results.

On March 9, 2015, the Company announced that JDL Technologies, Inc., had been awarded a new contract by the School Board of Broward County to provide Local Area Network, Wireless Local Area Network and data center upgrades, among other IT services, to the public K-12 schools of Broward County, Florida. The Company estimates that the contract has the potential to generate up to approximately $83 million of revenue over the next five years. Although JDL Technologies expects to begin providing services under the contact in the second quarter of calendar 2015, JDL Technologies and the School Board of Broward County have not finalized the timing of the services that will be delivered under the contract.

(2) Employment Levels

As of March 1, 2015 the Company employed 578 people. Of this number, 406 were employed by Suttle (including 115 in Hector, Minnesota, 289 in Costa Rica and 2 in the U.K.), 122 by Transition Networks, Inc. (106 in Minnetonka, MN and 16 in the U.K.), 35 by JDL Technologies, Inc., and 15 corporate general and administrative positions.

(3) Executive Officers of Registrant

The executive officers of the Company and their ages at March 1, 2015 are set forth below. See Item 9B of this Form 10-K for additional information on the Company's management.

Name	Age	Position1
Roger H.D. Lacey	64	Vice-Chairman of the Board and Chief Executive Officer [2014]2
Edwin C. Freeman	59	Vice President, Treasurer and Chief Financial Officer [2013]3
Bruce Blackwood	52	President and General Manager, Suttle, Inc. [2007]4
Scott Otis	53	President and General Manager, Transition Networks, Inc. [2013]5
Scott Fluegge	45	President and General Manager, JDL Technologies, Inc [2011]6
George Wakileh	49	Vice President of Technology Development, Suttle, Inc. [2009] 7
Kristin A. Hlavka	33	Corporate Controller [2011]8

1 Dates in brackets indicate year in which officers began serving in such capacity. Executive officers serve at the pleasure of the Board of Directors.

2 Mr. Lacey has been a director of the Company since 2008, was appointed Vice Chair in September 2013, and was appointed Interim Chief Executive Officer in June 2014. On February 27, 2015 he was appointed as the Company's Chief Executive Officer. Mr. Lacey was Senior Vice President of Strategy and Corporate Development for 3M Corporation from 2009 until his retirement in 2013. In addition, from 2000 until his retirement, he was 3M Corporation's Chief Strategy Officer and head of mergers and acquisitions.

3 Mr. Freeman was appointed Chief Financial Officer in September 2013. From March 1992 to September 2013, he held management positions within operations and finance at Bro-Tex Co., Inc, a private company that distributes non-woven materials, most recently serving as the Vice President and Chief Financial Officer. Prior to his appointment as Chief Financial Officer, he served as a director of CSI since 1988.

4 Mr. Blackwood was appointed Vice President and General Manager of Suttle in December 2007, and was named President and General Manager in September 2013. 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.

5 Mr. Otis was appointed President and General Manager of Transition Networks in September 2013. From December 2010 to June 2011 he served as Vice President, Operations - Professional Services for TE Connectivity, Inc. Prior to December 2010, he was the Vice President, Marketing and Business Development – ADC Professional Services.

6 Mr. Fluegge was appointed Vice President and General Manager of JDL Technologies in December 2011, and was named President and General Manager in September 2013. Prior to this, he was the Vice President of Workload

Automation at GSS AMERICA / GSS INFOTECH / INFOSPECTRUM CONSULTING.

7 Mr. Wakileh has been Suttle's Global Vice President of Technology and Business Development since 2009. In addition, in June 2014 he was designated as the Company's Corporate Scientist, with responsibility for developing strategy for and leading technology development throughout the Company. Mr. Wakileh has over 20 years' experience in telecommunications technology development and strategy.

8 Ms. Hlavka was appointed Corporate Controller in May 2011. From July 2008 to April 2011, she served as the Assistant Corporate Controller. Prior to July 2008, she was an auditor for Deloitte and Touche, LLP.

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(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 11 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 a "safe harbor" 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 these 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 services and the regular introduction of new products and services that meet evolving customer requirements.

Competition in the markets for voice and data communications products is intense. 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. Our JDL subsidiary also experiences intense competition from other providers of IT products and services. 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. Some of our competitors and potential competitors have greater financial, technological, manufacturing, marketing, and personnel resources than we. Present and future competitors may be able to identify new markets and develop new products that 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 we. We cannot ensure 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 and services vary and are subject to fluctuation from quarter to quarter. The factors that may affect 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;

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Obsolescence charges;

Changes in shipment volume;

Changes in component pricing;

Increased price competition;

Changes in distribution channels;

Lower margins on competitive-bid contracts;

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, resulting in the loss of some customers and reducing revenue during the pendency of business combinations and related integration activities.

We believe future consolidation may occur among our customers as they attempt to increase market share and achieve greater economies of scale. Consolidation has affected our business as our customers focus on completing business combinations and integrating their operations. In some instances, customers integrating large-scale acquisitions have reduced their purchases of our products as they integrate.

The business impact to us of significant customer mergers is likely to be unclear until sometime after these 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. We cannot ensure that we will continue to supply equipment to the surviving communications service provider after a business combination is completed.

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

A large portion of our revenues is derived from a relatively small number of customers, with our top ten customers accounting for 72%, 83% and 76% of net sales for 2014, 2013 and 2012, respectively. In fiscal 2014, 2013 and 2012, AT&T accounted for approximately 33%, 24% and 17% of our sales, respectively. Another one of our largest customers, Verizon, accounted for 6%, 8% and 8% of our net sales for the years 2014, 2013 and 2012. If we lose a significant customer for any reason, our sales and gross profit will be negatively affected.

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, short product life cycles and rapidly changing customer requirements 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. 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. Our failure to modify our products to support new alternative technologies or failure to achieve widespread customer acceptance of these modified products could cause us to lose market share and cause our revenues to decline.

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.

Some 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.

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. We cannot ensure 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. We cannot ensure 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.

Our business units are dependent upon federal government spending.

Our JDL Technologies and Transition Networks business units are involved in projects that receive much of their funding from the United States federal government. To the extent that federal government spending is delayed or curtailed by government actions, our revenues and operating results may be adversely affected.

We evaluate and frequently pursue acquisitions, but we may not successfully close these 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 product lines. We cannot, however, ensure 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, despite the effort and management attention invested.

The impact of future acquisitions on our business, operating results and financial condition is uncertain. 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 of customer orders and our ability to fulfill those orders in a timely manner;
- 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;
- the timing of revenue recognition;

the timing of new product and service introductions;

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 timing of federal and state government funding of projects;

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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 from, and subcontract much of our product manufacturing to outside firms that specialize in these 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. We cannot ensure 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 or inventory write-downs, which could adversely affect our business and results of operations.

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

We believe that our future growth depends 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. We cannot ensure 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.

Our sales and operations may continue to be impacted adversely by current global economic conditions.

Over the past several years, financial markets globally have experienced periods of extreme disruption. These have included, among other things, extreme volatility in securities prices, severely diminished liquidity and credit availability, ratings downgrades of some investments and declining valuations of others. The frequency, severity and duration of these disruptions in the financial markets and the global economy are unknown. We cannot ensure that there will not be a further deterioration in financial markets and in business conditions generally. These economic developments have adversely affected our business in a number of ways and will likely continue to adversely affect our business during the foreseeable future.

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 these 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;

limitations on business combinations with interested shareholders; and

a super majority vote by shareholders is required to approve certain corporate actions, including merger transactions.

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

CSI conducts administrative, manufacturing and engineering functions 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 some 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 109,000 square 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.

- Transition Networks leases 7,000 square feet of office space in the U.K. for its Transition Networks, EMEA operations.

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

ITEM 3. LEGAL PROCEEDINGS

The Company is subject to claims and lawsuits that have been filed in the ordinary course of business. From time to time, the Company brings suit against others to enforce contract rights or property rights, or to collect debts in the ordinary course of business. Management believes that the resolution or settlement of currently pending litigation will not have a material adverse effect on the results of operations or liquidity of the Company.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT’S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASE OF EQUITY SECURITIES

(a) MARKET INFORMATION

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

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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 2014 and 2013.

	2014		2013	
	High	Low	High	Low
First	$ 13.92	$ 10.78	$ 11.25	$ 9.75
Second	13.50	10.75	10.69	9.55
Third	13.09	10.68	12.35	9.66
Fourth	12.15	10.00	12.25	9.95

(b) HOLDERS

At March 1, 2015 there were approximately 563 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, 2015	$ .16
October 1, 2014	.16
July 1, 2014	.16
April 1, 2014	.16
January 1, 2014	.16
October 1, 2013	.16
July 1, 2013	.16
April 1, 2013	.16
December 27, 2012	.16

The Company accelerated the payment of the dividend declared in the fourth quarter of 2012 and paid the dividend on December 27, 2012 rather than January 1, 2013. 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, 2014:

Securities Authorized for Issuance Under Equity Compensation Plans

	Number of shares of common stock to be issued upon exercise of	Weighted-average	Number of shares of common stock available for future

Plan Category (1)	outstanding options, warrants and rights	exercise price of outstanding options warrants and rights	issuance under equity compensation plans (excluding shares in column (a))
Equity compensation plans approved by security holders:			
1992 Stock Plan-Employee Plan	22,008	$ 14.15	—
1992 Stock Plan-Nonemployee Director Plan	90,000	$ 10.56	—
1990 Employee Stock Purchase Plan	4,028	$ 9.45	21,483
2011 Executive Incentive Compensation Plan	628,861	$ 11.58	321,928

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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) FIVE YEAR PERFORMANCE GRAPH

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, 2009 and the reinvestment of all dividends.

Comparison of Five-Year Cumulative Total Return

Company or Index	2009	2010	2011	2012	2013	2014
Communications Systems, Inc.	$100.000	$118.455	$123.289	$96.579	$109.726	$109.165
NASDAQ US	100.000	129.261	151.943	152.417	177.459	236.879
NASDAQ TELCOM	100.000	110.924	132.294	139.737	168.433	191.004

(f) RECENT SALES OF UNREGISTERED SECURITIES

Not applicable.

(g) PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

During the three months ended December 31, 2014 the Company repurchased shares of stock as follows:

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares (or Units) Purchased (1)	Average Price Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (2)
October 2014	357	$ 10.75	—	411,910
November 2014	194	11.89	—	411,910
December 2014	—	—	—	411,910
Total	551	$ 11.15	—	411,910

(1) The shares in this column represent shares that were surrendered to us by plan participants to satisfy withholding tax obligations related to share-based compensation.

(2) Shares represent remaining amount of a 500,000 share repurchase authorization approved by the Company’s Board in October 2008 and publicly announced in November 2008.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data has been derived from our consolidated financial statements and should be read in conjunction with the Consolidated Financial Statements and related notes thereto set forth in Item 8 and with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in Item 7 of this Annual Report on Form 10-K.

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

	Year Ended December 31				
	2014	2013	2012	2011	2010
Selected Income Statement Data					
Sales	$119,071	$131,320	$104,250	$143,775	$120,072
Costs and Expenses:					
Cost of sales	76,913	86,421	62,753	84,880	68,872
Selling, general and administrative expenses	38,628	36,743	38,101	40,108	35,586
Impairment loss	—	5,850	—	1,272	—
Restructuring expense	238	1,149	—	—	—
Total Costs and Expenses	115,779	130,163	100,854	126,260	104,458
Operating Income	3,292	1,157	3,396	17,515	15,614
Other (Expense) Income, Net	(112)	(53)	2	105	20
Income Before Income Taxes	3,180	1,104	3,398	17,620	15,634
Income Tax Expense	1,219	2,061	1,160	7,822	5,919
Net Income (Loss)	$1,961	$(957)	$2,238	$9,798	$9,715
Basic Net Income (Loss) Per Share	$0.23	$(0.11)	$0.26	$1.16	$1.16
Diluted Net Income (Loss) Per Share	$0.23	$(0.11)	$0.26	$1.15	$1.15
Cash Dividends Declared Per Share	$0.64	$0.64	$0.64	$0.60	$0.59
Average Dilutive Shares Outstanding	8,640	8,531	8,519	8,496	8,415
Selected Balance Sheet Data					
Total Assets	$100,286	$103,533	$112,535	$116,659	$109,070
Property, Plant and Equipment, Net	18,153	14,941	14,475	14,019	13,214
Long-term Liabilities	1,271	1,838	3,298	3,741	5,004
Stockholders' Equity	86,020	88,622	93,995	97,531	91,397

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

Overview

Communications Systems, Inc. provides physical connectivity infrastructure products and services for global deployments of broadband networks through the following business units:

Suttle
Founded in 1910, today Suttle is a leader in innovative network solutions that meet service providers' needs from the central office all the way to the premise through OSP and premise distribution offerings for voice, data and video. Suttle's product portfolio incorporates the best available technology, leveraging existing infrastructure, and laying the foundation for future growth. Products are designed to comply with the most stringent industry standards. Quality management systems are ISO 9001 and TL9000 certified.

Suttle's best known brands include SOHO AccessTM—a full line of wiring components —and the new FutureLinkTM brand of high-speed and tool-less solutions that lower the service providers' cost of ownership. The newest MediaMAXTM brand provides optimized wired and wireless gigabit connectivity for home and small office structured distribution.

Transition Networks
With over 25 years of growth and expertise in hardware and software development, Transition Networks offers customers the ability to affordably integrate the benefits of fiber optics into any data network, in any application, and in any environment. Offering support for multiple protocols, any interface, and a multitude of hardware platforms, Transition Networks' portfolio gives customers the power to deliver and manage network traffic reliably over fiber. Based in Minneapolis, Minnesota, Transition Networks distributes hardware-based connectivity solutions exclusively through a network of resellers in over 90 countries.

JDL Technologies
JDL Technologies provides outsourced IT services and infrastructure to the education, healthcare, government and enterprise market segments. JDL's portfolio of technology solutions includes virtualization, managed services, wired and wireless network design and implementation services, and converged infrastructure configuration and deployment. JDL's largest customer has traditionally been the School Board of Broward County, Florida (SBBC). JDL runs SBBC's Network Operation Center that monitors all network elements (servers, switches, routers) and over 60,000 computers in 265 buildings for the nation's 6th largest school district.

Key 2014 Developments

The Company's 2014 sales were $119.1 million, a 9% decrease compared to 2013 sales of $131.3 million.

The Company's 2014 net income was $2.0 million, or $0.23 per diluted share, compared to a net loss of $958,000 or ($0.11) per diluted share in fiscal 2013. In 2013, the Company had a $5.8 million goodwill write-off.

At 2014 year end, the Company had cash, cash equivalents and investments of $29.9 million and positive working capital of $56.9 million.

Suttle sales increased 24% to $67.3 million in 2014 compared to $54.3 million in 2013, driven in part by an $11.6 million increase in sales of FTTx products. Suttle's operating income increased 78% to $6.6 million in 2014 from $3.7 million in 2013.

Transition Networks sales decreased 2% to $43.2 million in 2014 compared to $43.9 million in 2013.

Sales by JDL Technologies decreased 74% to $8.6 million in 2014 compared to $33.1 million in 2013. JDL's 2013 results included almost $23 million in revenues from a large infrastructure project that generated only $119,000 in revenues in 2014.

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, we may make "forward looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. We may make these 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 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. For a detailed discussion of a number of such risk factors, please see Item 1A above.

Critical Accounting Policies

Inventory Valuation: We value inventories 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 historical usage, 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: 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 it will realize these deferred assets from future taxable income. We determine the valuation allowance for deferred income tax benefits based upon the expectation of whether the benefits are more likely than not to be realized. The Company records interest and penalties related to income taxes as income tax expense in the Consolidated Statements of Income.

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 and Transition Networks 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. 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.

Results of Operations

2014 Compared to 2013

Sales were $119,071,000 in 2014, a 9% decrease from sales of $131,320,000 in 2013. Operating income increased 185% to $3,293,000 in 2014 as compared to $1,156,000 in 2013. Income before income taxes increased 188% to $3,181,000 from $1,103,000 in 2013. Net income increased 305% to $1,962,000 in 2014 compared to a net loss of $958,000 in 2013.

Suttle Results

Suttle sales increased 24% to $67,330,000 in 2014 compared to $54,346,000 in 2013. Sales by product groups in 2014 and 2013 were:

	Suttle Sales by Product Group			
	2014		2013	
Modular connecting products	$	13,015,000	$	14,077,000
DSL products		6,052,000		8,057,000
Structured cabling products		31,916,000		26,900,000
FTTx products		16,073,000		4,444,000
Other products		274,000		868,000
	$	67,330,000	$	54,346,000

Suttle's sales by customer groups in 2014 and 2013 were:

	Suttle Sales by Customer Group			
	2014		2013	
Telecommunication customers	$	56,681,000	$	43,296,000
Distributors		5,882,000		5,938,000
International		4,530,000		4,547,000
Other		237,000		565,000
	$	67,330,000	$	54,346,000

The increase in sales is due primarily to increased sales to Suttle's domestic telecommunication customers. Sales to the telephone companies increased 31% to $56,681,000 in 2014 compared to $43,296,000 in 2013 due to growth in high-speed copper connectivity products and success in securing new business in multiple FTTx domains. Sales to these customers accounted for 84% of Suttle's sales in 2014 compared to 80% of sales in 2013. Sales to distributors decreased 1% and accounted for 9% of sales in 2014 compared to 11% in 2013. International sales accounted for 7% of Suttle's 2014 sales and remained stable compared to 2013.

Sales of structured cabling products increased 19% due to increased spending by telecommunication customers. Sales of FTTx products increased 262% due to securing new business in multiple FTTx domains. Modular connecting products sales decreased 8% due to shifts in technology. Sales of DSL products decreased 25% due to the maturation of the market and increased pricing pressures.

Suttle's gross margin increased 33% to $20,992,000 in 2014 compared to $15,812,000 in 2013. The gross margin percentage increased to 31% in 2014 as compared to 29% in 2013 due to introduction of new FTTx products, focused value engineering and cost optimization efforts, and economies of scale.

Selling, general and administrative expenses increased $2,520,000, or 21% to $14,389,000, or 21.4% of sales, in 2014 compared to $11,869,000 in 2013, or 21.8% of sales, due to investment and recruitment of expertise in sales, operations, technology, product management, and engineering as well as increased expenses associated with the implementation of a new ERP system.

Suttle's operating income increased 78% to $6,603,000 in 2014 from $3,716,000 in 2013.

Transition Networks

Transition Networks develops, markets, and sells 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 the majority of its revenues from one-time network upgrade projects. The core markets for these products are enterprise, service providers, government, and industrial users. 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 decreased 2% to $43,174,000 in 2014 compared to $43,857,000 in 2013. Transition Networks organizes its sales force by vertical markets and segments its customers geographically. Sales by customer groups in 2014 and 2013 were:

	Transition Networks Sales by Region			
	2014		2013	
North America	$	31,529,000	$	30,661,000
EMEA		4,291,000		5,145,000
Rest of world		7,354,000		8,051,000
	$	43,174,000	$	43,857,000

The following table summarizes Transition Networks' 2014 and 2013 sales by product group:

	Transition Networks Sales by Product Group			
	2014		2013	
Media converters	$	28,362,000	$	28,979,000
Ethernet switches		4,727,000		4,394,000
Ethernet adapters		3,939,000		4,165,000
Other products		6,146,000		6,319,000
	$	43,174,000	$	43,857,000

Sales in North America increased 3% or $868,000 compared to 2013 due to increased sales into the Federal government channel. International sales decreased $1,551,000, or 12%, due mainly to continued sluggish economic activity in Europe.

Gross margin decreased 14% to $19,199,000 in 2014 compared to $22,419,000 in 2013. Gross margin as a percentage of sales decreased to 44% in 2014 compared to 51% in 2013 due to unfavorable product mix and competitive prices.

Selling, general and administrative expenses decreased 1% to $21,393,000, or 49.6% of sales, in 2014 from $21,581,000 in 2013, or 49.2% of sales. Operating loss decreased 51% to $2,432,000 in 2014 compared to an operating loss of $5,012,000 in 2013 due to the write off of goodwill totaling $5,850,000 in the third quarter of 2013.

Transition Networks continues to develop products based on market needs as well as by following industry standards set by such organizations as the Institute of Electrical and Electronics Engineers (IEEE) and the Metro Ethernet Forum (MEF). It also continues 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. decreased 74% to $8,567,000 in 2014 compared to $33,116,000 in 2013. The following table summarizes JDL's revenues by customer group in 2014 and 2013:

	JDL Revenue by Customer Group			
	2014		2013	
Broward County FL schools	$	6,504,000	$	7,928,000
Miami Dade County FL schools		119,000		22,988,000

All other	1,944,000	2,200,000
	$ 8,567,000	$ 33,116,000

Revenues earned in Broward County FL decreased $1,424,000 or 18% in 2014 due to the Federal government's decision to withhold all priority two E-Rate funding for the current fiscal year, which required the district to find alternate funding sources for planned projects. Revenues earned in Miami Dade County in 2013 and 2014 were derived from a large E-Rate funded infrastructure project. This was completed in the first quarter of 2014. Revenue from JDL Technologies' sales to small and medium sized commercial businesses (SMBs) decreased by 12% or $256,000 as there were fewer large infrastructure transactions completed during the year due to a combination of market trends and JDL's ongoing emphasis on higher margin managed services growth.

JDL gross margin decreased 70% to $1,968,000 in 2014 compared to $6,668,000 in 2013. Gross margin as a percentage of sales increased to 23% in 2014 from 20% in 2013 reflecting the fact that a significant portion of its 2013 revenue was hardware-based, rather than its more traditional value-added service.

Selling, general and administrative expenses decreased 14% in 2014 to $2,846,000, or 33.2% of sales, compared to $3,292,000 in 2013, or 9.9% of sales, due to a decrease in internal costs associated with the higher revenue achieved in the previous year's E-Rate driven business. Selling, general and administrative expenses as a percentage of sales were much higher in the 2014 period as JDL's non-variable general and administrative expenses constituted a much higher percentage of the lower 2014 sales. JDL reported an operating loss of $878,000 in 2014 compared to operating income of $3,376,000 in 2013.

Because federal and local funding for investments in IT infrastructure and services for K-12 public schools varies substantially from year to year, JDL Technologies has experienced notable swings in quarterly and annual revenues. This revenue volatility is expected to continue in future years. On a positive note, the modernized E-Rate program announced for 2015 and beyond extends funding to managed IT services, including wireless as a service, which JDL Technologies is well-positioned to leverage. JDL Technologies anticipates that 2015 E-Rate funding will be available toward the end of 2015, although, based on previous funding experience, JDL may not earn any related revenue until early 2016.

On March 9, 2015, the Company announced that its JDL subsidiary has been awarded a network services contract for the public K-12 schools of Broward County Florida. JDL will be paid for its services from several sources, including proceeds from Broward County bond issuance that was approved in November 2014 and payments from the federal government under the E-Rate program. Although JDL Technologies expects to begin providing services under the contact in the second quarter of calendar 2015, JDL Technologies and the School Board of Broward County have not finalized the timing of the services that will be delivered under the contract.

To reduce dependence on government funding and its characteristic volatility, JDL Technologies continues to aggressively pursue opportunities to provide managed services, migration to the cloud, virtualization, HIPAA-compliant IT services, and other network and infrastructure services to SMBs with a focus on the healthcare, legal and financial services, and logistics markets. As part of this initiative, JDL Technologies has adopted HIPAA standards that enable JDL to serve healthcare providers as a HIPAA-compliant Business Associate, which constitutes an important competitive advantage.

Other

Income before income taxes increased 188% to $3,181,000 in 2014 compared to $1,103,000 in 2013. The Company's effective income tax rate was 38% in 2014 compared to 187% in 2013. The 2014 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, and the effect of operations conducted in lower foreign tax rate jurisdictions, as explained in Note 10 to the consolidated financial statements. The 2013 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, provisions for interest charges for uncertain income tax positions, the effect of operations conducted in lower foreign tax rate jurisdictions, and the goodwill impairment not deductible for income tax purposes.

2013 Compared to 2012

Sales were $131,320,000 in 2013, a 26% increase from sales of $104,250,000 in 2012. Operating income decreased 66% to $1,156,000 in 2013 as compared to $3,396,000 in 2012. Income before income taxes decreased 68% to $1,103,000 from $3,398,000 in 2012. Net income decreased 143% to a net loss of $958,000 in 2013 compared to income of $2,238,000 in 2012.

Suttle

Suttle sales increased 21% to $54,346,000 in 2013 compared to $45,030,000 in 2012. Sales by product groups in 2013 and 2012 were:

	Suttle Sales by Product Group	
	2013	2012
Modular connecting products	$ 14,077,000	$ 13,428,000
DSL products	8,057,000	8,254,000
Structured cabling products	26,900,000	18,081,000
FTTx products	4,444,000	
Other products	868,000	5,267,000
	$ 54,346,000	$ 45,030,000

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Suttle's sales by customer groups in 2013 and 2012 were:

	Suttle Sales by Customer Group			
	2013		2012	
Telecommunication customers	$	43,296,000	$	33,645,000
Distributors		5,938,000		5,540,000
International		4,547,000		5,394,000
Other		565,000		451,000
	$	54,346,000	$	45,030,000

The increase in sales is due primarily to increased sales to Suttle's domestic telecommunication customers. Sales to these customers increased 29% to $43,296,000 in 2013 compared to $33,645,000 in 2012 due to fulfillment of new contracts for recently introduced Suttle products and increased sales tied to enhanced network deployments by telecommunication service providers. Sales to these customers accounted for 80% of Suttle's sales in 2013 compared to 75% of sales in 2012. Sales to distributors increased 7% and accounted for 11% of sales in 2013 compared to 12% in 2012. The increase in this customer group is a result of increased opportunities in the domestic market for new single family unit (SFU) and multi-dwelling unit (MDU) construction. International sales accounted for 8% of Suttle's 2013 sales, but declined 16% compared to 2012. The decrease in sales in this customer group is due to a reduction in revenue from Austin Taylor's legacy products, including the termination of a non-profitable OEM contract.

Modular connecting products sales increased 5% due to an increase in new MDU construction in the U.S. housing market and an increase in sales tied to enhanced network deployments. Sales of structured cabling products increased 49% due to increased MDU construction activity in the U.S housing market and an increase in sales tied to enhanced network deployments. Sales of DSL products decreased 2% due to the maturation of the market and increased pricing pressures.

Suttle's gross margin increased 32% to $15,812,000 in 2013 compared to $11,974,000 in 2012. The gross margin percentage increased to 29% in 2013 compared to 27% in 2012 due to product mix changes and increased production levels.

Selling, general and administrative expenses increased $964,000, or 9% to $11,869,000 in 2013 compared to $10,905,000 in 2012 due to continued investment into new product development and market expansion initiatives.

Suttle's operating income increased 248% to $3,716,000 in 2013 from $1,068,000 in 2012.

Transition Networks

Transition Networks sales decreased 19% to $43,857,000 in 2013 compared to $53,843,000 in 2012. Transition Networks organizes its sales force by vertical markets and segments its customers geographically. Sales by customer groups in 2013 and 2012 were:

	Transition Networks Sales by Region			
	2013		2012	
North America	$	30,661,000	$	39,386,000
EMEA		5,145,000		5,744,000
Rest of world		8,051,000		8,713,000
	$	43,857,000	$	53,843,000

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The following table summarizes Transition Networks' 2013 and 2012 sales by product group:

	Transition Networks Sales by Product Group			
	2013		2012	
Media converters	$	28,979,000	$	35,817,000
Ethernet switches		4,394,000		4,738,000
Ethernet adapters		4,165,000		4,948,000
Other products		6,319,000		8,340,000
	$	43,857,000	$	53,843,000

Sales in North America decreased 22% in 2013, or $8,725,000 compared to 2012 due to declines in Federal government spending and delays in certain programs. International sales decreased $1,261,000, or 9%, due to currency fluctuations, project timing and continuing economic problems in certain countries.

Gross margin decreased 20% to $22,419,000 in 2013 compared to $27,995,000 in 2012. Gross margin as a percentage of sales decreased to 51% in 2013 compared to 52% in 2012 due to unfavorable product mix.

Selling, general and administrative expenses decreased 12% to $21,581,000 in 2013 from $24,645,000 in 2012 due to corporate restructuring and cost reduction measures taken throughout the year. Due to the goodwill write-off totaling $5,850,000 in the third quarter of 2013, operating income decreased 250% to an operating loss of $5,012,000 in 2013 compared to operating income of $3,350,000 in 2012.

JDL Technologies, Inc.

Sales by JDL Technologies, Inc. (the Company's IT services business unit) increased 516% to $33,116,000 in 2013 compared to $5,377,000 in 2012. The following table summarizes JDL's revenues by customer group in 2013 and 2012:

	JDL Revenue by Customer Group			
	2013		2012	
Broward County FL schools	$	7,928,000	$	3,265,000
Miami Dade County FL schools		22,988,000		825,000
All other		2,200,000		1,287,000
	$	33,116,000	$	5,377,000

Revenues earned in Broward County FL increased $4,663,000 or 143% in 2013 due to the E-Rate 15 initiative, which was significantly larger than the prior year's initiative. Revenues earned in Miami Dade County are related to the district's "Bringing Wireless to the Classroom" initiative for which the district was granted federal funding under the E-Rate program to expand wireless connectivity for students and staff. All other revenues increased $913,000 due to JDL's concentrated effort to grow its revenues from small to medium sized businesses.

JDL gross margin increased 336% to $6,668,000 in 2013 compared to $1,529,000 in 2012. Gross margin as a percentage of sales decreased to 20% in 2013 from 28% in 2012 reflecting the fact that a significant portion of its 2013 revenue was hardware-based, rather than JDL's more traditional value-added service.

Selling, general and administrative expenses increased 29% in 2013 to $3,292,000 compared to $2,550,000 in 2012 due to the year over year growth of the sales and administration teams required to manage JDL's continued expansion in both education and commercial markets. JDL reported operating income of $3,376,000 in 2013 compared to an operating loss of $1,022,000 in 2012.

Other

Income before income taxes decreased 68% to $1,103,000 in 2013 compared to $3,398,000 in 2012. The Company's effective income tax rate was 187% in 2013 compared to 34% in 2012. The 2013 effective rate was significantly higher than the standard rate of 35% primarily because the Company incurred a $5.8 million goodwill impairment charge in 2013, the majority of which was not deductible for income tax purposes. Other factors affecting the effective income tax rate include state income taxes, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges for uncertain income tax positions, and the effect of operations conducted in lower foreign tax rate jurisdictions. The 2012 effective rate was lower than the standard rate of 35% due to state income taxes, the release of valuation allowance placed on foreign net operating losses, and the effect of operations conducted in lower foreign tax rate jurisdictions.

Acquisitions and Dispositions

The Company is a growth-oriented manufacturer of telecommunications connecting and networking devices. The Company continually searches for acquisition candidates with products that will enable the Company to better serve its target markets.

Effects of Inflation

Inflation has not had a significant effect on operations in recent years. The Company does not have long-term production or procurement contracts and has historically been able to adjust pricing and purchasing decisions to respond to inflationary pressures.

Liquidity and Capital Resources

As of December 31, 2014, the Company had approximately $29,880,000 in cash, cash equivalents and investments. Of this amount, $1,073,000 was invested in short-term money market funds that are not considered to be bank deposits and are not insured or guaranteed by the 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 in cash and cash equivalents is operating cash and certificates of deposit, which are fully insured through the FDIC. The Company also had $16,143,000 in investments consisting of certificates of deposit and corporate notes and bonds that are traded on the open market and are classified as available-for-sale at December 31, 2014.

The Company had working capital of $56,911,000, consisting of current assets of approximately $69,906,000 and current liabilities of $12,995,000 at December 31, 2014 compared to working capital of $70,599,000, consisting of current assets of $83,672,000 and current liabilities of $13,073,000 at the end of 2013. The Company's working capital at December 31, 2014 decreased from the prior year-end as the Company increased its ownership of long-term investments to $11,540,000 from $3,921,000.

Cash flow provided by operating activities was approximately $12,172,000 in 2014 compared to $773,000 provided by operations in 2013. Significant working capital changes from 2013 to 2014 included a decrease in receivables of $9,057,000 due to the collection of outstanding receivables by JDL Technologies related to the Miami Dade project primarily completed in 2013 and an increase in Suttle-related inventory and related accounts payable.

Cash provided by investing activities was $12,048,000 of cash in 2014 compared to cash used of $5,775,000 in 2013. The Company continued to make capital investments and purchases of certificates of deposit and other marketable securities, moving more of its capital into longer term investments.

Net cash used by financing activities was $6,301,000 in 2014 compared to $4,390,000 in 2013. The Company made $566,000 in contingent consideration payments related to the Patapsco acquisition in 2011. There are no future contingent consideration payments related to this acquisition. Cash dividends paid on common stock increased to $5,572,000 in 2014 ($0.64 per common share) from $4,099,000 in 2013 ($0.48 per common share) due to an accelerated payment of the dividend declared and paid in December 2012. Proceeds from common stock issuances, principally shares sold to the Company's Employee Stock Ownership Plan and under the Company's Employee Stock Purchase Plan, totaled approximately $246,000 in 2014 and $311,000 in 2013, net of acquisitions of Company stock from employees in order to satisfy withholding tax obligations related to share-based compensation, pursuant to terms of Board and shareholder-approved compensation plans. The Company did not repurchase any shares in 2014 or 2013 under the Board authorized program. At December 31, 2014, Board of Director authority to purchase approximately 411,910 additional shares remained in effect.

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 $490,000 during 2014. The outstanding balance on the mortgage was $628,000 at December 31, 2014.

The Company expects that the effective income tax rate for fiscal 2015 will be approximately 33%.

The Company had no outstanding obligations under its line of credit at December 31, 2014 and 2013, and the Company's entire credit line ($10,000,000 at March 1, 2015) is available for use. Interest on borrowings on the credit line is at LIBOR plus 1.1% (1.4% at December 31, 2014). There were no borrowings on the line of credit during 2014 or 2013. The credit agreement expires October 31, 2016 and is secured by assets of the Company. 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.

Contractual Obligation Summary

The following table summarizes our contractual obligations at December 31, 2014 and the effect these obligations are expected to have on our liquidity and cash flow in future periods:

	Less than One Year	1 – 3 Years	3 – 5 Years	More Than 5 Years
Long-term debt	$524,000	$104,000	$—	$—
Interest on long-term debt	27,000	1,000	—	—
Pensions	268,000	262,000	284,000	801,000
Operating leases	290,000	86,000	—	
Total	$1,109,000	$453,000	$284,000	$801,000

As of December 31, 2014, the Company had no other material commitments (either cancelable or non-cancelable) for capital expenditures, short or long term debt, capital leases or other purchase commitments related to ongoing operations.

New Accounting Pronouncements

See Note 1 of the "Notes to the Consolidated Financial Statements" under Item 8 herein for a discussion of new accounting standards.

Off Balance Sheet Arrangements

None.

ITEM 7A. 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 December 31, 2014 our bank line of credit carried a LIBOR rate plus 1.1%. The Company's investments are money market, certificates of deposit, commercial paper, and corporate notes and bonds types of investments that earn interest at prevailing market rates and as such do not have material risk exposure.

Based on the Company's operations, in the opinion of management, the Company is not exposed to material future losses due to market risk.

The Company uses the U.S. dollar as its functional currency in Costa Rica and China. Accordingly, the Company believes its risk of material loss due to fluctuations in foreign currency markets to be small.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

(a) FINANCIAL STATEMENTS

REPORT OF MANAGEMENT

The management of Communications Systems, Inc. and its subsidiary companies is responsible for the integrity and objectivity of the financial statements and other financial information contained in the annual report. The financial statements and related information were prepared in accordance with accounting principles generally accepted in the United States of America and include amounts that are based on management's informed judgments and estimates.

In fulfilling its responsibilities for the integrity of financial information, management maintains accounting systems and related controls. These controls provide reasonable assurance, at appropriate costs, that assets are safeguarded against losses and that financial records are reliable for use in preparing financial statements. Management recognizes its responsibility for conducting the Company's affairs according to the highest standards of personal and corporate conduct.

The Audit Committee of the Board of Directors, comprised solely of outside directors, meets with the independent auditors and management periodically to review accounting, auditing, financial reporting and internal control matters. The independent auditors have free access to this committee, without management present, to discuss the results of their audit work and their opinion on the adequacy of internal financial controls and the quality of financial reporting.

/s/ Roger H.D. Lacey
Roger H.D. Lacey
Chief Executive Officer

/s/ Edwin C. Freeman
Edwin C. Freeman
Chief Financial Officer

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Communications Systems, Inc.:

We have audited the accompanying consolidated balance sheets of Communications Systems, Inc., and subsidiaries (the “Company”) as of December 31, 2014 and 2013, and the related consolidated statements of income (loss) and comprehensive income (loss), changes in stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 2014. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Communications Systems, Inc. and subsidiaries at December 31, 2014 and 2013, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company’s internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control-Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 12, 2015 expressed an unqualified opinion on the Company’s internal control over financial reporting.

/s/ Deloitte & Touche LLP
Minneapolis, Minnesota
March 12, 2015

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Communications Systems, Inc.:

We have audited the internal control over financial reporting of Communications Systems, Inc., and subsidiaries (the "Company") as of December 31, 2014, based on criteria established in Internal Control — Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on the criteria established in Internal Control — Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2014, of the Company, and our report dated March 12, 2015, expressed an unqualified opinion on those financial statements and financial statement schedule.

/s/ Deloitte & Touche LLP
Minneapolis, Minnesota
March 12, 2015

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31 2014	December 31 2013
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$13,736,857	$20,059,120
Investments	4,602,717	5,742,314
Trade accounts receivable, less allowance for doubtful accounts of $22,000 and $69,000, respectively	13,839,662	22,902,323
Inventories	31,109,653	29,111,656
Prepaid income taxes	2,317,688	1,381,502
Other current assets	1,050,000	716,784
Deferred income taxes	3,249,164	3,758,750
TOTAL CURRENT ASSETS	69,905,741	83,672,449
PROPERTY, PLANT AND EQUIPMENT, net	18,153,152	14,941,492
OTHER ASSETS:		
Investments	11,540,261	3,920,978
Funded pension assets	172,405	305,028
Other assets	514,676	692,794
TOTAL OTHER ASSETS	12,227,342	4,918,800
TOTAL ASSETS	$100,286,235	$103,532,741
LIABILITIES AND STOCKHOLDERS’ EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	$524,220	$489,706
Accounts payable	5,180,631	4,894,869
Accrued compensation and benefits	3,696,930	3,927,728
Accrued consideration	—	558,801
Other accrued liabilities	2,146,582	1,765,428
Dividends payable	1,446,498	1,436,318
TOTAL CURRENT LIABILITIES	12,994,861	13,072,850
LONG TERM LIABILITIES:		
Uncertain tax positions	77,279	400,846
Deferred income taxes	1,089,994	809,179
Long-term debt - mortgage payable	103,603	627,823
TOTAL LONG-TERM LIABILITIES	1,270,876	1,837,848
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; 8,654,756 and 8,553,320 shares issued and outstanding, respectively	432,738	427,666

Additional paid-in capital	38,593,230	37,110,671
Retained earnings	47,689,688	51,323,718
Accumulated other comprehensive loss	(695,158)	(240,012)
TOTAL STOCKHOLDERS' EQUITY	86,020,498	88,622,043
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$100,286,235	$103,532,741

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

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

	Year Ended December 31		
	2014	2013	2012
Sales	$119,071,439	$131,319,510	$104,249,654
Costs and expenses:			
Cost of sales	76,912,881	86,420,982	62,752,763
Selling, general and administrative expenses	38,627,801	36,742,869	38,100,773
Impairment loss	—	5,849,853	—
Restructuring expense	237,838	1,149,439	—
Total costs and expenses	115,778,520	130,163,143	100,853,536
Operating income	3,292,919	1,156,367	3,396,118
Other income and (expenses):			
Investment and other income	80,392	125,985	75,187
(Loss)/gain on sale of assets	(112,242)	(73,126)	62,630
Interest and other expense	(79,841)	(106,101)	(136,255)
Other (expense) income, net	(111,691)	(53,242)	1,562
Income from operations before income taxes	3,181,228	1,103,125	3,397,680
Income tax expense	1,219,355	2,061,013	1,159,566
Net income (loss)	1,961,873	(957,888)	2,238,114
Other comprehensive (loss) income, net of tax:			
Additional minimum pension liability adjustments	155,000	37,000	1,311,000
Unrealized (losses)/gains on available-for-sale securities	(42,666)	(21,964)	26,223
Foreign currency translation adjustment	(567,480)	333,000	(2,032,877)
Total other comprehensive (loss) income	(455,146)	348,036	(695,654)
Comprehensive income (loss)	$1,506,727	$(609,852)	$1,542,460
Basic net income (loss) per share:	$0.23	$(.11)	$.26
Diluted net income (loss) per share:	$0.23	$(.11)	$.26
Weighted Average Basic Shares Outstanding	8,622,032	8,531,073	8,508,497
Weighted Average Dilutive Shares Outstanding	8,640,416	8,531,073	8,518,613

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

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
BALANCE AT DECEMBER 31, 2011	8,466,774	$423,339	$35,533,273	$61,466,342	$ 107,606	$97,530,560
Net income				2,238,114		2,238,114
Issuance of common stock under Employee Stock Purchase Plan	13,849	692	171,078			171,770
Issuance of common stock to Employee Stock Ownership Plan	36,145	1,807	506,391			508,198
Issuance of common stock under Employee Stock Option Plan	12,000	600	84,983			85,583
Issuance of common stock under Executive Stock Plan	16,156	808	39,503			40,311
Tax benefit from non-qualified employee stock options			67,835			67,835
Share based compensation			302,964			302,964
Purchase of common stock	(70,028)	(3,501)	(301,509)	(452,941)		(757,951)
Shareholder dividends ($0.64 per share)				(5,496,336)		(5,496,336)
Other comprehensive loss					(695,654)	(695,654)
BALANCE AT DECEMBER 31, 2012	8,474,896	423,745	36,404,518	57,755,178	(588,048)	93,995,393
Net loss				(957,888)		(957,888)
Issuance of common stock under Employee Stock Purchase Plan	16,977	849	172,354			173,203
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	1,849	92	27,312			27,404
Tax benefit from non-qualified stock options			16,284			16,284
Share based compensation			(80,886)			(80,886)

Shareholder dividends ($0.64 per share)				(5,473,572)		(5,473,572)
Other comprehensive income					348,036	348,036
BALANCE AT DECEMBER 31, 2013	8,553,320	427,666	37,110,671	51,323,718	(240,012)	88,622,043
Net income				1,961,873		1,961,873
Issuance of common stock under Employee Stock Purchase Plan	14,104	705	166,637			167,342
Issuance of common stock to Employee Stock Ownership Plan	32,520	1,626	360,647			362,273
Issuance of common stock under Non-Employee Stock Option Plan	12,000	600	98,760			99,360
Issuance of common stock under Executive Stock Plan	44,769	2,239	0			2,239
Tax benefit from non-qualified stock options			80,402			80,402
Share based compensation			784,785			784,785
Other share retirements	(1,957)	(98)	(8,672)	(14,052)		(22,822)
Shareholder dividends ($0.64 per share)				(5,581,851)		(5,581,851)
Other comprehensive loss					(455,146)	(455,146)
BALANCE AT DECEMBER 31, 2014	8,654,756	432,738	38,593,230	47,689,688	(695,158)	86,020,498

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

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31		
	2014	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	$1,961,873	$(957,888)	$2,238,114
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,482,300	2,184,830	2,133,511
Share based compensation	784,785	(80,886)	302,964
Deferred taxes	790,402	(317,727)	(631,626)
Impairment loss	—	5,849,853	—
Change in fair value of acquisition-related contingent consideration	—	(43,898)	85,501
Loss/(gain) on sale of assets	112,242	73,126	(62,630)
Excess tax benefit from share based payments	(80,402)	(16,284)	(67,835)
Changes in assets and liabilities:			
Trade receivables	9,057,078	(8,207,253)	(189,775)
Inventories	(2,039,599)	4,647,916	(7,705,772)
Prepaid income taxes	(936,186)	732,618	1,776,601
Other assets	(282,456)	89,533	252,378
Accounts payable	105,602	(4,342,626)	4,819,481
Accrued compensation and benefits	139,698	994,012	(2,250,647)
Other accrued liabilities	405,424	71,293	(680,171)
Income taxes payable	(243,165)	96,704	(15,168)
Other	(85,519)	—	195,244
Net cash provided by operating activities	12,172,077	773,323	200,170
CASH FLOWS FROM INVESTING ACTIVITIES:			
Capital expenditures	(5,577,039)	(2,699,347)	(2,607,958)
Purchases of investments	(12,682,351)	(4,401,321)	(15,010,778)
Proceeds from the sale of fixed assets	51,073	82,078	198,109
Proceeds from the sale of investments	6,160,000	12,794,000	20,456,039
Net cash (used in) provided by investing activities	(12,048,317)	5,775,410	3,035,412
CASH FLOWS FROM FINANCING ACTIVITIES:			
Cash dividends paid	(5,571,672)	(4,099,087)	(6,734,466)
Mortgage principal payments	(489,706)	(457,464)	(427,345)
Proceeds from issuance of common stock, net of shares withheld	246,119	310,857	297,664
Excess tax benefit from stock based payments	80,402	16,284	67,835
Payment of contingent consideration related to acquisition	(565,647)	(161,060)	(370,096)
Purchase of common stock	—	—	(757,951)
Net cash used in financing activities	(6,300,504)	(4,390,470)	(7,924,359)
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	(145,519)	31,145	42,779
	(6,322,263)	2,189,408	(4,645,998)

NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS			
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	20,059,120	17,869,712	22,515,710
CASH AND CASH EQUIVALENTS AT END OF YEAR	$13,736,857	$20,059,120	$17,869,712
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Income taxes paid	$1,591,257	$1,556,590	$87,343
Interest paid	73,860	106,101	138,477
Dividends declared not paid	1,446,498	1,436,318	—
Capital expenditures in accounts payable	188,564	—	—

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

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2014, 2013 and 2012

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of business: Communications Systems, Inc. (herein collectively called “CSI,” “our” or the “Company”) is a Minnesota corporation organized in 1969 that operates directly and through its subsidiaries located in the United States, Costa Rica, and the United Kingdom. CSI is principally engaged through its Suttle business unit 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 business unit IT solutions including network design, computer infrastructure installations, IT service management, change management, network security and network operations services.

The Company classifies its businesses into three segments: Suttle, which manufactures U.S. standard modular connecting and wiring devices for voice and data communications; Transition Networks, which designs and markets media conversion products, ethernet switches, and other connectivity and data transmission products; and JDL Technologies, (JDL), which provides IT services. Effective January 1, 2014, the Company realigned the financial reporting for its business units. As a result of this realignment, all corporate general and administrative expenses that were previously categorized as “Other” are now included within the three business units as fully allocated costs. There are no material intersegment revenues.

Principles of consolidation: The consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany transactions and accounts have been eliminated.

Use of estimates: The presentation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company uses estimates based on the best information available in recording transactions and balances resulting from operations. Actual results could differ from those estimates. The Company’s estimates consist principally of reserves for doubtful accounts, sales returns, warranty costs, asset impairment evaluations, accruals for compensation plans, self-insured medical and dental accruals, pension liabilities, lower of cost or market inventory adjustments, provisions for income taxes and deferred taxes and depreciable lives of fixed assets.

Cash equivalents: For purposes of the consolidated statements of cash flows, the Company considers all highly liquid investments with a maturity of three months or less at the time of purchase to be cash equivalents. As of December 31, 2014, the Company had $13,737,000 in cash and cash equivalents. Of this amount, $1,073,000 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 company (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 is operating cash and certificates of deposit which are fully insured through the FDIC.

Investments: Investments consist of certificates of deposit, commercial paper, and corporate notes and bonds that are traded on the open market and are classified as available-for-sale at December 31, 2014. Available-for-sale investments are reported at fair value with unrealized gains and losses excluded from operations and reported as a separate component of stockholders’ equity, net of tax (see Accumulated other comprehensive loss below).

Inventories: Inventories are stated at the lower of cost or market. Cost is determined by the first-in, first-out method. Provision to reduce inventories to the lower of cost or market is made based on a review of excess and obsolete inventories, estimates of future sales, examination of historical consumption rates and the related value of component parts.

Property, plant and equipment: Property, plant and equipment are recorded at cost. Depreciation is computed using the straight-line method. Depreciation included in cost of sales and selling, general and administrative expenses for continuing operations was $2,375,000, $2,030,000 and $2,058,000 for 2014, 2013 and 2012, respectively. Maintenance and repairs are charged to operations and additions or improvements are capitalized. Items of property sold, retired or otherwise disposed of are removed from the asset and accumulated depreciation accounts and any gains or losses on disposal are reflected in operations.

Intangible Assets: Intangible assets with indefinite useful lives are not amortized, but are tested at least annually for impairment.

Recoverability of long-lived assets: The Company reviews its long-lived assets periodically when impairment indicators exist as required under generally accepted accounting principles. Potential impairment is determined by comparing the carrying value of the assets with expected net cash flows expected to be provided by operating activities of the business or related products. If the sum of the expected future net cash flows is less than the carrying value, an impairment loss would be measured by comparing the amount by which the carrying value exceeds the fair value of the asset.

Warranty: The Company 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 following table presents the changes in the Company's warranty liability for the years ended December 31, 2014 and 2013, which relate to normal product warranties and a five-year obligation to provide for potential future liabilities for certain network equipment sales:

	Year Ended December 31	
	2014	2013
Beginning balance	$ 564,000	$ 590,000
Amounts charged to expense	(14,000)	237,000
Actual warranty costs paid	(116,000)	(263,000)
Ending balance	$ 434,000	$ 564,000

Accumulated other comprehensive loss: The components of accumulated other comprehensive loss are as follows:

	December 31	
	2014	2013
Minimum pension liability	$ 1,951,000	$ 1,796,000
Unrealized (loss) gain on available-for-sale investments	(41,000)	2,000
Foreign currency translation	(2,605,000)	(2,038,000)
	$ (695,000)	$ (240,000)

The functional currency of Austin Taylor and Patapsco is the British pound. Assets and liabilities denominated in this foreign currency were translated into U.S. dollars at year-end exchange rates. Revenue and expense transactions were translated using average exchange rates. Suttle Costa Rica and Transition China use the U.S. dollar as their functional currency.

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 such 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.

Research and development: Research and development costs consist of outside testing services, equipment and supplies associated with enhancing existing products and developing new products. Research and development costs are expensed when incurred and totaled $7,835,000 in 2014, $2,760,000 in 2013 and $2,304,000 in 2012.

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 adjusts for the dilutive effect of potential common shares outstanding. The Company's only potential common shares outstanding are stock options and unvested shares, which resulted in a dilutive effect of 18,384 shares, 0 shares and 10,116 shares in 2014, 2013 and 2012, respectively. The Company calculates the dilutive effect of outstanding options and unvested shares using the treasury stock method. The number of shares not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of common stock during the year for 2014, 2013, and 2012 was 243,427, 0 and 80,290, respectively. Due to the net loss in 2013, there was no dilutive impact from outstanding stock options or unvested shares.

Share based compensation: The Company accounts for share based compensation awards on a fair value basis. The estimated grant date fair value of each stock-based award is recognized in income over the requisite service period (generally the vesting period). The estimated fair value of each option is calculated using the Black-Scholes option-pricing model.

Accounting standards issued:
In May 2014, the Financial Accounting Standards Board (FASB) issued a new accounting standard update on revenue recognition from contracts with customers. The new guidance will replace all current U.S. GAAP guidance on this topic and eliminate all industry-specific guidance. According to the new guidance, revenue is recognized when promised goods or services are transferred to customers in an amount that reflects the consideration the Company expects to receive in exchange for those goods or services. This guidance will be effective for the Company beginning January 1, 2017 and can be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption. Early adoption is not permitted. The Company has not yet selected a transition method and is evaluating the impact of adopting this new accounting standard update on the financial statements and related disclosures.

In January 2015, the FASB issued guidance that eliminates from GAAP the concept of an extraordinary item. As a result, an entity will no longer (1) segregate an extraordinary item from the results of ordinary operations; (2) separately present an extraordinary item on its income statement, net of tax, after income from continuing operations; and (3) disclose income taxes and earnings-per-share data applicable to an extraordinary item. The new guidance will be effective for us in our first quarter of 2016 and early adoption is permitted. We do not expect the adoption of this standard to have a material effect on our reporting and disclosure.

Accounting standards adopted:
There have been no new accounting pronouncements or changes in accounting pronouncements adopted during the period that are of significance or potential significance to the Company.

NOTE 2 –CASH EQUIVALENTS AND INVESTMENTS

The following tables show the Company's cash equivalents and available-for-sale securities' amortized cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category recorded as cash equivalents or short and long term investments as of December 31, 2014 and December 31, 2013:

December 31, 2014

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash Equivalents	Short-Term Investments	Long-Term Investments
Cash equivalents:							
Money Market funds	$1,073,000	$—	$—	$1,073,000	$1,073,000	$	$
Subtotal	1,073,000	—	—	1,073,000	1,073,000	—	—
Investments:							
Certificates of deposit	7,414,000	1,000	(32,000)	7,383,000	—	1,920,000	5,463,000
Corporate Notes/Bonds	8,777,000	6,000	(23,000)	8,760,000	—	2,683,000	6,077,000
Subtotal	16,191,000	7,000	(55,000)	16,143,000	—	4,603,000	11,540,000
Total	$17,264,000	$7,000	$(55,000)	$17,216,000	$1,073,000	$4,603,000	$11,540,000

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December 31, 2013

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash Equivalents	Short-Term Investments	Long-Term Investments
Cash equivalents:							
Money Market funds	$5,752,000	$—	$—	$5,752,000	$5,752,000	$	$
Subtotal	5,752,000	—	—	5,752,000	5,752,000	—	—
Investments:							
Certificates of deposit	4,024,000	1,000	(5,000)				