

COMMUNICATIONS SYSTEMS INC

Form 10-Q

May 06, 2016

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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, 2016

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

41-0957999

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(State or other jurisdiction of
incorporation or organization) (Federal Employer
Identification No.)

10900 Red Circle Drive, Minnetonka, MN 55343
(Address of principal executive offices) (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES 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 a check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined by Rule 12b-2 of the Exchange Act).

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

| Class | Name of Exchange On Which Registered | Outstanding at May 1, 2016 |
|-------|---|----------------------------|
|-------|---|----------------------------|

| | | |
|-------------------------|--------|-----------|
| Common Stock, par value | NASDAQ | 8,832,854 |
| \$.05 per share | | |

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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Table of Contents**COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)****ASSETS**

| | March 31 2016 | December 31 2015 |
|--|--------------------------|---------------------------------|
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$7,459,316 | \$9,812,737 |
| Investments | 7,931,517 | 5,228,668 |
| Trade accounts receivable, less allowance for doubtful accounts of \$112,000 and \$123,000, respectively | 18,479,882 | 17,849,207 |
| Inventories | 24,923,332 | 24,985,560 |
| Prepaid income taxes | 2,794,112 | 2,972,271 |
| Other current assets | 1,218,296 | 1,041,303 |
| TOTAL CURRENT ASSETS | 62,806,455 | 61,889,746 |
| PROPERTY, PLANT AND EQUIPMENT, net | 17,131,316 | 17,468,420 |
| OTHER ASSETS: | | |
| Investments | 2,370,335 | 6,293,505 |
| Goodwill | 1,462,503 | 1,462,503 |
| Other assets | 943,411 | 802,056 |
| TOTAL OTHER ASSETS | 4,776,249 | 8,558,064 |
| TOTAL ASSETS | \$84,714,020 | 87,916,230 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Current portion of long-term debt | \$— | \$ 103,603 |
| Line of credit borrowings | 1,500,000 | — |
| Accounts payable | 7,132,645 | 8,373,292 |
| Accrued compensation and benefits | 2,740,705 | 3,050,822 |
| Accrued consideration | 142,234 | 442,234 |
| Other accrued liabilities | 2,275,601 | 1,996,609 |
| Dividends payable | 1,495,544 | 1,474,892 |
| TOTAL CURRENT LIABILITIES | 15,286,729 | 15,441,452 |
| LONG TERM LIABILITIES: | | |
| Long-term compensation plans | 36,436 | — |
| Uncertain tax positions | 111,952 | 102,633 |
| Deferred income taxes | 31,482 | 61,453 |
| Pension liabilities | — | 126,001 |
| TOTAL LONG-TERM LIABILITIES | 179,870 | 290,087 |

COMMITMENTS AND CONTINGENCIES (Footnote 8)

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; 8,832,854 and 8,754,550 shares issued and outstanding, respectively | 441,643 | 437,727 |
| Additional paid-in capital | 40,887,062 | 40,129,285 |
| Retained earnings | 28,370,965 | 32,284,061 |
| Accumulated other comprehensive loss | (452,249) | (666,382) |
| TOTAL STOCKHOLDERS' EQUITY | 69,247,421 | 72,184,691 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$84,714,020 | \$87,916,230 |

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

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

| | Three Months Ended March 31 | |
|--|--|----------------|
| | 2016 | 2015 |
| Sales | \$24,666,444 | \$19,544,936 |
| Costs and expenses: | | |
| Cost of sales | 17,897,426 | 14,657,998 |
| Selling, general and administrative expenses | 9,637,061 | 10,578,176 |
| Pension liability adjustment gains | (4,147,836) | — |
| Total costs and expenses | 23,386,651 | 25,236,174 |
| Operating income (loss) | 1,279,793 | (5,691,238) |
| Other income (expenses): | | |
| Investment and other income | 27,652 | 62,963 |
| Gain on sale of assets | 808,322 | 4,285 |
| Interest and other expense | (9,071) | (13,218) |
| Foreign currency translation loss | (4,238,497) | |
| Other income, net | (3,411,594) | 54,030 |
| Loss from operations before income taxes | (2,131,801) | (5,637,208) |
| Income tax expense (benefit) | 334,866 | (1,473,732) |
| Net loss | (2,466,667) | (4,163,476) |
| Other comprehensive income (loss), net of tax: | | |
| Additional minimum pension liability adjustments | (4,147,836) | (12,646) |
| Unrealized gain on available-for-sale securities | 37,003 | 55,120 |
| Foreign currency translation adjustment | 4,324,966 | (130,317) |
| Total other comprehensive income (loss) | 214,133 | (87,843) |
| Comprehensive loss | \$(2,252,534) | \$(4,251,319) |
| Basic net loss per share: | \$(0.28) | \$(0.48) |
| Diluted net loss per share: | \$(0.28) | \$(0.48) |
| Weighted Average Basic Shares Outstanding | 8,859,865 | 8,660,819 |
| Weighted Average Dilutive Shares Outstanding | 8,859,865 | 8,660,819 |
| 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
STATEMENT OF
CHANGES IN
STOCKHOLDERS'
EQUITY
(Unaudited)**

| | Common Stock | | Additional | Retained | Accumulated | Total |
|---|--------------|-----------|--------------------|--------------|--------------------------------|----------------|
| | Shares | Amount | Paid-in Capital | Earnings | Other Comprehensive Loss | |
| BALANCE AT DECEMBER 31, 2015 | 8,754,550 | \$437,727 | \$40,129,285 | \$32,284,061 | \$(666,382) |) \$72,184,691 |
| Net loss | | | | (2,466,667) | | (2,466,667) |
| Issuance of common stock under Employee Stock Purchase Plan | 6,450 | 324 | 49,794 | | | 50,118 |
| Issuance of common stock to Employee Stock Ownership Plan | 60,278 | 3,014 | 465,346 | | | 468,360 |
| Issuance of common stock under Executive Stock Plan | 14,626 | 731 | 0 | | | 731 |
| Tax benefit from stock based payments | | | (22,874) | | | (22,874) |
| Share based compensation | | | 279,642 | | | 279,642 |
| Purchase of common stock | (3,050) | (153) | (14,131) | (7,036) | | (21,320) |
| Shareholder dividends | | | | (1,439,393) | | (1,439,393) |
| Other comprehensive income | | | | | 214,133 | 214,133 |
| BALANCE AT MARCH 31, 2016 | 8,832,854 | \$441,643 | \$40,887,062 | \$28,370,965 | \$(452,249) |) \$69,247,421 |

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

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

| | Three Months Ended March 31 | |
|---|--|---------------|
| | 2016 | 2015 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$(2,466,667) | \$(4,163,476) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 890,411 | 780,477 |
| Share based compensation | 279,642 | 238,349 |
| Deferred taxes | (29,972) | (89,248) |
| Gain on sale of assets | (808,322) | (4,285) |
| Excess tax benefit from share-based payments | 22,874 | 5,712 |
| Changes in assets and liabilities: | | |
| Trade receivables | (633,822) | 2,956,932 |
| Inventories | 45,478 | (1,398,048) |
| Prepaid income taxes | 178,159 | (1,496,921) |
| Other assets | (350,173) | (657,485) |
| Accounts payable | (1,119,113) | 1,071,831 |
| Accrued compensation and benefits | 196,909 | (371,707) |
| Other accrued liabilities | 283,666 | 256,330 |
| Income taxes payable | (13,555) | (5,168) |
| Other | 49,103 | — |
| Net cash used in operating activities | (3,475,382) | (2,876,707) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Capital expenditures | (806,970) | (853,074) |
| Proceeds from the sale of fixed assets | 969,114 | 22,853 |
| Proceeds from the sale of investments | 1,257,324 | 734,537 |
| Net cash provided by (used in) investing activities | 1,419,468 | (95,684) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Borrowings on line of credit | 1,500,000 | — |
| Cash dividends paid | (1,418,741) | (1,395,200) |
| Mortgage principal payments | (103,603) | (127,727) |
| Proceeds from issuance of common stock, net of shares withheld | 29,529 | (7,541) |
| Excess tax benefit from share-based payments | (22,874) | (5,712) |
| Payment of deferred consideration related to acquisition | (300,000) | — |

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| | | |
|--|-------------|--------------|
| Net cash used in financing activities | (315,689) | (1,536,180) |
| EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH | 18,182 | (78,662) |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (2,353,421) | (4,587,233) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 9,812,737 | 13,736,857 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$7,459,316 | \$9,149,624 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Income taxes paid | \$198,418 | \$500 |
| Interest paid | 8,058 | 13,121 |
| Dividends declared not paid | 1,495,544 | 1,463,075 |
| Capital expenditures in accounts payable | 81,700 | 218,019 |
| Acquisition costs in accrued consideration | 142,234 | — |

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

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COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Communications Systems, Inc. (herein collectively called “CSI” or the “Company”) is a Minnesota corporation organized in 1969 that operates primarily as a holding company conducting its business through four business units having operations in the United States, Costa Rica, and the United Kingdom. Through its Suttle business unit, the Company manufactures and sells copper and fiber connectivity systems, enclosure systems, and active technologies for voice, data and video communications. Through its Transition Networks business unit, the Company manufactures and sells media converters, network interface devices, network interface cards, Ethernet switches and other connectivity products that offer the ability to affordably integrate the benefits of fiber optics into any data network. Through its JDL Technologies business unit, the Company provides technology solutions including virtualization, managed services, wired and wireless network design and implementation, HIPAA-compliant IT services, and converged infrastructure configuration and deployment. Through its Net2Edge business unit, the Company provides business-critical systems for customers worldwide with a sharp focus on the telecommunications carrier and enables carriers to upgrade from legacy networks to high-speed services.

Financial Statement Presentation

The condensed consolidated balance sheets and condensed consolidated statement of changes in stockholders’ equity as of March 31, 2016 and the related condensed consolidated statements of loss and comprehensive loss, and the condensed consolidated statements of cash flows for the periods ended March 31, 2016 and 2015 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, 2016 and 2015 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, 2015 Annual Report to Shareholders on Form 10-K. The results of operations for the period ended March 31, 2016 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, 2015, appropriately represent, in all material respects, the current status of accounting policies, and are incorporated herein by reference.

Table of ContentsAccumulated Other Comprehensive Loss

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

| | Foreign Currency Translation | Unrealized (loss)/gain on securities | Pension liability adjustment | Accumulated Other Comprehensive Loss |
|--|---|---|---|---|
| December 31, 2015 | \$(4,801,000) | \$ (13,000) | \$4,148,000 | \$ (666,000) |
| Net current period change | 87,000 | 37,000 | | 124,000 |
| Reclassification adjustments into income | 4,238,000 | | (4,148,000) | 90,000 |
| March 31, 2016 | \$(476,000) | \$ 24,000 | \$— | \$ (452,000) |

The Company recognized \$4,238,000 in foreign currency translation losses within the income statement during the first quarter due to the substantial liquidation of our Austin Taylor facility in the U.K. Refer to Note 12 for further information regarding the pension liability adjustment recognized in income in the first quarter of 2016.

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 and cash equivalents or short and long term investments as of March 31, 2016 and December 31, 2015:

March 31, 2016

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Cash Equivalents | Short-Term Investments | Long-Term Investments |
|--------------------|---------------------------|---------------------------------------|--|-------------------|-----------------------------|-----------------------------------|----------------------------------|
| Cash equivalents: | | | | | | | |
| Money Market funds | \$2,480,000 | \$ — | \$ — | \$2,480,000 | \$2,480,000 | \$ | \$ |
| Subtotal | 2,480,000 | — | — | 2,480,000 | 2,480,000 | — | — |
| Investments: | | | | | | | |

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| | | | | | | | |
|-------------------------|---------------|-----------|-------------|---------------|--------------|--------------|--------------|
| Certificates of deposit | 5,251,000 | 11,000 | (1,000) | 5,261,000 | — | 2,891,000 | 2,370,000 |
| Corporate Notes/Bonds | 5,040,000 | 2,000 | (1,000) | 5,041,000 | — | 5,041,000 | — |
| Subtotal | 10,291,000 | 13,000 | (2,000) | 10,302,000 | — | 7,932,000 | 2,370,000 |
| Total | \$ 12,771,000 | \$ 13,000 | \$ (2,000) | \$ 12,782,000 | \$ 2,480,000 | \$ 7,932,000 | \$ 2,370,000 |

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| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Cash Equivalents | Short-Term Investments | Long-Term Investments |
|-------------------------|---------------------------|---------------------------------------|--|-------------------|-----------------------------|-----------------------------------|----------------------------------|
| Cash equivalents: | | | | | | | |
| Money Market funds | \$ 1,944,000 | \$ — | \$ — | \$ 1,944,000 | \$ 1,944,000 | \$ | \$ |
| Subtotal | 1,944,000 | — | — | 1,944,000 | 1,944,000 | — | — |
| Investments: | | | | | | | |
| Certificates of deposit | 5,493,000 | 3,000 | (8,000) | 5,488,000 | — | 1,202,000 | 4,286,000 |
| Corporate Notes/Bonds | 6,056,000 | — | (22,000) | 6,034,000 | — | 4,027,000 | 2,007,000 |
| Subtotal | 11,549,000 | 3,000 | (30,000) | 11,522,000 | — | 5,229,000 | 6,293,000 |
| Total | \$ 13,493,000 | \$ 3,000 | \$ (30,000) | \$ 13,466,000 | \$ 1,944,000 | \$ 5,229,000 | \$ 6,293,000 |

As part of the Company's amended credit agreement with Wells Fargo Bank, the Company has pledged \$5.0 million in long term investments against the line of credit. The Company tests for other-than-temporary losses on a quarterly basis and has considered the unrealized losses shown above to be temporary in nature. The Company intends to hold these investments until it can recover the full principal amount and has the ability to do so based on its other sources of liquidity. The Company expects these recoveries to occur prior to the contractual maturities. All unrealized losses as of March 31, 2016 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, 2016.

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, 2016:

| | Amortized Cost | Estimated Market Value |
|---------------------------------------|---------------------------|---------------------------------------|
| Due within one year | \$7,924,000 | \$7,932,000 |
| Due after one year through five years | 2,367,000 | 2,370,000 |
| | \$10,291,000 | \$10,302,000 |

The Company did not recognize any gross realized gains, and gross realized losses were immaterial, during the three-month periods ending March 31, 2016 and 2015, 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 85% of the price at the end of each current quarterly plan term. The most recent term ended March 31, 2016. The ESPP is considered compensatory under current Internal Revenue Service rules. At March 31, 2016, after giving effect to the shares issued as of that date, 94,790 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. The 2011 Incentive Plan, as amended, allows the issuance of up to 2,000,000 shares of common stock.

During 2016, stock options covering 187,989 shares have been awarded to key executive employees and directors. These 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 93,828 shares to key employees during the first quarter of 2016 under the Company's long-term incentive plan for performance over the 2016 to 2018 period. The actual number of shares of deferred stock, if any, that are ultimately earned by the respective employees will be determined based on achievement against performance goals at the end of the three year period ending December 31, 2018 and any shares earned will be issued in the first quarter of 2019 to those key employees still with the Company at that time.

At March 31, 2016, 110,091 shares have been issued under the 2011 Incentive Plan, 1,037,577 shares are subject to currently outstanding options, deferred stock awards, and unvested restricted stock units, and 852,332 shares are eligible for grant under future awards.

Stock Option Plan for Directors

Shares of common stock are reserved for issuance to non-employee directors under options granted by the Company prior to 2011 under its Stock Option Plan for Non-Employee Directors (the “Director Plan”). Under the Director Plan nonqualified stock options to acquire shares of common stock were automatically granted to each non-employee director concurrent with annual meetings of shareholders in 2010 and earlier years, with the exercise price of options granted being the fair market value of the common stock on the date of the respective shareholder meetings. Options granted under the Director Plan expire 10 years from date of grant. No options were granted under the Director Plan in 2014 or 2015. The Company amended the Director Plan in May 2011 to prohibit future option grants. As of March 31, 2016, there were 75,000 shares subject to outstanding options under the Director Plan.

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 limitations in the Stock Plan. The Company amended the Stock Plan in 2011 to prohibit future stock options or other equity awards.

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At March 31, 2016, after reserving for stock options and deferred stock awards granted in prior years and adjusting for forfeitures and issuances during the year, there were 22,008 shares reserved for issuance under the Stock Plan. The Company has not awarded stock options or deferred stock under the Stock Plan since 2011.

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, 2015 to March 31, 2016:

| | Options | Weighted average exercise price per share | Weighted average remaining contractual term |
|---------------------------------|----------------|--|--|
| Outstanding – December 31, 2015 | 721,924 | \$ 11.70 | 4.89 |
| Awarded | 187,989 | 6.93 | |
| Exercised | — | — | |
| Forfeited | — | — | |
| Outstanding – March 31, 2016 | 909,913 | 10.72 | 5.11 |
| Exercisable at March 31, 2016 | 345,042 | \$ 11.80 | 3.55 |
| Expected to vest March 31, 2016 | 909,913 | 10.72 | 5.11 |

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, 2016 was \$78,000. The intrinsic value of all options exercised during the three months ended March 31, 2016 was \$0. Net cash proceeds from the exercise of all stock options were \$0 for the three months ended March 31, 2016 and 2015.

Changes in Deferred Stock Outstanding

The following table summarizes the changes in the number of deferred stock shares under the Stock Plan and 2011 Incentive Plan over the period December 31, 2015 to March 31, 2016:

| | Shares | Weighted Average Grant Date Fair Value |
|---------------------------------|---------------|---|
| Outstanding – December 31, 2015 | 126,427 | \$ 11.73 |
| Granted | 102,161 | 7.28 |
| Vested | (14,626) | 12.55 |
| Forfeited | (22,106) | 11.59 |
| Outstanding – March 31, 2016 | 191,856 | 9.32 |

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Table of ContentsChanges in Restricted Stock Units Outstanding

The following table summarizes the changes in the number of restricted stock units under the 2011 Incentive Plan over the period December 31, 2015 to March 31, 2016:

| | Shares | Weighted Average Grant Date Fair Value |
|---------------------------------|--------|---|
| Outstanding – December 31, 2015 | 32,816 | \$ 11.41 |
| Granted | — | — |
| Issued | — | — |
| Forfeited | — | — |
| Outstanding – March 31, 2016 | 32,816 | 11.41 |

Compensation Expense

Share-based compensation expense recognized for the three-month period ended March 31, 2016 was \$280,000 before income taxes and \$182,000 after income taxes. Share-based compensation expense recognized for the three-month period ended March 31, 2015 was \$238,000 before income taxes and \$155,000 after income taxes. Unrecognized compensation expense for the Company's plans was \$1,152,000 at March 31, 2016 and is expected to be recognized over a weighted-average period of 2.3 years. Excess tax benefits from the exercise of stock options and issuance of stock included in financing cash flows for the three month periods ended March 31, 2016 and 2015 were \$(23,000) and \$(6,000), 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 | December |
|-----------------------------|-----------------|-----------------|
| | 2016 | 31 |
| | | 2015 |
| Finished goods | \$ 14,215,000 | \$ 14,112,000 |
| Raw and processed materials | 10,708,000 | 10,874,000 |
| | \$ 24,923,000 | \$ 24,986,000 |

NOTE 5 – ACQUISITION

On June 1, 2015, the Company acquired all of the shares of Twisted Technologies, Inc. (“Twisted Technologies”). The purchase price was \$1,463,000, with cash acquired totaling \$83,000. The purchase price includes initial consideration of \$1,000,000, deferred consideration of \$300,000 paid out on March 31, 2016, and \$163,000 in estimated contingent consideration. The Company has agreed to pay consideration contingent upon the Twisted Technologies business meeting revenue targets over a three-year period, with the consideration to be paid after each annual period has lapsed. The Company has recognized \$163,000 as the estimated fair value of the contingent consideration at the date of acquisition. The maximum payout is not limited. At March 31, 2016, the Company had estimated liabilities of \$142,000 related to these outstanding contingent consideration payments.

The assets and liabilities of Twisted Technologies were recorded in the consolidated balance sheet within the JDL Technologies segment at March 31, 2016. The purchase price allocation was based on estimates of the fair value of assets acquired and liabilities assumed and included total assets of \$1,591,000, including goodwill of \$1,463,000, and total liabilities of \$128,000. The entire goodwill balance is deductible for tax purposes.

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NOTE 6 –GOODWILL AND INTANGIBLE ASSETS

The changes in the carrying amount of goodwill for the three months ended March 31, 2016 by segment are as follows:

| | JDL |
|-----------------------------|-------------|
| January 1, 2016 | \$1,463,000 |
| Goodwill acquired | — |
| March 31, 2016 | \$1,463,000 |
| Gross goodwill | 1,463,000 |
| Accumulated impairment loss | |
| Balance at March 31, 2016 | \$1,463,000 |

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

| | March 31, 2016 | | | |
|------------------------|------------------------------|---------------------------------|-------------------------------------|------------|
| | Gross Carrying Amount | Accumulated Amortization | Foreign Currency Translation | Net |
| Trademarks | 91,000 | (50,000 |) | (8,000 |
| Customer relationships | 491,000 | (202,000 |) | (59,000 |
| Technology | 229,000 | (188,000 |) | (27,000 |
| | 811,000 | (440,000 |) | (94,000 |
| | | | |) 33,000 |
| | | | |) 230,000 |
| | | | |) 14,000 |
| | | | |) 277,000 |
| | December 31, 2015 | | | |
| | Gross Carrying Amount | Accumulated Amortization | Foreign Currency Translation | Net |
| Trademarks | 91,000 | (48,000 |) | (8,000 |
| Customer relationships | 491,000 | (197,000 |) | (46,000 |
| Technology | 229,000 | (183,000 |) | (22,000 |
| | 811,000 | (428,000 |) | (76,000 |
| | | | |) 35,000 |
| | | | |) 248,000 |
| | | | |) 24,000 |
| | | | |) 307,000 |

Amortization expense on these identifiable intangible assets was \$24,000 and \$24,000 in 2016 and 2015, respectively. The amortization expense is included in selling, general and administrative expenses. At March 31, 2016, the estimated future amortization expense for definite-lived intangible assets for the remainder of 2016 and all of the following four fiscal years is as follows:

Year Ending December 31:

| | |
|------|----------|
| 2016 | \$64,000 |
| 2017 | 54,000 |
| 2018 | 50,000 |
| 2019 | 43,000 |
| 2020 | 43,000 |

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NOTE 7 – WARRANTY

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

The following table presents the changes in the Company's warranty liability for the three-month periods ended March 31, 2016 and 2015, respectively, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

| | 2016 | 2015 |
|----------------------------|-------------|-------------|
| Beginning balance | \$554,000 | \$434,000 |
| Amounts charged to expense | 19,000 | 142,000 |
| Actual warranty costs paid | (34,000) | (22,000) |
| Ending balance | \$539,000 | \$554,000 |

NOTE 8 – 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 9 – DEBT

Long-term Debt

The mortgage on the Company's headquarters building was payable in monthly installments and carried an interest rate of 6.83%. The mortgage matured on March 1, 2016 and the Company made payments totaling \$104,000 in the first quarter of 2016 to fully settle the liability. The mortgage was secured by the building.

Line of Credit

The Company has a \$10,000,000 line of credit from Wells Fargo Bank. The Company had \$1,500,000 in outstanding borrowings against the line of credit at March 31, 2016 and no borrowings at March 31, 2015. Due to the revolving nature of loans under our credit facility, additional borrowings and periodic repayments and re-borrowings may be made until the maturity date. The total amount available for borrowings under our credit facility at March 31, 2016 was \$8,500,000. Interest on borrowings on the credit line is at LIBOR plus 1.75% (1.9% at March 31, 2016). The credit agreement expires October 31, 2016 and is secured by assets of the Company. The Company has pledged \$5.0 million in long term investments against the line of credit. Our credit agreement contains financial covenants including tangible net worth minimums and a minimum cash balance. The Company was in compliance with its financial covenants at March 31, 2016.

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NOTE 10 – 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. In April 2016, we received notification from the Internal Revenue Service that they would be performing an examination of our 2012 and 2013 federal consolidated income tax returns. We do not expect that any settlement or payment that may result from the examination will have a material effect on our results of operations.

At March 31, 2016 there was \$226,000 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 2012-2015 remain open to examination by the Internal Revenue Service and the years 2011-2015 remain open to examination by various state tax departments. The tax years from 2012-2015 remain open in Costa Rica.

The Company's effective income tax rate was (15.7%) for the first three months of 2016. The effective tax rate differs from the federal tax rate of 35% due to state income taxes, foreign tax rate differences, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges for uncertain income tax positions, and changes in valuation allowances related to deferred tax assets. The foreign operating losses may ultimately be deductible in the countries in which they occurred; however the Company has not recorded a deferred tax asset for these losses due to uncertainty regarding the eventual realization of the benefit. The effect of the foreign operations was an overall rate decrease of approximately (24.9%) for the three months ended March 31, 2016. The Company's effective income tax rate for the three months ended March 31, 2015 was 26.1%, and differed from the federal tax rate due to state income taxes, foreign losses not deductible for U.S. income tax purposes and provisions for interest charges.

NOTE 11 – SEGMENT INFORMATION

Effective January 1, 2016, the Company realigned its business operations. As a result of the realignment, the Company has segregated its Transition Networks subsidiary TN EMEA (now renamed Net2Edge) as a separate operating segment. Following this realignment, the Company classifies its businesses into four segments as follows:

- Suttle manufactures and markets connectivity infrastructure products for broadband and voice communications;

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

JDL Technologies provides technology solutions including virtualization, managed services, wired and wireless network design and implementation, HIPAA-compliant IT services, and converged infrastructure configuration and deployment; and

Net2Edge provides business-critical systems for customers worldwide with a sharp focus on the telecommunications carrier and enables carriers to upgrade from legacy networks to high-speed services.

Management has chosen to organize the enterprise and disclose reportable segments based on our products and services. Intersegment revenues are eliminated upon consolidation. To conform to the 2016 presentation, the Company has reclassified 2015 segment information to present the Net2Edge business unit as a separate segment.

Information concerning the Company's continuing operations in the various segments for the three month periods ended March 31, 2016 and 2015 is as follows:

| | Suttle | Transition Networks | JDL Technologies | Net2Edge | Other | Intersegment Eliminations | Total |
|--|---------------|----------------------------|-------------------------|-----------------|--------------|----------------------------------|--------------|
| Three Months Ended March 31, 2016 | | | | | | | |
| Sales | \$11,789,000 | \$8,330,000 | \$4,312,000 | \$569,000 | \$— | \$(334,000) | \$24,666,000 |
| Cost of sales | 9,744,000 | 5,147,000 | 2,858,000 | 241,000 | — | (93,000) | 17,897,000 |
| Gross profit | 2,045,000 | 3,183,000 | 1,454,000 | 328,000 | — | (241,000) | 6,769,000 |
| Selling, general and administrative expenses | 3,487,000 | 4,638,000 | 1,006,000 | 731,000 | | (225,000) | 9,637,000 |
| Pension liability adjustment gains | | | — | | (4,148,000) | | (4,148,000) |
| Operating (loss) income | \$(1,442,000) | \$(1,455,000) | \$448,000 | \$(403,000) | \$4,148,000 | \$(16,000) | \$1,280,000 |
| Depreciation and amortization | \$576,000 | \$221,000 | \$61,000 | \$33,000 | \$— | \$— | \$891,000 |
| Capital expenditures | \$479,000 | \$85,000 | \$75,000 | \$— | \$184,000 | \$(16,000) | \$807,000 |
| Assets | \$38,941,000 | \$19,617,000 | \$5,649,000 | \$2,295,000 | \$18,234,000 | \$(22,000) | \$84,714,000 |

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| | Suttle | Transition Networks | JDL Technologies | Net2Edge | Other | Intersegment Eliminations | Total |
|---|----------------|--------------------------------|-----------------------------|-----------------|--------------|--------------------------------------|----------------|
| Three Months Ended March 31, 2015 | | | | | | | |
| Sales | \$10,590,000 | \$7,766,000 | \$865,000 | \$332,000 | \$— | \$ (8,000) | \$19,545,000 |
| Cost of sales | 9,149,000 | 4,607,000 | 824,000 | 86,000 | — | (8,000) | 14,658,000 |
| Gross profit | 1,441,000 | 3,159,000 | 41,000 | 246,000 | — | — | 4,887,000 |
| Selling, general and administrative expenses | 4,306,000 | 4,766,000 | 810,000 | 696,000 | — | — | 10,578,000 |
| Restructuring expense | | — | | | | | — |
| Operating income (loss) | \$(2,865,000) | \$(1,607,000) | \$(769,000) | \$(450,000) | \$— | \$ — | \$(5,691,000) |
| Depreciation and amortization | \$507,000 | \$213,000 | \$26,000 | \$34,000 | \$— | \$ — | \$780,000 |
| Capital expenditures | \$649,000 | \$66,000 | \$44,000 | \$20,000 | \$74,000 | \$ — | \$853,000 |
| Assets | \$40,210,000 | \$25,065,000 | \$4,367,000 | \$1,805,000 | \$24,353,000 | \$ — | \$95,800,000 |

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NOTE 12 – PENSIONS

The Company's U.K. based subsidiary Austin Taylor maintained a defined benefit pension plan. The Company does not provide any other post-retirement benefits to its employees. Components of net periodic benefit of the pension plans for the three months ended March 31, 2016 and 2015 were:

| | Three Months Ended March 31 | |
|------------------------------|--|-------------|
| | 2016 | 2015 |
| Service cost | \$— | \$2,000 |
| Interest cost | 26,000 | 34,000 |
| Expected return on assets | (24,000) | (45,000) |
| Settlement benefit | (43,000) | — |
| Net periodic pension benefit | \$(41,000) | \$(9,000) |

The Company settled all its obligations under pension plan in the first quarter of 2016. The Company had contributed \$650,000 toward the settlement of the pension into annuities in 2015, which resulted in the recognition of \$1,222,000 of pension settlement costs in the income statement in the fourth quarter of 2015. The Company contributed an additional \$68,000 toward the settlement in the first quarter of 2016, which resulted in a benefit of \$43,000 recorded within operating expenses. As a result of the final settlement of all of its pension obligations, in the first quarter of 2016, the Company recorded \$4,148,000 in pension liability adjustment gains previously recorded in accumulated other comprehensive income within operating expenses in the consolidated statement of income.

NOTE 13 – NET INCOME (LOSS) 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 no dilutive effect for the three month periods ended March 31, 2016 and 2015. The Company calculates the dilutive effect of outstanding options using the treasury stock method. Due to the net losses in the first three months of 2015 and 2016, there was no dilutive impact from stock options or unvested shares. Options totaling 753,591 and 522,922 were excluded from the calculation of diluted earnings per share for the three months ended March 31, 2016 and 2015 because the exercise price was greater than the average market price of common stock during the period and deferred stock awards totaling 167,390 and 205,010 shares would not have been included for the three months ended March 31, 2016 and 2015 because of unmet performance conditions.

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NOTE 14 – FAIR VALUE MEASUREMENTS

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

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

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

Level 3 – Significant inputs to pricing 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, 2016 and December 31, 2015, are summarized below:

| | March 31, 2016 | | | |
|-------------------------|----------------|-----------|---------|------------------|
| | Level 1 | Level 2 | Level 3 | Total Fair Value |
| Cash equivalents: | | | | |
| Money Market funds | \$2,480,000 | \$— | \$— | \$2,480,000 |
| Certificates of deposit | — | — | — | — |
| Subtotal | 2,480,000 | — | — | 2,480,000 |
| Short-term investments: | | | | |
| Certificates of deposit | — | 2,891,000 | — | 2,891,000 |
| Corporate Notes/Bonds | — | 5,041,000 | — | 5,041,000 |
| Subtotal | — | 7,932,000 | — | 7,932,000 |

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| | | | | | |
|-------------------------|-------------|--------------|-------------|--------------|---|
| Long-term investments: | | | | | |
| Certificates of deposit | — | 2,370,000 | — | 2,370,000 | |
| Corporate Notes/Bonds | — | — | — | — | |
| Subtotal | — | 2,370,000 | — | 2,370,000 | |
| Current Liabilities: | | | | | |
| Accrued Consideration | — | — | (142,000) | (142,000) |) |
| Subtotal | — | — | (142,000) | (142,000) |) |
| | | | | | |
| Total | \$2,480,000 | \$10,302,000 | \$(142,000) | \$12,640,000 | |

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| | December 31, 2015 | | | |
|--------------------------|-------------------|---------------|--------------|------------------|
| | Level 1 | Level 2 | Level 3 | Total Fair Value |
| Cash equivalents: | | | | |
| Money Market funds | \$ 1,944,000 | \$— | \$— | \$ 1,944,000 |
| Subtotal | 1,944,000 | — | — | 1,944,000 |
| Short-term investments: | | | | |
| Certificates of deposit | — | 1,202,000 | — | 1,202,000 |
| Corporate Notes/Bonds | — | 4,027,000 | — | 4,027,000 |
| Subtotal | — | 5,229,000 | — | 5,229,000 |
| Long-term investments: | | | | |
| Certificates of deposit | — | 4,286,000 | — | 4,286,000 |
| Corporate Notes/Bonds | — | 2,007,000 | — | 2,007,000 |
| Subtotal | — | 6,293,000 | — | 6,293,000 |
| Current Liabilities: | | | | |
| Contingent Consideration | — | — | (142,000) | (142,000) |
| Subtotal | — | — | (142,000) | (142,000) |
| Total | \$ 1,944,000 | \$ 11,522,000 | \$ (142,000) | \$ 13,324,000 |

The estimated fair value of contingent consideration as of March 31, 2016 was \$142,000, 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 revenue targets and assumed probabilities. There was no change in the estimated contingent consideration during the three months ended March 31, 2016.

We record transfers between levels of the fair value hierarchy, if necessary, at the end of the reporting period. There were no transfers between levels during the three months ended March 31, 2016.

NOTE 15 – SUBSEQUENT EVENTS

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

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

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 connectivity infrastructure products for broadband and voice communications;

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

JDL Technologies provides technology solutions including virtualization, managed services, wired and wireless network design and implementation, HIPAA-compliant IT services, and converged infrastructure configuration and deployment; and

Net2Edge provides business-critical systems for customers worldwide with a sharp focus on the telecommunications carrier and enables carriers to upgrade from legacy networks to high-speed services.

First Quarter 2016 Summary

Consolidated sales of \$24.7 million compared to \$19.5 million in Q1 2015, driven by higher sales at each of the business units.

Operating income was \$1.3 million compared to an operating loss of \$5.7 million in Q1 2015.

Net loss was \$2.5 million, or (\$0.28) per diluted share, compared to a net loss of \$4.2 million, or (\$0.48) per diluted share, in Q1 2015.

Forward-looking statements

In this report and, from time to time, in reports filed with the Securities and Exchange Commission (“SEC”), 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:

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General Risks and Uncertainties:

The ability of the CSI parent to oversee that the Company's four operating units function in an efficient and cost-effective manner;

The ability of our four business operating units to operate profitably; and

The impact of changing economic circumstances on government expenditures in our markets.

Suttle Risks and Uncertainties:

Suttle's dependence upon its sales to a small number of major communication service providers and their continued investment and deployment into building out their networks;

Volatility in purchases of Suttle's products by major communication service providers as well as recent, increased pressure on our margins;

Suttle's ability to continue to introduce and sell new fiber-network based-products such as G.hn products and FTTx (fiber-to-the-home or node) products to replace declining sales and lower or fluctuating gross margins in its legacy products, and

The continued recovery of the housing market in the United States.

Transition Networks Risks and Uncertainties:

The ability of Transition Networks to develop and sell new products for new and existing markets at a level adequate to counter the decline in sales from its traditional products;

Transition Networks' ability to profitably penetrate targeted international markets; and

· Transition Networks' reliance on contract manufacturers and OEM's for supply of its products.

JDL Technologies Risks and Uncertainties:

· JDL's ability to continue to obtain business from its traditional South Florida school district customers;

JDL's ability to profitably increase its business serving small and medium-sized commercial businesses, including profitably leveraging its June 1, 2015 acquisition of Twisted Technologies; and

JDL's ability to establish and maintain a productive and efficient workforce given revenues that have historically fluctuated significantly from period to period, in part due to the uncertainty and timing of federal government funding of school initiatives, including the E-Rate program.

In addition, the Company will discuss other factors from time to time in its filings with the SEC, including risk factors presented under Item 1A of the Company's most recently filed annual report on Form 10-K or quarterly reports on Form 10-Q.

Table of Contents**Company Results**

Three Months Ended March 31, 2016 Compared to

Three Months Ended March 31, 2015

Consolidated sales increased 26% in 2016 to \$24,666,000 compared to \$19,545,000 in 2015. Consolidated operating income in 2016 was \$1,280,000 compared to an operating loss of \$5,691,000 in the first quarter of 2015, due to \$4,148,000 in pension liability adjustment gains recognized in operating income in 2016 due to the settlement of the pension plan. Net loss in 2016 was \$2,467,000 or \$ (0.28) per share compared to \$4,163,000 or \$ (0.48) per share in the first quarter of 2015.

Suttle Results

Suttle sales increased 11% in the first quarter of 2016 to \$11,789,000 compared to \$10,590,000 in the same period of 2015 due to an increase in product volume to major communication service providers. Sales by customer groups in the first quarter of 2016 and 2015 were:

| | Suttle Sales by Customer Group | |
|---------------------------------|---------------------------------------|---------------------|
| | 2016 | 2015 |
| Communication service providers | \$10,574,000 | \$8,812,000 |
| International | 537,000 | 995,000 |
| Distributors | 678,000 | 783,000 |
| | \$11,789,000 | \$10,590,000 |

Suttle's sales by product groups in first quarter of 2016 and 2015 were:

| | Suttle Sales by Product Group | |
|---|--------------------------------------|---------------------|
| | 2016 | 2015 |
| Structured cabling and connecting system products | \$10,598,000 | \$9,441,000 |
| DSL and other products | 1,191,000 | 1,149,000 |
| | \$11,789,000 | \$10,590,000 |

Sales to the major communication service providers increased 20% in 2016 due to an increase in new product volume and stabilization of legacy products. Sales to major communication service providers accounted for 90% of Suttle's sales in the first quarter of 2016 compared to 83% of sales in 2015. Sales to distributors decreased 13% in 2016 due to a decline in legacy product lines and accounted for 6% and 7% of sales in the first quarters of 2016 and 2015, respectively. International sales decreased 46% in 2016 and accounted for 5% of Suttle's first quarter 2016 sales, due to the ordering cycle of DSL products for a major customer.

Sales of structured cabling and connecting system products increased 12% due to acceptance and deployments of new products by major communication service providers.

Suttle's gross margin increased 42% in the first quarter of 2016 to \$2,045,000 compared to \$1,441,000 in the same period of 2015. Gross margin as a percentage of sales increased to 17.3% from 13.6% in the same period of 2015 due to contribution from new products and improved productivity in the manufacturing process. Selling, general and administrative expenses decreased 19% to \$3,487,000, or 29.6% of sales, in the first quarter of 2016 compared to \$4,306,000, or 40.7% of sales, in the same period in 2015 due to lower research and development expenses and lower expenses related to the ERP implementation and support, which was substantially completed in 2015. Suttle incurred \$840,000 and \$1,396,000 in research and development expenses in the respective 2016 and 2015 first quarters, as it continues to invest in enhancing existing products and developing new products. Suttle incurred an operating loss of \$1,442,000 in the first quarter of 2016 compared to a loss of \$2,865,000 in 2015.

Table of Contents**Transition Networks Results**

Transition Networks sales increased 7% to \$8,330,000 in the first quarter of 2016 compared to \$7,766,000 in 2015 due to improvements in North America partially offset by declines in rest of world markets. Transition Networks organizes its sales force by channel to market and segments its customers geographically. First quarter sales by region are presented in the following table:

| | Transition Networks Sales by Region | |
|--------------------------------------|--|--------------------|
| | 2016 | 2015 |
| North America | \$6,250,000 | \$5,293,000 |
| Rest of World | 1,199,000 | 1,639,000 |
| Europe, Middle East, Africa (“EMEA”) | 881,000 | 834,000 |
| | \$8,330,000 | \$7,766,000 |

The following table summarizes Transition Networks’ 2016 and 2015 first quarter sales by its major product groups:

| | Transition Networks Sales by Product Group | |
|--------------------------------|---|--------------------|
| | 2016 | 2015 |
| Media converters | \$5,335,000 | \$5,403,000 |
| Ethernet switches and adapters | 1,543,000 | 1,049,000 |
| Other products | 1,452,000 | 1,314,000 |
| | \$8,330,000 | \$7,766,000 |

Sales in North America increased 18% in 2016 or \$957,000 due to improvements in the federal government business. International sales decreased \$393,000, or 16%, due to weakness in certain Latin American markets and Japan. Ethernet switches and adapters increased 47% or \$494,000 due to favorable project timing related to a federal government program.

Gross margin on first quarter Transition Networks’ sales increased 1% to \$3,183,000 in 2016 as compared to \$3,159,000 in 2015. Gross margin as a percentage of sales decreased to 38.2% in 2016 from 40.7% in 2015 due to unfavorable product mix and inventory adjustments. Selling, general and administrative expenses decreased 3% to \$4,638,000, or 55.7% of sales, in 2016 compared to \$4,766,000, or 61.4% of sales, in 2015 due to reductions in selling costs in North America. Transition Networks incurred an operating loss of \$1,455,000 in 2016 compared to a loss of \$1,607,000 in 2015.

Table of Contents**JDL Technologies Results**

JDL Technologies sales increased 398% to \$4,312,000 in the first quarter of 2016 compared to \$865,000 in 2015.

JDL's revenues by customer group were as follows:

| | JDL Revenue by Customer Group | |
|-----------|--|------------------|
| | 2016 | 2015 |
| Education | \$3,090,000 | \$328,000 |
| All other | 1,222,000 | 537,000 |
| | \$4,312,000 | \$865,000 |

Revenues earned from the education sector increased \$2,762,000 or 842% in the first quarter of 2016 as compared to the 2015 first quarter due to the ongoing wireless refresh project that began in the second quarter of 2015. Revenue from JDL Technologies' sales to small and medium-sized commercial businesses (SMBs) increased \$685,000, or 128% due to its continued focus of growing the commercial practice in the managed services space coupled with the June 2015 acquisition of Twisted Technologies.

Gross margin increased 3446% to \$1,454,000 in the first quarter of 2016 compared to \$41,000 in the same period in 2015. Gross margin as a percentage of sales increased to 33.7% in 2016 from 4.8% in 2015 due to sales mix. Gross margin as a percentage of 2015 sales was abnormally low due to low sales volume and relatively fixed overhead costs. Selling, general and administrative expenses increased 24% in 2016 to \$1,006,000, or 23.3% of sales, compared to \$810,000, or 93.6% of sales, in 2015. Selling, general and administrative expenses increased primarily due to an increase in staffing and back office expenses associated with a higher level of sales activity. JDL Technologies reported operating income of \$448,000 in the first quarter of 2016 compared to an operating loss of \$769,000 in the same period of 2015.

Net2Edge Results

In 2016, the Company realigned its business operations and separated out Net2Edge (formerly known as TN EMEA). Net2Edge's sales increased 71% to \$569,000 in the first quarter of 2016 compared to \$332,000 in 2015 due to increased sales on its new Liberator product line. Gross margin increased 33% to \$328,000 in the first quarter of 2016 compared to \$246,000 in the same period of 2015. Gross margin as a percentage of sales decreased to 57.6% in 2016

from 73.8% in 2015 due to product mix from legacy products to new product lines. Selling, general and administrative expenses increased 5% in 2016 to \$731,000 compared to \$696,000 in 2015 due to an increase in research and development spend as the Company works on developing new product lines. Net2Edge reported an operating loss of \$403,000 in the first quarter of 2016 compared to a loss of \$451,000 in the same period of 2015.

Other

The Company's loss before income taxes decreased to \$2,132,000 in 2016 compared to \$5,637,000 in 2014. The Company recognized a net gain of \$808,000, primarily due to the sale of the Austin Taylor facility and a foreign currency translation loss of \$4,238,000, due to the substantial liquidation of Austin Taylor within other expenses during the first quarter of 2016. The Company's effective income tax rate was (15.7%) in 2016 and 26.1% in 2015. This effective tax rate for 2016 differs from the federal tax rate of 35% due to state income taxes, foreign tax rate differences, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges for uncertain income tax positions, and changes in valuation allowances related to deferred tax assets.

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Liquidity and Capital Resources

As of March 31, 2016, the Company had approximately \$17,761,000 in cash, cash equivalents and investments. Of this amount, \$2,480,000 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 that are fully insured through the FDIC. The Company also had \$10,302,000 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 March 31, 2016.

The Company had working capital of \$47,519,000, consisting of current assets of approximately \$62,806,000 and current liabilities of \$15,287,000 at March 31, 2016 compared to working capital of \$46,449,000, consisting of current assets of \$61,890,000 and current liabilities of \$15,441,000 at December 31, 2015.

Cash flow used by operating activities was approximately \$3,475,000 in 2016 compared to \$2,877,000 used in the same period of 2015. Significant working capital changes from December 31, 2015 to March 31, 2016 included an increase in receivables of \$634,000 and a decrease in payables of \$1,119,000.

Net cash provided by investing activities was \$1,419,000 in 2016 compared to \$96,000 used in the same period of 2015, due to proceeds from the sale of investments and a gain on the sale of assets, specifically the land and building of our Austin Taylor facility in the U.K. during the first quarter.

Net cash used in financing activities was \$316,000 in 2016 compared to \$1,536,000 used in the same period of 2015. Cash dividends paid on common stock increased to \$1,419,000 in 2016 (\$0.16 per common share) from \$1,395,000 in 2015. Proceeds from common stock issuances, principally shares sold to the Company's Employee Stock Ownership Plan and issued under the Company's Employee Stock Purchase Plan, totaled approximately \$51,000 in 2016 and \$43,000 in 2015. The Company did not repurchase any shares in 2016 or 2015 under the Board-authorized program. At March 31, 2016, Board of Director authority to purchase approximately 411,910 additional shares remained in effect. The Company acquired \$21,000 and \$51,000 in 2016 and 2015, respectively, 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 has a \$10,000,000 line of credit from Wells Fargo Bank. Interest on borrowings on the credit line is at LIBOR plus 1.5% (1.9% at March 31, 2016). The Company had \$1,500,000 in outstanding borrowings against the line

of credit at March 31, 2016 and no borrowings at March 31, 2015. 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.

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Critical Accounting Policies

Our critical accounting policies, including the assumptions and judgments underlying them, are discussed in our 2015 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, 2016.

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

Recently Issued Accounting Pronouncements

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. As a result of the FASB's July 2015 deferral of the standard's required implementation date, the guidance is effective for interim and annual reporting periods beginning after December 15, 2017. The Company is currently evaluating the impact of adopting this standard on its consolidated financial statements.

In April 2015, the FASB issued accounting guidance that changes the presentation of debt issuance costs. The core principle of this revised accounting guidance is that debt issuance costs are not assets, but adjustments to the carrying cost of debt. The Company adopted this guidance in the first quarter of 2016 with no material impact on its consolidated financial statements.

In July 2015, the FASB issued an accounting standard on inventory, which simplifies the subsequent measurement of inventory by requiring entities to measure inventory at the lower of cost or net realizable value, except for inventory measured using the last-in, first-out (LIFO) or the retail inventory methods. This standard requires entities to compare

the cost of inventory to one measure – net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The standard is effective for the annual period beginning after December 15, 2015 and interim periods within those annual periods, with early adoption permitted, and is to be applied prospectively. The Company does not expect the adoption of this standard to have a material impact on its consolidated financial statements.

In November 2015, the FASB issued an accounting standard on deferred taxes, which removes the requirement to present deferred tax assets and liabilities as current and noncurrent on the balance sheet based on the classification of the related asset or liability, and instead requires classification of all deferred tax assets and liabilities as noncurrent. This guidance will be effective for interim and annual reporting periods beginning after December 15, 2016, and early adoption is permitted. Other than the prescribed classification of all deferred tax assets and liabilities as noncurrent, the Company does not expect the implementation of this standard to have a material impact on its consolidated financial statements.

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In February 2016, the FASB issued new accounting requirements regarding accounting for leases, which requires an entity to recognize both assets and liabilities arising from financing and operating leases, along with additional qualitative and quantitative disclosures. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within that reporting period, and early adoption is permitted. We have not yet determined the potential effects on our financial condition or results of operations.

In March 2016, the FASB issued a new accounting standard that will change certain aspects of accounting for share-based payments to employees, including the accounting for income taxes, forfeitures and statutory withholding requirements, as well as classification in the statement of cash flows. The new standard is effective for annual and interim periods beginning after December 15, 2016. We have not yet determined the impact this standard will have on our financial condition or results of operations.

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, 2016 our bank line of credit carried a variable interest rate based on LIBOR plus 1.5%.

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.

Except as set forth below, 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

Issuer Repurchases of Equity Securities

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | (a) Total Number of Shares (or Units) Purchased | Average Price Paid per Share (or Unit) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | (b) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|---------------|---|---|--|---|
| January 2016 | — | \$ — | — | 411,910 |
| February 2016 | — | — | — | 411,910 |
| March 2016 | 3,050 | 6.99 | — | 411,910 |
| Total | 3,050 | \$ 6.99 | — | 411,910 |

(a) 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.

(b) 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 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

Not Applicable.

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 Communications Systems, Inc. Press Release dated May 5, 2016 announcing 2016 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/ Roger H.D. Lacey
Roger H.D. Lacey
Chief Executive
Officer

Date: May 6, 2016

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

Date: May 6, 2016