

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

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended **March 31, 2013**

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-31588

**COMMUNICATIONS SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

MINNESOTA  
(State or other jurisdiction of  
incorporation or organization)

41-0957999  
(Federal Employer  
Identification No.)

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

55343  
(Zip Code)

(952) 996-1674

Registrant's telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x 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

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the registrant was required to submit and post such files). YES x NO o

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

| Class                                      | Name of Exchange<br>On Which Registered | Outstanding at May 1, 2013 |
|--|---|----------------------------|
| Common Stock, par value<br>\$.05 per share | NASDAQ                                  | 8,529,037                  |

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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

|  | March 31<br>2013      | December 31<br>2012 |
|--|-----------------------|---------------------|
| <b>ASSETS</b>  |                       |                     |
| <b>CURRENT ASSETS:</b>   |                       |                     |
| Cash and cash equivalents  | \$ 10,824,540         | \$ 17,869,712       |
| Investments  | 10,679,437            | 12,701,538          |
| Trade accounts receivable, less allowance for doubtful accounts of \$55,000 and \$69,000, respectively | 18,358,611            | 14,683,227          |
| Inventories  | 36,980,325            | 33,752,710          |
| Prepaid income taxes   | 2,015,128             | 2,113,926           |
| Other current assets   | 922,561               | 783,352             |
| Deferred income taxes  | 4,144,404             | 4,013,628           |
| <b>TOTAL CURRENT ASSETS</b>  | <b>83,925,006</b>     | <b>85,918,093</b>   |
| <b>PROPERTY, PLANT AND EQUIPMENT, net</b>  | <b>14,403,000</b>     | <b>14,474,913</b>   |
| <b>OTHER ASSETS:</b>   |                       |                     |
| Investments  | 6,203,992             | 5,376,397           |
| Goodwill   | 5,797,671             | 5,956,934           |
| Other assets   | 739,931               | 808,308             |
| <b>TOTAL OTHER ASSETS</b>  | <b>12,741,594</b>     | <b>12,141,639</b>   |
| <b>TOTAL ASSETS</b>  | <b>\$ 111,069,600</b> | <b>112,534,645</b>  |

**LIABILITIES AND STOCKHOLDERS EQUITY**

|                                    |                   |                   |
|------------------------------------|-------------------|-------------------|
| <b>CURRENT LIABILITIES:</b>        |                   |                   |
| Current portion of long-term debt  | \$ 465,320        | \$ 457,464        |
| Accounts payable                   | 7,990,304         | 9,237,233         |
| Accrued compensation and benefits  | 2,536,366         | 3,044,864         |
| Accrued consideration              | 581,750           | 770,041           |
| Other accrued liabilities          | 1,955,024         | 1,670,009         |
| Dividends payable                  | 1,453,035         | 61,833            |
| <b>TOTAL CURRENT LIABILITIES</b>   | <b>14,981,799</b> | <b>15,241,444</b> |
| <b>LONG TERM LIABILITIES:</b>      |                   |                   |
| Long-term compensation plans       | 42,069            | 350,457           |
| Uncertain tax positions            | 327,221           | 320,426           |
| Deferred income taxes              | 1,423,459         | 1,381,785         |
| Pension liabilities                | 325,810           | 127,611           |
| Long-term debt - mortgage payable  | 998,211           | 1,117,529         |
| <b>TOTAL LONG-TERM LIABILITIES</b> | <b>3,116,770</b>  | <b>3,297,808</b>  |

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; 8,523,719 and 8,474,896 shares issued and outstanding, respectively | 426,186           | 423,745           |
| Additional paid-in capital   | 37,087,003        | 36,404,518        |
| Retained earnings  | 56,606,937        | 57,755,178        |
| Accumulated other comprehensive loss   | (1,149,095)       | (588,048)         |
| <b>TOTAL STOCKHOLDERS EQUITY</b>   | <b>92,971,031</b> | <b>93,995,393</b> |

**TOTAL LIABILITIES AND STOCKHOLDERS EQUITY** **\$ 111,069,600** **\$ 112,534,645**

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



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

|  | <b>Three Months Ended March 31</b> |               |
|--|------------------------------------|---------------|
|  | <b>2013</b>                        | <b>2012</b>   |
| Sales  | \$ 27,452,731                      | \$ 24,243,922 |
| Costs and expenses:  |                                    |               |
| Cost of sales  | 17,676,804                         | 14,295,294    |
| Selling, general and administrative expenses               | 9,405,150                          | 9,818,182     |
| Total costs and expenses                                   | 27,081,954                         | 24,113,476    |
| Operating income   | 370,777                            | 130,446       |
| Other income and (expenses):                               |                                    |               |
| Investment and other income (expense)                      | 87,291                             | (20,698)      |
| (Loss)/gain on sale of assets                              | (47,262)                           | 20,572        |
| Interest and other expense                                 | (29,386)                           | (36,759)      |
| Other income (loss), net                                   | 10,643                             | (36,885)      |
| Income from operations before income taxes                 | 381,420                            | 93,561        |
| Income tax expense   | 139,061                            | 38,483        |
| Net income   | 242,359                            | 55,078        |
| Other comprehensive income (loss), net of tax:             |                                    |               |
| Additional minimum pension liability adjustments           | (205,815)                          | 135,892       |
| Unrealized gains/(losses) on available-for-sale securities | (12,078)                           | 12,052        |
| Foreign currency translation adjustment                    | (343,154)                          | 138,017       |
| Total other comprehensive (loss) income                    | (561,047)                          | 285,961       |
| Comprehensive (loss) income                                | \$ (318,688)                       | \$ 341,039    |
| Basic net income per share:                                | \$ 0.03                            | \$ 0.01       |
| Diluted net income per share:                              | \$ 0.03                            | \$ 0.01       |
| Weighted Average Basic Shares Outstanding                  | 8,486,533                          | 8,473,774     |
| Weighted Average Dilutive Shares Outstanding               | 8,496,318                          | 8,510,345     |
| Dividends declared per share                               | \$ 0.16                            | \$ 0.16       |

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

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

|  | Common Stock |            | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total         |
|--|--------------|------------|----------------------------------|----------------------|---|---------------|
|  | Shares       | Amount     |                                  |                      |   |               |
| BALANCE AT DECEMBER 31, 2012                                   | 8,474,896    | \$ 423,745 | \$ 36,404,518                    | \$ 57,755,178        | \$ (588,048)                                  | \$ 93,995,393 |
| Net income   |              |            |                                  | 242,359              |   | 242,359       |
| Issuance of common stock under<br>Employee Stock Purchase Plan | 4,225        | 211        | 43,729                           |                      |   | 43,940        |
| Issuance of common stock to Employee<br>Stock Ownership Plan   | 44,598       | 2,230      | 461,589                          |                      |   | 463,819       |
| Share based compensation                                       |              |            | 177,167                          |                      |   | 177,167       |
| Shareholder dividends  |              |            |                                  | (1,390,600)          |   | (1,390,600)   |
| Other comprehensive loss                                       |              |            |                                  |                      | (561,047)                                     | (561,047)     |
| BALANCE AT MARCH 31, 2013                                      | 8,523,719    | \$ 426,186 | \$ 37,087,003                    | \$ 56,606,937        | \$ (1,149,095)                                | \$ 92,971,031 |

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

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

|   | <b>Three Months Ended March 31</b> |               |
|---|------------------------------------|---------------|
|   | <b>2013</b>                        | <b>2012</b>   |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                    |               |
| Net income  | \$ 242,359                         | \$ 55,078     |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |               |
| Depreciation and amortization   | 485,793                            | 584,690       |
| Share based compensation  | 177,167                            | 111,044       |
| Deferred taxes  | (89,101)                           | 55,533        |
| Change in fair value of acquisition-related contingent consideration              | 27,231                             |               |
| Loss/(gain) on sale of assets   | 47,262                             | (20,572)      |
| Changes in assets and liabilities:  |                                    |               |
| Trade receivables   | (3,707,328)                        | 148,107       |
| Inventories   | (3,309,289)                        | (1,082,165)   |
| Prepaid income taxes  | 111,201                            | (76,842)      |
| Other assets  | (137,257)                          | 132,159       |
| Accounts payable  | (1,229,882)                        | 9,451         |
| Accrued compensation and benefits   | (350,808)                          | (3,136,397)   |
| Other accrued liabilities   | 255,243                            | (235,703)     |
| Income taxes payable  | (5,499)                            | 8,287         |
| Net cash used in operating activities   | (7,482,908)                        | (3,447,330)   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                    |               |
| Capital expenditures  | (479,129)                          | (681,099)     |
| Purchases of investments  | (2,932,571)                        | (2,007,701)   |
| Acquisition of business   |                                    | (43,639)      |
| Proceeds from the sale of fixed assets  | 24,971                             | 74,372        |
| Proceeds from the sale of investments   | 4,115,000                          | 4,359,039     |
| Net cash provided by investing activities   | 728,271                            | 1,700,972     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                    |               |
| Cash dividends paid   |                                    | (1,269,737)   |
| Mortgage principal payments   | (111,462)                          | (104,123)     |
| Proceeds from issuance of common stock  | 43,940                             | 54,409        |
| Payment of contingent consideration related to acquisition                        | (161,060)                          |               |
| Net cash used in financing activities   | (228,582)                          | (1,319,451)   |
| EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH                                   | (61,953)                           | 25,584        |
| NET DECREASE IN CASH AND CASH EQUIVALENTS   | (7,045,172)                        | (3,040,225)   |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR                                    | 17,869,712                         | 22,515,710    |
| CASH AND CASH EQUIVALENTS AT END OF YEAR  | \$ 10,824,540                      | \$ 19,475,485 |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>                         |                                    |               |
| Income taxes paid   | \$ 116,297                         | \$ 62,934     |
| Interest paid   | 26,261                             | 35,822        |
| Dividends declared not paid   | 1,363,795                          | 1,355,294     |

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



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

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

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

Financial Statement Presentation

The condensed consolidated balance sheets and condensed consolidated statement of changes in stockholders' equity as of March 31, 2013 and the related condensed consolidated statements of income and comprehensive income, and the condensed consolidated statements of cash flows for the periods ended March 31, 2013 and 2012 have been prepared by Company management. In the opinion of management, all adjustments (which include only normal recurring adjustments, except where noted) necessary to present fairly the financial position, results of operations, and cash flows at March 31, 2013 and 2012 and for the periods then ended have been made.

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

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

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

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### Revenue Recognition

The Company's manufacturing operations (Suttle and Transition Networks) recognize revenue when the earnings process is complete, evidenced by persuasive evidence of an agreement, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectability is reasonably assured. Revenue is recognized for domestic and international sales at the shipping point or delivery to customers, based on the related shipping terms. Risk of loss transfers at the point of shipment or delivery to customers, and the Company has no further obligation after this time. Sales are made directly to customers and through distributors. Payment terms for distributors are consistent with the terms of the Company's direct customers. The Company records a provision for sales returns, sales incentives, and warranty costs at the time of the sale, based on historical experience and current trends.

JDL generally records revenue on hardware, software and related equipment sales and installation contracts when the revenue recognition criteria are met and products are installed and accepted by the customer. JDL records revenue on service contracts on a straight-line basis over the contract period, unless evidence suggests the revenue is earned in a different pattern. Each contract is individually reviewed to determine when the earnings process is complete.

### Accumulated Other Comprehensive Income

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

|   | March 31<br>2013 | December 31<br>2012 |
|---|------------------|---------------------|
| Foreign currency translation                      | \$ (2,713,628)   | \$ (2,370,474)      |
| Unrealized gain on available-for-sale investments | 11,512           | 23,590              |
| Minimum pension liability                         | 1,553,021        | 1,758,836           |
|   | \$ (1,149,095)   | \$ (588,048)        |

### NOTE 2 CASH EQUIVALENTS AND INVESTMENTS

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

| March 31, 2013           |                      |                              |                               |                      |                     |                           |                          |
|--------------------------|----------------------|------------------------------|-------------------------------|----------------------|---------------------|---------------------------|--------------------------|
|                          | Amortized Cost       | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value           | Cash<br>Equivalents | Short-Term<br>Investments | Long-Term<br>Investments |
| <b>Cash equivalents:</b> |                      |                              |                               |                      |                     |                           |                          |
| Money Market funds       | \$ 3,211,661         | \$                           | \$                            | \$ 3,211,661         | \$ 3,211,661        | \$                        | \$                       |
| Subtotal                 | 3,211,661            |                              |                               | 3,211,661            | 3,211,661           |                           |                          |
| <b>Investments:</b>      |                      |                              |                               |                      |                     |                           |                          |
| Certificates of deposit  | 5,438,166            | 2,442                        | (3,860)                       | 5,436,748            |                     | 4,477,193                 | 959,555                  |
| Corporate Notes/Bonds    | 9,774,853            | 30,959                       | (3,458)                       | 9,802,354            |                     | 4,557,917                 | 5,244,437                |
| Commercial Paper         | 1,642,521            | 1,806                        |                               | 1,644,327            |                     | 1,644,327                 |                          |
| Subtotal                 | 16,855,540           | 35,207                       | (7,318)                       | 16,883,429           |                     | 10,679,437                | 6,203,992                |
| <b>Total</b>             | <b>\$ 20,067,201</b> | <b>\$ 35,207</b>             | <b>\$ (7,318)</b>             | <b>\$ 20,095,090</b> | <b>\$ 3,211,661</b> | <b>\$ 10,679,437</b>      | <b>\$ 6,203,992</b>      |

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December 31, 2012

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

The Company tests for other than temporary losses on a quarterly basis and has considered the unrealized losses indicated above to be temporary in nature. The Company intends to hold the investments until it can recover the full principal amount and has the ability to do so based on other sources of liquidity. The Company expects these recoveries to occur prior to the contractual maturities. All unrealized losses as of March 31, 2013 were in a continuous unrealized loss position for less than twelve months and are not deemed to be other than temporarily impaired as of March 31, 2013.

The following table summarizes the estimated fair value of our investments, designated as available-for-sale and classified by the contractual maturity date of the securities as of March 31, 2013:

|                                       | Amortized Cost | Estimated Market Value |
|---------------------------------------|----------------|------------------------|
| Due within one year                   | \$ 10,673,829  | \$ 10,679,437          |
| Due after one year through five years | 6,181,711      | 6,203,992              |
|                                       | \$ 16,855,540  | \$ 16,883,429          |

The Company did not recognize any gross realized gains, and gross realized losses were immaterial, during the three-month periods ending March 31, 2013 and 2012, respectively. If the Company had realized gains or losses, they would be included within investment and other income in the accompanying consolidated results of operations.

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NOTE 3 - STOCK-BASED COMPENSATION

Employee Stock Purchase Plan

Under the Company's Employee Stock Purchase Plan ( ESPP ), employees are able to acquire shares of common stock at 90% of the price at the end of each current quarterly plan term. The most recent term ended March 31, 2013. The ESPP is considered compensatory under current Internal Revenue Service rules. At March 31, 2013, after giving effect to the shares issued as of that date, 48,339 shares remain available for purchase under the ESPP.

2011 Executive Incentive Compensation Plan

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

During the first quarter of 2013, stock options covering 160,302 shares were awarded to key executive employees, which options expire seven years from the date of award and vest 25% each year beginning one year after the date of award. The Company also granted deferred stock awards of 177,532 shares to key employees during the first quarter under the Company's long-term incentive plan for performance over the 2013 to 2015 period. The actual number of shares of deferred stock, if any, that are earned by the respective employees will be determined based on achievement against cumulative performance goals for the three years ending December 31, 2015 and the shares earned will be issued in the first quarter of 2016 to those key employees still with the Company at that time. The Company also granted deferred stock awards of up to 11,576 shares to executive employees that could be earned under the Company's short-term incentive plan if actual revenue equaled or exceeded 150% of 2012 quarterly or annual revenue targets. The shares earned by the respective executive employees will be issued no later than the first quarter of 2014.

At March 31, 2013, 425,879 shares remained available for future issuance under the 2011 Incentive Plan.

Stock Option Plan for Directors

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

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

### 1992 Stock Plan

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

At March 31, 2013, after reserving for stock options and deferred stock awards granted in prior years and adjusting for forfeitures and issuances during the year, there were 154,430 shares reserved for issuance under the Stock Plan. The Company has not awarded stock options or deferred stock under this plan in 2013.

### Changes in Stock Options Outstanding

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

|                                 | <b>Options</b> | <b>Weighted average<br/>exercise price<br/>per share</b> | <b>Weighted average<br/>remaining<br/>contractual term</b> |
|---------------------------------|----------------|--|--|
| Outstanding December 31, 2012   | 311,153        | \$ 12.05   | 4.98   |
| Awarded                         | 160,302        | 10.10  |  |
| Exercised                       |                |  |  |
| Forfeited                       |                |  |  |
| Outstanding March 31, 2013      | 471,455        | 11.39  | 5.50   |
| Excercisable at March 31, 2013  | 214,496        | \$ 11.43   | 4.33   |
| Expected to vest March 31, 2013 | 465,701        | 11.38  | 5.49   |

The aggregate intrinsic value of all options (the amount by which the market price of the stock on the last day of the period exceeded the market price of the stock on the date of grant) outstanding at March 31, 2013 was \$65,000. The intrinsic value of all options exercised during the three months ended March 31, 2013 was \$0. Net cash proceeds from the exercise of all stock options were \$0 and \$0 for the three months ended March 31, 2013 and 2012, respectively.

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

|                               | Shares  | Weighted Average<br>Grant Date<br>Fair Value |
|-------------------------------|---------|--|
| Outstanding December 31, 2012 | 160,790 | \$ 14.16                                     |
| Granted                       | 190,108 | 9.83   |
| Vested                        |         |  |
| Forfeited                     | (3,263) | 12.18  |
| Outstanding March 31, 2013    | 347,635 | 11.81  |

Compensation Expense

Share-based compensation expense recognized for the three-month period ended March 31, 2013 was \$177,000 before income taxes and \$115,000 after income taxes. Share-based compensation expense recognized for the three-month period ended March 31, 2012 was \$111,000 before income taxes and \$72,000 after income taxes. Unrecognized compensation expense for the Company's plans was \$1,396,000 at March 31, 2013. Excess tax benefits from the exercise of stock options and issuance of restricted stock included in financing cash flows for the three month periods ended March 31, 2013 and 2012 were \$0 and \$0, respectively. Share-based compensation expense is recorded as a part of selling, general and administrative expenses.

## NOTE 4 - INVENTORIES

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

|                             | March 31<br>2013 | December 31<br>2012 |
|-----------------------------|------------------|---------------------|
| Finished goods              | \$ 24,776,340    | \$ 21,252,143       |
| Raw and processed materials | 12,203,985       | 12,500,567          |
|                             | \$ 36,980,325    | \$ 33,752,710       |

## NOTE 5 GOODWILL AND OTHER INTANGIBLE ASSETS

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

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The changes in the carrying amount of goodwill for the three months ended March 31, 2013 and 2012 by segment is as follows:

|                              | Suttle      | Transition Networks | Total        |
|------------------------------|-------------|---------------------|--------------|
| January 1, 2012              | \$          | \$ 5,990,571        | \$ 5,990,571 |
| March 31, 2012               | \$          | \$ 5,990,571        | \$ 5,990,571 |
| January 1, 2013              | \$          | \$ 5,956,934        | \$ 5,956,934 |
| Foreign currency translation |             | (159,263)           | (159,263)    |
| March 31, 2013               | \$          | \$ 5,797,671        | \$ 5,797,671 |
| Gross goodwill               | 1,271,986   | \$ 5,797,671        | \$ 7,069,657 |
| Accumulated impairment loss  | (1,271,986) |                     | (1,271,986)  |
| Balance at March 31, 2013    | \$          | \$ 5,797,671        | \$ 5,797,671 |

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

|                        | March 31, 2013        |                          |                              | Net     |
|------------------------|-----------------------|--------------------------|------------------------------|---------|
|                        | Gross Carrying Amount | Accumulated Amortization | Foreign Currency Translation |         |
| Trademarks             | 81,785                | (18,045)                 | (5,839)                      | 57,901  |
| Customer relationships | 490,707               | (75,792)                 | (35,028)                     | 379,887 |
| Technology             | 228,996               | (70,734)                 | (16,345)                     | 141,917 |
|                        | 801,488               | (164,571)                | (57,212)                     | 579,705 |

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

Amortization expense on these identifiable intangible assets was \$25,000 and \$26,000 in 2013 and 2012, respectively. The amortization expense is included in selling, general and administrative expenses.

NOTE 6 WARRANTY

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

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The following table presents the changes in the Company's warranty liability for the three-month periods ended March 31, 2013 and 2012, respectively, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

|                            | 2013       | 2012       |
|----------------------------|------------|------------|
| Beginning balance          | \$ 590,000 | \$ 634,000 |
| Amounts charged to expense | 90,000     | 87,000     |
| Actual warranty costs paid | (123,000)  | (97,000)   |
| Ending balance             | \$ 557,000 | \$ 623,000 |

## NOTE 7 CONTINGENCIES

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

## NOTE 8 INCOME TAXES

In the preparation of the Company's consolidated financial statements, management calculates income taxes based upon the estimated effective rate applicable to operating results for the full fiscal year. This includes estimating the current tax liability as well as assessing differences resulting from different treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. These assets and liabilities are analyzed regularly and management assesses the likelihood that deferred tax assets will be recovered from future taxable income.

At March 31, 2013 there was \$256,000 of net uncertain tax benefit positions that would reduce the effective income tax rate if recognized. The Company records interest and penalties related to income taxes as income tax expense in the Condensed Consolidated Statements of Income.

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

The Company's effective income tax rate was 36.5% for the first three months of 2013. The effective tax rate differs from the federal tax rate of 35% due to state income taxes, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges, and the effect of operations conducted in lower foreign tax rate jurisdictions. The effect of the foreign operations is an overall rate decrease of approximately 2.6% for the three months ended March 31, 2013. There were no additional uncertain tax positions identified in the first quarter of 2013. The Company's effective income tax rate for the three months ended March 31, 2012 was 41.1%, and differed from the federal tax rate due to state income taxes, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges, and settlement of uncertain tax positions.



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## NOTE 9 SEGMENT INFORMATION

The Company classifies its businesses into three segments as follows:

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

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

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

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

Information concerning the Company's continuing operations in the various segments for the three-month periods ended March 31, 2013 and 2012 is as follows:

|  | Suttle        | Transition Networks | JDL Technologies | Other         | Total          |
|--|---------------|---------------------|------------------|---------------|----------------|
| <b>Three Months Ended March 31, 2013</b>     |               |                     |                  |               |                |
| Sales  | \$ 12,412,188 | \$ 10,813,121       | \$ 4,227,422     | \$            | \$ 27,452,731  |
| Cost of sales                                | 9,096,683     | 5,092,291           | 3,487,830        |               | 17,676,804     |
| Gross profit                                 | 3,315,505     | 5,720,830           | 739,592          |               | 9,775,927      |
| Selling, general and administrative expenses | 2,357,941     | 5,495,179           | 559,132          | 992,898       | 9,405,150      |
| Operating income (loss)                      | \$ 957,564    | \$ 225,651          | \$ 180,460       | \$ (992,898)  | \$ 370,777     |
| Depreciation and amortization                | \$ 216,749    | \$ 179,866          | \$ 14,447        | \$ 74,731     | \$ 485,793     |
| Capital expenditures                         | \$ 164,402    | \$ 131,354          | \$ 15,361        | \$ 168,012    | \$ 479,129     |
| Assets                                       | \$ 26,834,977 | \$ 31,484,025       | \$ 14,551,382    | \$ 38,199,216 | \$ 111,069,600 |

|  | Suttle        | Transition Networks | JDL Technologies | Other          | Total          |
|--|---------------|---------------------|------------------|----------------|----------------|
| <b>Three Months Ended March 31, 2012</b>     |               |                     |                  |                |                |
| Sales  | \$ 10,577,304 | \$ 12,938,193       | \$ 728,425       | \$             | \$ 24,243,922  |
| Cost of sales                                | 7,675,962     | 6,128,836           | 490,496          |                | 14,295,294     |
| Gross profit                                 | 2,901,342     | 6,809,357           | 237,929          |                | 9,948,628      |
| Selling, general and administrative expenses | 2,368,441     | 5,622,237           | 584,968          | 1,242,536      | 9,818,182      |
| Operating income (loss)                      | \$ 532,901    | \$ 1,187,120        | \$ (347,039)     | \$ (1,242,536) | \$ 130,446     |
| Depreciation and amortization                | \$ 244,025    | \$ 241,436          | \$ 27,091        | \$ 72,138      | \$ 584,690     |
| Capital expenditures                         | \$ 402,899    | \$ 82,451           | \$ 10,096        | \$ 185,653     | \$ 681,099     |
| Assets                                       | \$ 28,172,970 | \$ 34,646,429       | \$ 1,629,899     | \$ 47,998,048  | \$ 112,447,346 |

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## NOTE 10 PENSIONS

The Company's U.K. based subsidiary Austin Taylor maintains defined benefit pension plans. The Company does not provide any other post-retirement benefits to its employees. Components of net periodic benefit cost of the pension plans for the three months ended March 31, 2013 and 2012 were:

|                                    | <b>Three Months Ended March 31</b> |             |
|------------------------------------|------------------------------------|-------------|
|                                    | <b>2013</b>                        | <b>2012</b> |
| Service cost                       | \$ 65,000                          | \$ 9,000    |
| Interest cost                      | 57,000                             | 62,000      |
| Expected return on assets          | (62,000)                           | (69,000)    |
| Amortization of prior service cost |                                    | 12,000      |
| Net periodic pension cost          | \$ 60,000                          | \$ 14,000   |

## NOTE 11 NET INCOME PER SHARE

Basic net income per common share is based on the weighted average number of common shares outstanding during each year. Diluted net income per common share takes into effect the dilutive effect of potential common shares outstanding. The Company's only potential common shares outstanding are stock options and shares associated with the long-term incentive compensation plans, which resulted in a dilutive effect of 9,785 and 36,571 shares for the three month periods ended March 31, 2013 and 2012, respectively. The Company calculates the dilutive effect of outstanding options using the treasury stock method. Options totaling 116,290 were excluded from the calculation of diluted earnings per share for the three-months ended March 31, 2013 because the exercise price was greater than the average market price of common stock during the period and deferred stock awards totaling 323,236 shares were not included for the three-months ended March 31, 2013 because of unmet performance conditions. All options were included for the three-month period ended March 31, 2012 because the exercise price was greater than the average market price of common stock during the period and deferred stock awards totaling 149,470 shares were not included for the three-month period ended March 31, 2012 because of unmet performance conditions.

## NOTE 12 FAIR VALUE MEASUREMENTS

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

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

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

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

Financial assets and liabilities measured at fair value as of March 31, 2013 and December 31, 2012, are summarized below:

| <b>March 31, 2013</b>          |                     |                      |                     |                         |
|--------------------------------|---------------------|----------------------|---------------------|-------------------------|
|                                | <b>Level 1</b>      | <b>Level 2</b>       | <b>Level 3</b>      | <b>Total Fair Value</b> |
| <b>Cash equivalents:</b>       |                     |                      |                     |                         |
| Money Market funds             | \$ 3,211,661        | \$                   | \$                  | \$ 3,211,661            |
| Subtotal                       | 3,211,661           |                      |                     | 3,211,661               |
| <b>Short-term investments:</b> |                     |                      |                     |                         |
| Certificates of deposit        |                     | 4,477,193            |                     | 4,477,193               |
| Corporate Notes/Bonds          |                     | 4,557,917            |                     | 4,557,917               |
| Commercial Paper               |                     | 1,644,327            |                     | 1,644,327               |
| Subtotal                       |                     | 10,679,437           |                     | 10,679,437              |
| <b>Long-term investments:</b>  |                     |                      |                     |                         |
| Certificates of deposit        |                     | 959,555              |                     | 959,555                 |
| Corporate Notes/Bonds          |                     | 5,244,437            |                     | 5,244,437               |
| Subtotal                       |                     | 6,203,992            |                     | 6,203,992               |
| <b>Current Liabilities:</b>    |                     |                      |                     |                         |
| Accrued Consideration          |                     |                      | (581,750)           | (581,750)               |
| Subtotal                       |                     |                      | (581,750)           | (581,750)               |
| <b>Total</b>                   | <b>\$ 3,211,661</b> | <b>\$ 16,883,429</b> | <b>\$ (581,750)</b> | <b>\$ 19,513,339</b>    |

| <b>December 31, 2012</b>       |                     |                      |                     |                         |
|--------------------------------|---------------------|----------------------|---------------------|-------------------------|
|                                | <b>Level 1</b>      | <b>Level 2</b>       | <b>Level 3</b>      | <b>Total Fair Value</b> |
| <b>Cash equivalents:</b>       |                     |                      |                     |                         |
| Money Market funds             | \$ 5,497,788        | \$                   | \$                  | \$ 5,497,788            |
| Subtotal                       | 5,497,788           |                      |                     | 5,497,788               |
| <b>Short-term investments:</b> |                     |                      |                     |                         |
| Certificates of deposit        |                     | 7,258,768            |                     | 7,258,768               |
| Corporate Notes/Bonds          |                     | 3,800,143            |                     | 3,800,143               |
| Commercial Paper               |                     | 1,642,627            |                     | 1,642,627               |
| Subtotal                       |                     | 12,701,538           |                     | 12,701,538              |
| <b>Long-term investments:</b>  |                     |                      |                     |                         |
| Certificates of deposit        |                     | 900,763              |                     | 900,763                 |
| Corporate Notes/Bonds          |                     | 4,475,634            |                     | 4,475,634               |
| Subtotal                       |                     | 5,376,397            |                     | 5,376,397               |
| <b>Current Liabilities:</b>    |                     |                      |                     |                         |
| Accrued Consideration          |                     |                      | (770,041)           | (770,041)               |
| Subtotal                       |                     |                      | (770,041)           | (770,041)               |
| <b>Total</b>                   | <b>\$ 5,497,788</b> | <b>\$ 18,077,935</b> | <b>\$ (770,041)</b> | <b>\$ 22,805,682</b>    |

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The estimated fair value of remaining contingent consideration as of March 31, 2013 was \$581,750, as noted above. The estimated fair value is considered a level 3 measurement because the probability weighted discounted cash flow methodology used to estimate fair value includes the use of significant unobservable inputs, primarily the contractual contingent consideration gross margin targets and assumed probabilities. The change in the estimated contingent consideration during the three months was due to \$161,060 in payments and \$27,231 in foreign currency gains.

There were no transfers between levels during the three months ended March 31, 2013.

NOTE 13 SUBSEQUENT EVENTS

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

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

### Overview

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

Suttle manufactures and markets copper and fiber connectivity systems, enclosure systems, xDSL filters and splitters, and active technologies for voice, data and video communications under the Suttle brand in the United States and internationally;

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

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

The Company's first quarter consolidated sales increased 13.2% in 2013 to \$27.5 million compared to \$24.2 million in 2012. Consolidated 2013 operating income increased to \$371,000 compared to \$130,000 in the 2012 first quarter. First quarter 2013 net income increased to \$242,000 compared to \$55,000 in the first quarter of 2012.

Suttle continued its strong growth by increasing 2013 first quarter revenue to \$12.4 million, a 17.4 % increase over the 2012 first quarter. Suttle revenues reflected increased sales to telecommunications service providers, due to the fulfillment of contracts for recently introduced Suttle products and increased sales tied to enhanced network deployments by these communications service providers. Suttle also had a significant increase in the sale of its structured cabling products driven by continued resurgence in the housing market, specifically in multi-tenant-dwelling construction.

Transition Networks sales decreased 16% to \$10.8 million, due primarily to the continued slowdown in government spending, which resulted in a decrease in North American revenue from \$9.3 million to \$6.7 million. Transition Networks international revenue increased from \$3.6 million to \$4.1 million, due to increased sales to Latin America and Asia despite decreased sales in the Company's Europe, Middle East and Africa markets. With the continued uncertainty over federal government spending, Transition Networks is taking steps to improve its 2013 revenues and profitability in a challenging domestic environment.

JDL Technology 2013 first quarter sales increased 481% to \$4.2 million due to its involvement in the Miami-Dade County School District ( M-DCSD ) Bringing Wireless to the Classroom initiative. In the fourth quarter of 2012, JDL Technologies was selected as one of the partners for this initiative, and it recognized \$3.2 of revenue from this program in the first quarter of 2013. JDL Technologies also achieved increased revenues from its long-time relationship with the Broward County Florida school district, and from other customers. JDL Technology's gross margin decreased to 17.5%, reflecting the fact that a significant portion of its revenue was hardware-based, rather than its more traditional value-added service. JDL Technologies continues to expand the customer base for its managed services, virtualization and migration-to-the-cloud products and services, and is focused on offering these services to small- and medium-sized businesses in the healthcare and commercial markets.

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Enterprise Resource Planning

During the first quarter, we continued the process of implementing our new Enterprise Resource Planning (ERP) system, which will significantly strengthen our long-term performance by standardizing all CSI business units on a common platform. The ERP system will bring efficiencies in the cycle from product concept to product development to bringing products to market; it will enable us to lower manufacturing costs and better manage our supply chain; and it will give us many tools to provide improved customer service. Although implementing this new ERP system has been a significant investment, we expect to achieve substantial dividends in improved execution and enhanced service to our customers. On April 4, 2013, our Transition Networks business unit went live on this system. This go-live was successful due to pre-planning and excellent education. Suttle will be the next business unit to go live, which we expect to occur later in 2013.

Forward-looking statements

In this report and, from time to time, in reports filed with the Securities and Exchange Commission, in press releases, and in other communications to shareholders or the investing public, the Company may make forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 concerning possible or anticipated future financial performance, business activities, plans, pending claims, investigations or litigation which are typically preceded by the words believes, expects, anticipates, intends or similar expressions. For these forward-looking statements, the Company claims the protection of the safe harbor for forward-looking statements contained in federal securities laws. Shareholders and the investing public should understand that these forward-looking statements are subject to risks and uncertainties that could cause actual performance, activities, anticipated results, outcomes or plans to differ significantly from those indicated in the forward-looking statements. These risks and uncertainties include, but are not limited to:

- our ability to manufacture and deliver our products to customers in the time frame these customers have specified;
- possible lower future sales to major telephone companies and other major customers;
- the introduction of competitive products and technologies;
- our ability to successfully control operating expenses in our business units;
- the general health of the telecom sector;
- the continuing worldwide financial downturn and sluggish economic conditions in certain market segments;
- our ability to stabilize the 2013 revenues and profitability of our Transition Networks business unit in light of continued uncertainty over federal government spending and the decline in Transition Networks legacy products;
- our ability to successfully and profitably integrate our acquisitions, including our July 2011 acquisition of Patapsco;
- delays in new product introductions;
- higher than expected expense related to new sales and marketing initiatives;
- unfavorable resolution of claims and litigation;
- availability of adequate supplies of raw materials and components;
- fuel prices;
- the dependence of our Transition Networks business unit on federal government spending;

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the timing and availability of the federal and school district components of the funding of our M-DCPS project could affect the timing of JDL's delivery of services and its receipt of revenues under the project; the fact the Company's margins from JDL's M-DCSD project are significantly lower than the margins from JDL's historical projects, which have included a significant value-added service component; and other factors discussed from time to time in the Company's filings with the Securities and Exchange Commission, including risk factors presented under Item 1A of the Company's most recently filed annual report on Form 10-K.

Three Months Ended March 31, 2013 Compared to  
Three Months Ended March 31, 2012

Consolidated sales increased 13% in 2013 to \$27,453,000 compared to \$24,244,000 in 2012. Consolidated operating income in 2013 increased to \$371,000 compared to \$130,000 in the first quarter of 2012. Net income in 2013 increased to \$242,000 compared to \$55,000 in the first quarter of 2012.

**Suttle**

Suttle sales increased 17% in the first quarter of 2013 to \$12,412,000 compared to \$10,577,000 in the same period of 2012 due to the fulfillment of contracts for recently introduced Suttle products and increased sales tied to enhanced network deployments by communications service providers. Sales by customer groups in the first quarter of 2013 and 2012 were:

|                     | <b>Suttle Sales by Customer Group</b> |                      |
|---------------------|---------------------------------------|----------------------|
|                     | <b>2013</b>                           | <b>2012</b>          |
| Telephone companies | \$ 9,395,000                          | \$ 7,450,000         |
| Distributors        | 1,577,000                             | 1,428,000            |
| International       | 1,312,000                             | 1,511,000            |
| Other               | 128,000                               | 188,000              |
|                     | <b>\$ 12,412,000</b>                  | <b>\$ 10,577,000</b> |

Suttle's sales by product groups in first quarter of 2013 and 2012 were:

|                             | <b>Suttle Sales by Product Group</b> |                      |
|-----------------------------|--------------------------------------|----------------------|
|                             | <b>2013</b>                          | <b>2012</b>          |
| Modular connecting products | \$ 3,349,000                         | \$ 3,235,000         |
| DSL products                | 2,140,000                            | 1,904,000            |
| Structured cabling products | 5,705,000                            | 4,041,000            |
| Other products              | 1,218,000                            | 1,397,000            |
|                             | <b>\$ 12,412,000</b>                 | <b>\$ 10,577,000</b> |

Sales to the major telephone companies increased 26% in 2013 due to the fulfillment of new product contracts and increased sales tied to enhanced network deployments. Sales to these customers accounted for 76% of Suttle's sales in the first quarter of 2013 compared to 70% of sales in 2012. Sales to distributors increased 10% in 2013 due to stronger demand for structured cabling products to support the increase in multi-dwelling unit construction. This customer segment accounted for 13% and 14% of sales in the first quarters of 2013 and 2012, respectively. International sales decreased 13% and accounted for 11% of Suttle's first quarter 2013 sales, due to a reduction in revenue from Austin Taylor's legacy products.

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Modular connecting products sales increased 4% and sales of structured cabling products increased 41% due to an increase in new multi-dwelling unit construction in the U.S. housing market and an increase in sales tied to enhanced network deployments. Sales of DSL products increased 12% due to the order cycle of major customers.

Suttle's gross margin increased 14% in the first quarter of 2013 to \$3,316,000 compared to \$2,901,000 in the same period of 2012. Gross margin as a percentage of sales remained consistent at 27% in 2013 and 2012. Selling, general and administrative expenses remained stable in the first quarter of 2013 compared to the same period in 2012. Suttle's operating income was \$958,000 in the first quarter of 2013 compared to \$533,000 in 2012.

**Transition Networks**

Transition Networks sales decreased 16% to \$10,813,000 in the first quarter of 2013 compared to \$12,938,000 in 2012 due primarily to a continued slowdown in federal government spending. Transition Networks organizes its sales force by vertical markets and segments its customers geographically. First quarter sales by region are presented in the following table:

|                                      | <b>Transition Networks Sales by Region</b> |               |
|--------------------------------------|--|---------------|
|                                      | <b>2013</b>                                | <b>2012</b>   |
| North America                        | \$ 6,700,000                               | \$ 9,327,000  |
| Europe, Middle East, Africa ( EMEA ) | 1,496,000                                  | 1,728,000     |
| Rest of World                        | 2,617,000                                  | 1,883,000     |
|                                      | \$ 10,813,000                              | \$ 12,938,000 |

The following table summarizes Transition Networks' 2013 and 2012 first quarter sales by its major product groups:

|                   | <b>Transition Networks Sales by Product Group</b> |               |
|-------------------|---|---------------|
|                   | <b>2013</b>                                       | <b>2012</b>   |
| Media converters  | \$ 7,462,000                                      | \$ 8,685,000  |
| Ethernet switches | 1,067,000   | 1,218,000     |
| Ethernet adapters | 729,000   | 1,207,000     |
| Other products    | 1,555,000   | 1,828,000     |
|                   | \$ 10,813,000                                     | \$ 12,938,000 |

Sales in North America decreased 28% or \$2,627,000 due to lower than anticipated demand from the federal government and traditional media converter markets. International sales increased \$502,000, or 14%, due to higher demand for telecommunication products, specifically within the Rest of World region.

Gross margin on first quarter Transition Networks' sales decreased 16% to \$5,721,000 in 2013 from \$6,809,000 in 2012. Gross margin as a percentage of sales remained stable at 53% in both 2013 and 2012. Selling, general and administrative expenses decreased 2% to \$5,495,000 in 2013 compared to \$5,622,000 in 2012 due to planned decreases in sales and marketing expenses. Operating income decreased to \$226,000 in 2013 compared to \$1,187,000 in 2012.



Table of Contents**JDL Technologies, Inc.**

JDL Technologies, Inc. sales increased 481% to \$4,227,000 in the first quarter of 2013 compared to \$728,000 in 2012.

JDL's revenues by customer group were as follows:

|                              | <b>JDL Revenue by Customer Group</b> |             |
|------------------------------|--------------------------------------|-------------|
|                              | <b>2013</b>                          | <b>2012</b> |
| Broward County FL schools    | \$ 697,000                           | \$ 481,000  |
| Miami Dade County FL schools | 3,167,000                            |             |
| All other                    | 363,000                              | 247,000     |
|                              | \$ 4,227,000                         | \$ 728,000  |

Revenues earned in Broward County, Florida increased \$216,000 or 45% in the first quarter of 2013 as compared to the 2012 first quarter 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. This project will continue throughout 2013. All other revenues increased \$116,000 due to JDL's concentrated effort in the commercial markets.

JDL gross margin increased 211% to \$740,000 in the first quarter of 2013 compared to \$238,000 in the same period in 2012. Gross margin as a percentage of sales decreased to 17.5% in 2013 from 33% in 2012 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 4% in 2013 to \$559,000 compared to \$585,000 in 2012. JDL reported operating income of \$180,000 in the first quarter of 2013 compared to an operating loss of \$347,000 in the same period of 2012.

**Other**

The Company's income before income taxes increased to \$381,000 in 2013 compared to \$94,000 in 2012. The Company's effective income tax rate was 36% in 2013 and 41% in 2012. This effective rate differs from the standard rate of 35% due to state income taxes, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges, and the effect of operations conducted in lower foreign tax rate jurisdictions.

Liquidity and Capital Resources

As of March 31, 2013, the Company had approximately \$27,708,000 in cash, cash equivalents and investments. Of this amount, \$3,212,000 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 \$16,883,000 in investments consisting 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 March 31, 2013.

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The Company had working capital of \$68,943,000, consisting of current assets of approximately \$83,925,000 and current liabilities of \$14,982,000 at March 31, 2013 compared to working capital of \$70,677,000, consisting of current assets of \$85,918,000 and current liabilities of \$15,241,000 at December 31, 2012.

Cash flow used in operating activities was approximately \$7,483,000 in the first three months of 2013 compared to \$3,447,000 in the same period of 2012. Significant working capital changes from December 31, 2012 to March 31, 2013 included an increase in inventories of \$3,309,000 due to high production levels related to increased orders and new product initiatives within one of our business segments, and an increase in receivables of \$3,707,000 due to higher sales in the first quarter of 2013 as compared to the first quarter of 2012.

Net cash provided by investing activities was \$728,000 in the first three months of 2013 compared to \$1,701,000 in cash used in the same period of 2012. The Company continued to make capital investments and purchases of certificates of deposit and other marketable securities.

Net cash used by financing activities was \$229,000 in the first three months of 2013 compared to \$1,319,000 in the same period of 2012. The Company made \$161,000 in contingent consideration payments related to the Patapsco acquisition. Cash dividends paid on common stock decreased to \$0 in 2013 from \$1,270,000 in 2012 (\$0.16 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 \$44,000 in 2013 and \$54,000 in 2012. The Company purchased and retired no shares in 2013 and 2012. At March 31, 2013, Board of Director authority to purchase approximately 411,910 additional shares remained in effect.

The Company has a \$10,000,000 line of credit from Wells Fargo Bank. Interest on borrowings on the credit line is at LIBOR plus 1.1% (1.4% at March 31, 2013). There were no borrowings on the line of credit during the first three months of 2013 or 2012. The credit agreement expires October 31, 2014 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.

Critical Accounting Policies

Our critical accounting policies, including the assumptions and judgments underlying them, are discussed in our 2012 Form 10-K in Note 1 Summary of Significant Accounting Policies included in our Consolidated Financial Statements. There were no significant changes to our critical accounting policies during the three months ended March 31, 2013.

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

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Recently Issued Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board issued guidance that requires disclosure of amounts reclassified out of accumulated other comprehensive income by component. Significant amounts are required to be presented by the respective line items of net income or should be cross-referenced to other disclosures. These disclosures may be presented on the income statement or in the notes to the financial statements. We adopted this standard during the first quarter of 2013. The adoption of this standard did not have a material effect on our financial statement disclosures.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

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

The vast majority of our transactions are denominated in U.S. dollars; as such, fluctuations in foreign currency exchange rates have historically not been material to the Company. At March 31, 2013 our bank line of credit carried a variable interest rate based on LIBOR plus 1.1%.

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

Item 4. Controls and Procedures

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

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

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Not Applicable.

Item 1A. Risk Factors

Not Applicable.

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

Not Applicable.

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

As the Company disclosed in a Form 8-K filed with the Securities and Exchange Commission on November 26, 2012, David T. McGraw, the Company's Chief Financial Officer advised the Company's Board of Directors that he would be retiring as Chief Financial Officer on December 31, 2013.

On May 9, 2013, Mr. McGraw notified the Company that he would be accelerating the date of his retirement as Chief Financial Officer to May 21, 2013, the date of the Company's 2013 Annual Meeting of Shareholders.

Item 6. Exhibits.

The following exhibits are included herein:

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rules 13a-14 and 15d-14 of the Exchange Act).
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rules 13a-14 and 15d-14 of the Exchange Act).
- 32. Certifications pursuant Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350).
- 99.1 Press Release dated May 9, 2013 announcing 2013 First Quarter Results.

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Signatures

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

Communications Systems, Inc.

By /s/ William G. Schultz  
William G. Schultz  
President and Chief Executive Officer

Date: May 10, 2013

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

Date: May 10, 2013