COMMUNICATIONS SYSTEMS INC
Form 10-Q
August 18, 2017

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 **June 30, 2017**

OR

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

For the transition period from _________ to _________

Commission File Number: 001-31588

COMMUNICATIONS SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

MINNESOTA (State or other jurisdiction of incorporation or organization)	41-0957999 (Federal Employer Identification No.)
10900 Red Circle Drive, Minnetonka, MN (Address of principal executive offices)	55343 (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

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

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer Smaller Reporting Company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 August 1, 2017**
Common Stock, par value $.05 per share	NASDAQ	8,956,343

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
ASSETS

	June 30 2017	**December 31 2016**
CURRENT ASSETS:		
Cash and cash equivalents	$19,112,086	$10,443,274
Investments	1,444,556	5,805,276
Trade accounts receivable, less allowance for doubtful accounts of $130,000 and $77,000, respectively	12,750,055	14,552,191
Inventories	18,274,381	22,204,902
Prepaid income taxes	595,273	1,400,118
Other current assets	978,082	967,332
TOTAL CURRENT ASSETS	53,154,433	55,373,093
PROPERTY, PLANT AND EQUIPMENT, net	14,197,023	15,719,403
OTHER ASSETS:		
Goodwill	—	1,462,503
Other assets, net	290,735	622,017
TOTAL OTHER ASSETS	290,735	2,084,520
TOTAL ASSETS	$67,642,191	$73,177,016
LIABILITIES AND STOCKHOLDERS’ EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$6,483,710	$6,953,710
Accrued compensation and benefits	3,072,470	2,149,973
Other accrued liabilities	1,679,387	1,851,938
Dividends payable	397,768	412,542
TOTAL CURRENT LIABILITIES	11,633,335	11,368,163
LONG TERM LIABILITIES:		
Long-term compensation plans	53,907	16,299
Uncertain tax positions	110,973	106,864
Deferred income taxes	—	52,998
TOTAL LONG-TERM LIABILITIES	164,880	176,161
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; 8,956,343 and 8,877,379 shares issued and outstanding, respectively	447,817	443,869
Additional paid-in capital	41,786,018	41,279,281
Retained earnings	14,267,533	20,596,203
Accumulated other comprehensive loss	(657,392)	(686,661)

TOTAL STOCKHOLDERS’ EQUITY	55,843,976	61,632,692
TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY	$67,642,191	$73,177,016

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 June 30		**Six Months Ended June 30**	
	2017	**2016**	**2017**	**2016**
Sales	$22,068,462	$26,311,442	$42,868,541	$50,977,886
Cost of sales	16,057,822	18,935,699	30,892,836	36,833,125
Gross profit	6,010,640	7,375,743	11,975,705	14,144,761
Operating expenses:				
Selling, general and administrative expenses	7,318,047	10,047,201	14,355,302	19,684,262
Pension liability adjustment gains	—	—	—	(4,147,836)
Impairment loss	1,617,389	—	1,617,389	—
Restructuring expense	1,141,992	—	1,529,630	—
Total operating expenses	10,077,428	10,047,201	17,502,321	15,536,426
Operating loss	(4,066,788)	(2,671,458)	(5,526,616)	(1,391,665)
Other income (expenses):				
Investment and other income (loss)	(1,667)	72,484	40,019	100,136
(Loss) Gain on sale of assets	(40,446)	—	(58,246)	808,322
Interest and other expense	(9,481)	(41,074)	(19,040)	(50,146)
Foreign currency translation loss	—	—	—	(4,238,497)
Other (expense) income, net	(51,594)	31,410	(37,267)	(3,380,185)
Loss from operations before income taxes	(4,118,382)	(2,640,048)	(5,563,883)	(4,771,850)
Income tax (benefit) expense	(27,685)	(95,550)	42,326	239,316
Net loss	(4,090,697)	(2,544,498)	(5,606,209)	(5,011,166)
Other comprehensive income (loss), net of tax:				
Additional minimum pension liability adjustments	—	—	—	(4,147,836)
Unrealized gain on available-for-sale securities	(1,163)	1,300	(2,947)	38,304
Foreign currency translation adjustment	37,204	(171,841)	32,216	4,153,125
Total other comprehensive income (loss)	36,041	(170,541)	29,269	43,593
Comprehensive loss	$(4,054,656)	$(2,715,039)	$(5,576,940)	$(4,967,573)
Basic net loss per share:	$(0.46)	$(0.29)	$(0.63)	$(0.56)
Diluted net loss per share:	$(0.46)	$(0.29)	$(0.63)	$(0.56)
Weighted Average Basic Shares Outstanding	8,947,070	8,849,236	8,920,779	8,899,056
Weighted Average Dilutive Shares Outstanding	8,947,070	8,849,236	8,920,779	8,899,056
Dividends declared per share	$0.04	$0.16	$0.08	$0.32

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 Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total
BALANCE AT DECEMBER 31, 2016	8,877,379	$443,869	$41,279,281	$20,596,203	$ (686,661)	$61,632,692
Net loss				(5,606,209)		(5,606,209)
Issuance of common stock under Employee Stock Purchase Plan	11,518	576	51,519			52,095
Issuance of common stock to Employee Stock Ownership Plan	47,248	2,362	216,396			218,758
Issuance of common stock under Executive Stock Plan	21,805	1,090	0			1,090
Share based compensation			246,266			246,266
Other share retirements	(1,607)	(80)	(7,444)	598		(6,926)
Shareholder dividends				(723,059)		(723,059)
Other comprehensive income					29,269	29,269
BALANCE AT JUNE 30, 2017	8,956,343	$447,817	$41,786,018	$14,267,533	$ (657,392)	$55,843,976

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)

	Six Months Ended June 30	
	2017	**2016**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(5,606,209)	$(5,011,166)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,722,382	1,833,848
Share based compensation	246,266	449,997
Deferred taxes	(52,999)	(20,528)
Impairment loss	1,617,389	—
Change in fair value of acquisition-related contingent consideration	—	(20,229)
Loss (gain) on sale of assets	58,246	(808,322)
Excess tax benefit from share-based payments	—	49,543
Changes in assets and liabilities:		
Trade accounts receivable	1,813,679	631,205
Inventories	3,958,892	(1,843,034)
Prepaid income taxes	806,070	(24,889)
Other assets	152,665	(821,584)
Accounts payable	(644,549)	1,763,436
Accrued compensation and benefits	1,176,457	1,185,587
Other accrued liabilities	(183,883)	120,537
Income taxes payable	4,109	(38,610)
Other	—	52,402
Net cash provided by (used in) operating activities	5,068,515	(2,501,807)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(138,374)	(1,271,190)
Proceeds from the sale of property, plant and equipment	73,400	969,114
Proceeds from the sale of investments	4,357,774	1,504,862
Net cash provided by investing activities	4,292,800	1,202,786
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings on line of credit	—	3,100,000
Cash dividends paid	(737,833)	(2,844,805)
Mortgage principal payments	—	(103,603)
Proceeds from issuance of common stock, net of shares withheld	46,259	57,368
Excess tax expense benefit from share-based payments	—	(49,543)
Payment of deferred consideration related to acquisition	—	(300,000)
Net cash used in financing activities	(691,574)	(140,583)
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	(929)	(118,677)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	8,668,812	(1,558,281)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	10,443,274	9,812,737
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$19,112,086	$8,254,456

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Income taxes (refunded) paid	$(662,821)	$274,918
Interest paid	19,641	23,327
Dividends declared not paid	397,768	1,503,034
Capital expenditures in accounts payable	171,985	26,418
Acquisition costs in accrued consideration	—	122,005

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. CSI is principally engaged through its Suttle business unit in the manufacture and sale of connectivity infrastructure products for broadband and voice communications and through its Transition Networks business unit in the manufacture of core media conversion products, Ethernet switches, and other connectivity and data transmission products. 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 enables telecommunications carriers to connect legacy networks to high-speed services.

The Company classifies its businesses into four segments corresponding to the Suttle, Transition Networks, JDL Technologies and Net2Edge business units. Non-allocated general and administrative expenses are separately accounted for as “Other” in the Company’s segment reporting. Intersegment revenues are eliminated upon consolidation.

Financial Statement Presentation

The condensed consolidated balance sheets and condensed consolidated statement of changes in stockholders’ equity as of June 30, 2017 and the related condensed consolidated statements of loss and comprehensive loss, and the condensed consolidated statements of cash flows for the periods ended June 30, 2017 and 2016 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 June 30, 2017 and 2016 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, 2016 Annual Report to Shareholders on Form 10-K. The results of operations for the period ended June 30, 2017 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 and 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, 2016, appropriately represent, in all material respects, the current status of accounting policies, and are incorporated herein by reference.

Accumulated Other Comprehensive Loss

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

	Foreign Currency Translation	**Unrealized (loss)/gain on securities**	**Accumulated Other Comprehensive Loss**
December 31, 2016	$ (704,000)	$ 17,000	$ (687,000)
Net current period change	33,000	(3,000)	30,000
June 30, 2017	$ (671,000)	$ 14,000	$ (657,000)

The Company recognized $4,238,000 in foreign currency translation losses within the income statement during the first quarter of 2016 due to the substantial liquidation of our Austin Taylor facility in the U.K. Refer to Note 11 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 June 30, 2017 and December 31, 2016:

June 30, 2017

	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**	**Cash Equivalents**	**Short-Term Investments**	**Long-Term Investments**

Cash equivalents:							
Money Market funds	$8,245,000	$ —	$ —	$8,245,000	$8,245,000	$—	$ —
Subtotal	8,245,000	—	—	8,245,000	8,245,000	—	—
Investments:							
Certificates of deposit	1,445,000	—	—	1,445,000	—	1,445,000	—
Subtotal	1,445,000	—	—	1,445,000	—	1,445,000	—
Total	$9,690,000	$ —	$ —	$9,690,000	$8,245,000	$1,445,000	$ —

December 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	$3,851,000	$ —	$ —	$3,851,000	$3,851,000	$—	$ —
Subtotal	3,851,000	—	—	3,851,000	3,851,000	—	—
Investments:							
Certificates of deposit	4,291,000	4,000	(1,000)	4,294,000	—	4,294,000	—
Corporate Notes/Bonds	1,511,000	—	—	1,511,000	—	1,511,000	—
Subtotal	5,802,000	4,000	(1,000)	5,805,000	—	5,805,000	—
Total	$9,653,000	$ 4,000	$ (1,000)	$9,656,000	$3,851,000	$5,805,000	$ —

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 June 30, 2017 were in a continuous unrealized loss position for less than twelve months and are not deemed to be other than temporarily impaired as of June 30, 2017.

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 June 30, 2017:

	Amortized Cost	**Estimated Market Value**
Due within one year	$1,445,000	$1,445,000

The Company did not recognize any gross realized gains or losses during the three and six month periods ending June 30, 2017 and 2016, respectively. If the Company had realized gains or losses, they would be included within investment and other income in the accompanying condensed consolidated statement of loss and comprehensive loss.

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 June 30, 2017. The ESPP is considered compensatory under current Internal Revenue Service rules. At June 30, 2017, after giving effect to the shares issued as of that date, 65,347 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 2017, stock options covering 259,686 shares have been awarded to key executive employees and directors. These options expire seven years from the date of award and generally vest 25% each year beginning one year after the date of award. The Company also granted deferred stock awards of 100,239 shares to key employees during the first quarter of 2017 under the Company's long-term incentive plan for performance over the 2017 to 2019 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, 2019 and any shares earned will be issued in the first quarter of 2020 to those key employees still with the Company at that time.

At June 30, 2017, 159,388 shares have been issued under the 2011 Incentive Plan, 1,302,763 shares are subject to currently outstanding options, deferred stock awards, and unvested restricted stock units, and 537,849 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 have been granted under the Director Plan since 2011 when the Company amended the Director Plan to prohibit future option grants. As of June 30, 2017, there were 51,000 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 equity awards. At June 30, 2017, after reserving for stock options and deferred stock awards granted in prior years and adjusting for forfeitures and issuances during the year, there were 10,230 shares reserved for issuance under the Stock Plan.

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, 2016 to June 30, 2017:

	Options	**Weighted average exercise price per share**	**Weighted average remaining contractual term**
Outstanding – December 31, 2016	922,930	$ 10.10	4.90
Awarded	259,686	4.42	
Exercised	—	—	
Forfeited	(34,888)	11.47	
Outstanding – June 30, 2017	1,147,728	8.77	4.99
Exercisable at June 30, 2017	671,183	$ 10.51	4.23
Expected to vest June 30, 2017	1,147,728	8.77	4.99

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 June 30, 2017 was $0. The intrinsic value of all options exercised during the six months ended June 30, 2017 was $0. Net cash proceeds from the exercise of all stock options were $0 in each of the six month periods ended June 30, 2017 and 2016.

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, 2016 to June 30, 2017:

	Shares	**Weighted Average Grant Date Fair Value**

Outstanding – December 31, 2016	149,260	$ 9.55
Granted	100,239	4.42
Vested	(8,464)	12.50
Forfeited	(38,111)	10.82
Outstanding – June 30, 2017	202,924	6.65

Changes in Restricted Stock Units Outstanding

The following table summarizes the changes in the number of restricted stock units under the 2011 Incentive Plan over the period December 31, 2016 to June 30, 2017:

	Shares	**Weighted Average Grant Date Fair Value**
Outstanding – December 31, 2016	27,134	$8.65
Granted	—	—
Issued	(13,341)	11.05
Forfeited	—	—
Outstanding – June 30, 2017	13,793	6.33

Compensation Expense

Share-based compensation expense recognized for the six month period ended June 30, 2017 was $246,000 before income taxes and $160,000 after income taxes. Share-based compensation expense recognized for the six month period ended June 30, 2016 was $450,000 before income taxes and $292,000 after income taxes. Unrecognized compensation expense for the Company’s plans was $616,000 at June 30, 2017 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 six month periods ended June 30, 2017 and 2016 were $ 0 and $ (50,000), 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:

	June 30 2017	**December 31 2016**
Finished goods	$9,597,000	$12,083,000
Raw and processed materials	8,677,000	10,122,000
	$18,274,000	$22,205,000

NOTE 5 –GOODWILL AND 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. In January 2017, the FASB issued new accounting guidance regarding the simplification of the test for goodwill impairment. The new standard eliminates the quantitative goodwill impairment analysis requirement to determine the fair value of individual assets and liabilities of a reporting unit to determine the amount of any goodwill impairment and instead permits an entity to recognize goodwill impairment loss as the excess of a reporting unit’s carrying value over the estimated fair value of the reporting unit, to the extent this amount does not exceed the carrying amount of goodwill. The Company chose to adopt this standard early for the annual impairment analysis in 2017. The Company performed the first step of the previous two-step process, which 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, an impairment adjustment must be recorded.

The Company performs its annual impairment analysis as of April 1 each year. The Company analyzed the reporting unit that had the goodwill and also analyzed the company as a whole, including the Company's four separate reporting units. Although JDL Technologies had been profitable for the past eight quarters, the cyclicality and unpredictability of revenues from its education sector raised issues in forecasting cash flows in future quarters used to estimate the reporting unit's fair value. Based on this analysis of comparing the fair value of each reporting unit to the book value, and comparing the Company's overall book value with its market capitalization, the Company determined that the book value exceeded the overall fair value of the reporting units as well as the Company's overall market value. As a result, the Company recorded a goodwill impairment charge totaling $1,463,000 during the second quarter of 2017.

The changes in the carrying amount of goodwill for the six months ended June 30, 2017 by segment are as follows:

	JDL Technologies
January 1, 2017	$ 1,463,000
Impairment loss	(1,463,000)
June 30, 2017	$ —
Gross goodwill	1,463,000
Accumulated impairment loss	(1,463,000)
Balance at June 30, 2017	$ —

As part of the overall annual impairment analysis noted above, the Company also reviewed other intangible assets for potential impairment. Based on this analysis, the Company deemed the intangible assets related to customer relationships to be impaired and recorded a $154,000 impairment loss during the second quarter of 2017.

The Company's identifiable intangible assets with finite lives, included in other assets, net on the condensed consolidated balance sheets, are being amortized over their estimated useful lives and were as follows:

	June 30, 2017				
	Gross Carrying Amount	Accumulated Amortization	Impairment loss	Foreign Currency Translation	Net
Trademarks	$93,000	$ (58,000)	$ —	$ (17,000)	$ 18,000
Customer relationships	491,000	(230,000)	(154,000)	(107,000)	—
Technology	229,000	(182,000)	—	(47,000)	—
	$813,000	$ (470,000)	$ (154,000)	$ (171,000)	$ 18,000

	December 31, 2016				
	Gross Carrying Amount	Accumulated Amortization	Impairment loss	Foreign Currency Translation	Net
Trademarks	$91,000	$ (50,000)	$ —	$ (20,000)	$ 21,000
Customer relationships	491,000	(200,000)	—	(122,000)	169,000
Technology	229,000	(172,000)	—	(57,000)	—
	$811,000	$ (422,000)	$ —	$ (199,000)	$ 190,000

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Amortization expense on these identifiable intangible assets was $24,000 and $47,000 for the six months ended 2017 and 2016, respectively. The amortization expense is included in selling, general and administrative expenses. At June 30, 2017, the estimated future amortization expense for definite-lived intangible assets for the remainder of 2017 and all of the following four fiscal years is as follows:

Year Ending December 31:	
2017	$ 5,000
2018	7,000
2019	2,000
2020	2,000
2021	2,000

NOTE 6 – WARRANTY

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

The following table presents the changes in the Company's warranty liability for the six month periods ended June 30, 2017 and 2016, respectively, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

	2017	**2016**
Beginning balance	$600,000	$554,000
Amounts charged to expense	25,000	78,000
Actual warranty costs paid	(35,000)	(58,000)
Ending balance	$590,000	$574,000

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 – 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 paid $104,000 in the first quarter of 2016 to fully settle the liability.

Line of Credit

The Company has a $15,000,000 line of credit from Wells Fargo Bank. The Company had no outstanding borrowings against the line of credit at June 30, 2017 and December 31, 2016. 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 June 30, 2017 was $9,971,000, based on the borrowing base calculation. Interest on borrowings on the credit line is at LIBOR plus 2.0% (3.2% at June 30, 2017). The credit agreement expires August 12, 2021 and is secured by assets of the Company. Our credit agreement contains financial covenants including a minimum liquidity balance of $10,000,000. Liquidity is calculated as the sum of unrestricted cash, marketable securities and the availability on the line of credit. The Company was in compliance with its financial covenants at June 30, 2017.

NOTE 9 – 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. Management analyzes these assets and liabilities regularly and assesses the likelihood that deferred tax assets will be recovered from future taxable income.

At June 30, 2017 there was $222,000 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 Loss and Comprehensive Loss.

The Company is subject to U.S. federal income tax as well as income tax of multiple state and foreign jurisdictions. The tax years 2013-2016 remain open to examination by the Internal Revenue Service and the years 2012-2016 remain open to examination by various state tax departments. The tax years from 2013-2016 remain open in Costa Rica. 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. As of June 30, 2017, the examination was complete. The settlement and payment that resulted from the examination did not have a material effect on our results of operations.

The Company's effective income tax rate was (0.8%) for the first six months of 2017. 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, stock compensation shortfalls 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 (18.2%) for the six months ended June 30, 2017. There were no additional uncertain tax positions identified in the first six months of 2017. The Company's effective income tax rate for the six months ended June 30, 2016 was (5.0%), and differed from the federal tax rate 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.

NOTE 10 – SEGMENT INFORMATION

The Company classifies its businesses into four segments as follows:

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 that address prevalent IT challenges, including virtualization and cloud solutions, managed services, wired and wireless network design and implementation, and converged infrastructure configuration and deployment; and

Net2Edge develops, manufactures and sells products that enable telecommunications carriers to connect 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.

Information concerning the Company's continuing operations in the various segments for the three and six month periods ended June 30, 2017 and 2016 is as follows:

	Suttle	Transition Networks	JDL Technologies	Net2Edge	Other	Intersegment Eliminations	Total
Three Months Ended June 30, 2017							
Sales	$8,580,000	$9,500,000	$4,026,000	$180,000	$—	$(218,000)	$22,068,000
Cost of sales	7,767,000	5,206,000	3,065,000	40,000	—	(20,000)	16,058,000
Gross profit	813,000	4,294,000	961,000	140,000	—	(198,000)	6,010,000
Selling, general and administrative expenses	2,325,000	3,933,000	557,000	701,000	—	(198,000)	7,318,000

Impairment loss	—	—	1,463,000	154,000	—	—	1,617,000
Restructuring expense	1,142,000	—	—	—	—	—	1,142,000
Operating (loss) income	$(2,654,000)	$361,000	$(1,059,000)	$(715,000)	$—	$—	$(4,067,000)
Depreciation and amortization	$579,000	$173,000	$77,000	$20,000	$—	$—	$849,000
Capital expenditures	$25,000	$25,000	$3,000	$43,000	$4,000	$—	$100,000
Assets	$31,292,000	$15,262,000	$4,122,000	$1,294,000	$15,699,000	$(27,000)	$67,642,000

	Suttle	**Transition Networks**	**JDL Technologies**	**Net2Edge**	**Other**	**Intersegment Eliminations**	**Total**
Three Months Ended June 30, 2016							
Sales	$11,216,000	$10,175,000	$4,650,000	$591,000	$—	$(321,000)	$26,311,000
Cost of sales	10,116,000	5,773,000	2,783,000	314,000	—	(50,000)	18,936,000
Gross profit	1,100,000	4,402,000	1,867,000	277,000	—	(271,000)	7,375,000
Selling, general and administrative expenses	3,661,000	4,762,000	961,000	931,000	—	(268,000)	10,047,000
Operating (loss) income	$(2,561,000)	$(360,000)	$906,000	$(654,000)	$—	$(3,000)	$(2,672,000)
Depreciation and amortization	$616,000	$232,000	$63,000	$32,000	$—	$—	$943,000
Capital expenditures	$342,000	$75,000	$9,000	$2,000	$40,000	$(3,000)	$465,000
Assets	$39,811,000	$19,798,000	$5,911,000	$1,670,000	$18,782,000	$(26,000)	$85,946,000

	Suttle	Transition Networks	JDL Technologies	Net2Edge	Other	Intersegment Eliminations	Total
Six Months Ended June 30, 2017							
Sales	$17,352,000	$18,504,000	$6,891,000	$537,000	$ —	$(416,000)	$42,868,000
Cost of sales	15,480,000	10,325,000	4,969,000	140,000	—	(22,000)	30,892,000
Gross profit	1,872,000	8,179,000	1,922,000	397,000	—	(394,000)	11,976,000
Selling, general and administrative expenses	4,536,000	7,672,000	1,133,000	1,408,000	—	(394,000)	14,355,000
Impairment loss	—	—	1,463,000	154,000	—	—	1,617,000
Restructuring expense	1,530,000	—	—	—	—	—	1,530,000
Operating (loss) income	$(4,194,000)	$507,000	$(674,000)	$(1,165,000)	$ —	$—	$(5,526,000)
Depreciation and amortization	$1,170,000	$360,000	$154,000	$38,000	$ —	$—	$1,722,000
Capital expenditures	$48,000	$25,000	$5,000	$60,000	$ —	$—	$138,000

	Suttle	Transition Networks	JDL Technologies	Net2Edge	Other	Intersegment Eliminations	Total
Six Months Ended June 30, 2016							
Sales	$23,005,000	$18,506,000	$8,963,000	$1,159,000	$—	$(655,000)	$50,978,000
Cost of sales	19,860,000	10,920,000	5,641,000	554,000	—	(142,000)	36,833,000
Gross profit	3,145,000	7,586,000	3,322,000	605,000	—	(513,000)	14,145,000
Selling, general and administrative expenses	7,147,000	9,401,000	1,968,000	1,662,000	—	(494,000)	19,684,000
Pension liability adjustment gains	—	—	—	—	(4,148,000)	—	(4,148,000)
Operating (loss) income	$(4,002,000)	$(1,815,000)	$1,354,000	$(1,057,000)	$4,148,000	$(19,000)	$(1,391,000)
Depreciation and amortization	$1,192,000	$453,000	$124,000	$65,000	$—	$—	$1,834,000
Capital expenditures	$821,000	$160,000	$84,000	$2,000	$223,000	$(19,000)	$1,271,000

NOTE 11 – PENSIONS

The Company's U.K. based subsidiary Austin Taylor maintained a defined benefit pension plan for its employees through March 31, 2016. 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 and six months ended June 30, 2017 and 2016 were:

	Three Months Ended June 30		Six Months Ended June 30	
	2017	**2016**	**2017**	**2016**
Service cost	$ —	$ —	$ —	$ —
Interest cost	—	—	—	26,000
Expected return on assets	—	—	—	(24,000)
Settlement benefit	—	—	—	(43,000)
Net periodic pension benefit	$ —	$ —	$ —	$ (41,000)

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The Company settled all its obligations under this 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 12 – NET 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 and six month periods ended June 30, 2017 and 2016. The Company calculates the dilutive effect of outstanding options using the treasury stock method. Due to the net losses in the first three and six months of 2017 and 2016, there was no dilutive impact from stock options or unvested shares. Options totaling 888,042 were excluded from the calculation of diluted earnings per share for the three months and six ended June 30, 2017 because the exercise price was greater than the average market price of common stock during the period and deferred stock awards totaling 187,958 shares would not have been included for the three and six months ended June 30, 2017 because of unmet performance conditions. Options totaling 896,192 and 739,870 were excluded from the calculation of diluted earnings per share for the three and six months ended June 30, 2016 because the exercise price was greater than the average market price of common stock during the period and deferred stock awards totaling 159,689 shares would not have been included for the three and six months ended June 30, 2016 because of unmet performance conditions.

NOTE 13 – 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.

As discussed in Note 5, we tested our goodwill for impairment as of April 1, 2017. As part of this impairment testing, the Company determined the fair value of the net assets of the JDL Technologies reporting unit, based primarily on discounted cash flows and forecasted future operating results, which represent Level 3 inputs. As a result of our analysis, the Company recorded a non-cash impairment charge of $1,463,000 to fully impair goodwill. A reconciliation of the beginning and ending balances of goodwill are included in Note 5.

Financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2017 and December 31, 2016, are summarized below:

June 30, 2017

	Level 1	**Level 2**	**Level 3**	**Total Fair Value**
Cash equivalents:				
Money Market funds	$8,245,000	$—	$ —	$8,245,000
Subtotal	8,245,000	—	—	8,245,000
Short-term investments:				
Certificates of deposit	—	1,445,000	—	1,445,000
Subtotal	—	1,445,000	—	1,445,000
Total	$8,245,000	$1,445,000	$ —	$9,690,000

December 31, 2016

	Level 1	Level 2	Level 3	Total Fair Value
Cash equivalents:				
Money Market funds	$3,851,000			