

ELECTRO SENSORS INC  
Form 10KSB  
March 25, 2005

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

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**Form 10-KSB**

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

**For the fiscal year ended December 31, 2004**

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**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 0-9587**

**ELECTRO-SENSORS, INC.**

(Name of Small Business Issuer in its Charter)

**Minnesota**

(State or Other Jurisdiction of Incorporation or  
Organization)

**41-0943459**

(IRS Employer Identification Number)

**6111 Blue Circle Drive**

**Minnetonka, Minnesota 55343-9108**

(Address of Principal Executive Offices, including Zip Code)

**(952) 930-0100**

(Registrant's Telephone Number, including Area Code)

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, \$0.10 par value**

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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

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days. Yes  No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

The issuer's revenues for the fiscal year ended December 31, 2004 were \$4,799,000.

The aggregate market value of the voting stock held by non-affiliates (persons other than officers, directors, or holders of more than 5% of the outstanding stock) of the registrant was approximately \$8,157,000 based upon the closing price of the Common Stock as reported on The Nasdaq Stock Market® on February 21, 2005.

The number of shares outstanding of the registrant's Common Stock, \$0.10 par value, on February 21, 2005 was 3,219,212.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's Proxy Statement for its Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-KSB.

Transitional Small Business Disclosure Format (check one): Yes  No

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**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**Form 10-KSB for the Year Ended December 31, 2004**  
**TABLE OF CONTENTS**

**PART I**

<u>Item 1</u>	<u>Description of Business</u>
<u>Item 2</u>	<u>Description of Property</u>
<u>Item 3</u>	<u>Legal Proceedings</u>
<u>Item 4</u>	<u>Submission of Matters to a Vote of Security Holders</u>

**PART II**

<u>Item 5</u>	<u>Market for Common Equity, Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities</u>
<u>Item 6</u>	<u>Management's Discussion and Analysis or Plan of Operation</u>
<u>Item 7</u>	<u>Financial Statements</u>
<u>Item 8</u>	<u>Changes In and Disagreements with Accountants on Accounting and Financial Disclosure</u>
<u>Item 8A</u>	<u>Controls and Procedures</u>
<u>Item 8B</u>	<u>Other Information</u>

**PART III**

<u>Item 9</u>	<u>Directors and Executive Officers of the Registrant</u>
<u>Item 10</u>	<u>Executive Compensation</u>
<u>Item 11</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>
<u>Item 12</u>	<u>Certain Relationships and Related Transactions</u>
<u>Item 13</u>	<u>Exhibits</u>
<u>Item 14</u>	<u>Principal Accountant Fees and Services</u>

**SIGNATURES**

**PART I**

**Item 1 Description of Business**

*Introduction*

Electro-Sensors, Inc. (the Company or ESI) is engaged in two distinct operating segments: (1) the manufacture and distribution of industrial production monitoring and process control systems through its Controls Division, and (2) the development and distribution of PC-based software for both automated survey processing and hand printed character recognition through its AutoData® Systems Division. The operating segments were based on the markets that were served and the products that we provided to those markets.

In addition, through its subsidiary ESI Investment Company, the Company periodically invests in other businesses and companies. Although ESI, through its subsidiary ESI Investment Company, invests in other businesses or companies, ESI does not intend to become an investment company and intends to remain primarily an operating company. The primary investments are 669,715 shares of August Technology Corporation and 2,207,036 shares of PPT Vision, Inc both of which are traded on the Nasdaq Stock Exchange. The PPT Vision investment is accounted for under the equity method of accounting.

Unless indicated otherwise, the terms Company and ESI when used herein, includes Electro-Sensors, Inc. and its consolidated subsidiaries. As of December 31, 2004, ESI had two consolidated subsidiaries: ESI Investment Company and Senstar Corporation.

ESI, incorporated in Minnesota in July 1968, has executive offices located at 6111 Blue Circle Drive, Minnetonka, Minnesota, 55343 and telephone number (952) 930-0100.

*Operating Segments/Principal Products/Markets*

*Production Monitoring Systems - Controls Division*

The Company's Controls Division manufactures and sells several different types of monitoring systems that measure actual machine production and operation rates, as well as systems that regulate the speed of related machines in production processes.

*Speed Monitoring Systems.* The Company's original products, speed monitoring systems, compare machine revolutions per minute or speed against acceptable rates as determined by the customer. The monitors generally have the same relative operating principle and use a non-contacting sensing head that translates the speed of a rotating shaft into analog

readouts. The systems include a signal-generating pulser disc or wrap that attaches to a rotating shaft, the sensing device, and a control unit. The systems vary in complexity, from a simple system that detects slow-downs or stoppages, to more sophisticated systems that warn of deviations from precise tolerances and that permit various subsidiary operations to be determined through monitoring the shaft speed.

Our speed monitoring systems include a line of digital products that translate sensor impulses from its production monitoring systems into digital readouts indicating production counts or rates, such as parts, gallons, or board feet. Our speed monitoring systems also include alarm systems, tachometers, and other devices that translate impulses from the sensors into alarm signals, computer inputs, or digital displays that are usable by the customer.

Two production-monitoring devices that do not operate by measuring shaft speeds are also in our speed monitoring systems product line. These devices are the tilt switch and vibration monitor. A tilt switch is designed to alert the operator when a storage bin or production system reaches a certain capacity (i.e. when grain fills a silo). A vibration monitor will alert an operator when the vibration in a production system exceeds or is below a specified level.

*Drive Control Systems.* In 1987, the Company expanded its speed monitoring systems product line to include products that regulate and synchronize machine speeds. Drive control system products not only monitor machine operation levels, but also regulate the speed of motors on related machines in a production sequence to ensure that the performance of the various machine(s) is coordinated. In the past, these distinct features allowed the Company to market these products under the Drive Control Systems name. The product line consists of a line of digital control products for motors that require a complete closed loop PID (Proportional Integral Derivative) control. The closed loop controllers coordinate production speed among process motors and reduce waste.

In 1988, the Company entered into a sales agreement with MKS Maschinen Kontroll Systeme GmbH ( MKS ), the West German manufacturer of a Synchronous Drive Controller ( SDC ) product line, giving the Company exclusive rights to distribute in the United States the drive control products manufactured by MKS. The SDC product line manufactured by MKS coordinates motors in a production machine with other parts of the machine process. The SDC products were designed for use as a precision speed reference for use with variable speed drives and enable manufacturers to match speed/velocity and phase/position of independently driven machines so they operate together. Applications include synchronizing overhead and floor conveyors and load sharing of multiple motors.

The Company believes that significant savings in both time and materials can be achieved by manufacturing companies by adding drive control technology to existing manufacturing processes to coordinate operation of related machines. The Company intends to continue to market its products in this retro-fit market and also to companies building new manufacturing machinery or processing systems.

The Company expects to continue to expend resources in development and marketing of its various Production Monitoring Systems throughout 2005.

#### *Character Recognition Systems AutoData® Systems Division*

The Company initially began development of its AutoData® Systems as a development project chartered to create opportunities using proprietary pattern recognition technology. The outcome of the project was a Microsoft® Windows® based software system that reads hand printed characters, checkmarks, and barcodes from scanned forms.

The Company's system offers an alternative to manual data entry, by automatically extracting information from paper forms and converting it into a format compatible with most computer databases. This intelligent data entry alternative saves time, strain, and money compared to the method of manual data entry. The basis of the handprint reading capability is Associative Pattern Memory (APM), a patented pattern recognition algorithm. APM is a trainable, neural network-based memory that was incorporated in a Dynamic Link Library (DLL). This DLL is the foundation of the four products currently sold by AutoData® Systems Division.

AutoData® Systems became an operating segment in January 1993. The first software package, AutoData® PRO , was released in May 1993. This software package was designed for the end user. AutoData® PRO, served as a utility software package designed to process only checkmark and handprint information from scanned forms. The software allowed the user to export the data in an ASCII file format.

In September 1993, AutoData® PRO II was released as an upgrade, along with AutoData® SDK . AutoData® SDK allowed Windows developers to embed the AutoData® DLL into their application in order to provide automated data collection from scanned or faxed forms.

In 1996, AutoData® Survey was released. AutoData® Survey was the Company's first software package to include an analysis and report generation feature, greatly enhancing the salability of AutoData® technology. This product was directed at the Healthcare market, where it gained a foothold in patient satisfaction measurement. AutoData® has released two upgrades to the original Survey software, and now markets AutoData® Survey Plus 2000 .

AutoData® Systems released AutoData® Scannable Office software in March 2000. This product provided an upgrade path for PRO II customers, and offered a key enhancement: integration with the Microsoft® Office suite. Scannable Office allows the user to utilize Microsoft® Word to create scannable forms. The software reads data from completed forms and automatically places extracted data directly into Microsoft® Excel, Access or any ODBC-compliant database, setting data up for analysis. Scannable Office has the widest recognition capabilities of the AutoData® end-user products; it contains handprint (ICR), Optical Character (OCR), Optical Mark (OMR), and barcode recognition capabilities.

In December 2002, the company released AutoData® ExpertScan software to its customer base. ExpertScan has handprint (ICR), Optical Mark (OMR) and barcode recognition capabilities. Like Survey Plus 2000, ExpertScan automates survey and form processing, as well as tabulation of results. The product offers several form design and reporting enhancements, and can be sold as an upgrade to Survey Plus 2000, as well as a stand-alone product. ExpertScan provides a mid-range option for AutoData® prospects, rounding out the company's product offering.

### *Marketing and Distribution*

*Controls Division.* The Controls Division sells its products primarily through home office sales people who deal directly with customers and a number of manufacturer's representatives with exclusive territories and non-exclusive distributors located throughout the United States and Canada. The sensing and control units are sold under the Electro-Sensors, Inc. brand as a range of products from simple sensors to complex motor speed controllers. These products are sold to businesses in all major standard industrial classifications, including food processing, chemicals, agricultural, mining, utility, forest products, steel, tire, glass and electronics. Any business that uses machinery with a rotating shaft is a potential customer.

For marketing, the Company advertises in national industrial periodicals that cover a wide range of industrial products and attends several tradeshows designated for the industry throughout the year. A corporate website and other related industry websites are also used for advertising and marketing purposes. The Company expects to continue to market its products in this and related markets.

*AutoData® Systems Division.* The AutoData® Systems Division markets its products primarily through home office sales personnel who deal directly with end-users and a limited number of Value-Added Resellers (VARs). The Company primarily sells in the United States, Canada and Western Europe, and currently actively markets only in the U.S.

### *Competition*

*Controls Division.* Competition for the Company's monitoring products arises from a broad range of industrial and commercial businesses. Design, quality and multiplicity of application, rather than price, are the focus of competition in selling these products. The Company has substantial competition for its production monitoring systems. Many of these competitors are well established and larger in terms of total sales volume. Among the larger competitors are: Danaher Controls, Red Lion Controls, Control Concepts, 4B Elevator Components Ltd., Durant Corporation, and Contrex, Inc. The Company believes its competitive advantages include that its products are sold as ready-to-install units and that its products have a wide range of applications. The Company's major disadvantages include the fact that its major competitors are much larger, have a broader variety of sensing instruments, and have larger sales forces and established names.

*AutoData® Systems.* Competition for the market segment primarily ranges from substitute products such as Data Entry suppliers, to directly competitive software suppliers, and more recently, suppliers of web-based survey software and services. We believe that few direct competitors have as sophisticated recognition capabilities as our AutoData® Systems products. However, our AutoData® products face direct competition from both ends of the spectrum: larger competitors offering a broader array of software products and services, and firms similar in size to our AutoData® Systems Division that offer a low-price, more limited product.



The market is segmented based primarily on price and capabilities, with the larger firms, notably Cardiff Software and Captiva Software, offering enterprise-wide systems with broad information capture capabilities. Our AutoData® products are focused on desktop, rather than enterprise-wide, solutions, positioning the Company as most appropriate to small offices and departments of larger organizations.

Because price is a primary competitive factor, the Company is subject to increasing pressures to make price adjustments to remain competitive. Such downward price adjustments, if any, may have an adverse impact on the Company's results of operations if not offset by an increase in revenues and/or a reduction in expenses.

### *Suppliers*

*Controls Division.* The Controls Division purchases parts and materials for its production monitoring systems from various manufacturers and distributors. In some instances, these materials are manufactured in accordance with proprietary designs. Multiple sources of these supplies and materials are readily available, and the Controls Division is not dependent on any single source for these supplies and materials. This Division has not experienced any problem of short supply or delays from its suppliers.

*AutoData® Systems.* The AutoData® Systems Division purchases a wide variety of supplies and materials from various vendors and is not dependent upon any one source.

The Company purchases a variety of parts, components, and other supplies from a variety of vendors for all of its operating divisions. While the Company attempts to have more than a single source of supply for those various parts, components and supplies, it is possible occasionally that there will be only one supplier for any single part, component or supply. Should a supplier be unwilling or unable to supply such an item in a timely manner, the Company's business could be materially adversely affected.

***Customers***

The Company is not dependent upon a single or a few customers for a material (10% or more) portion of its sales in any of its operating divisions.

***Patents, Trademarks and Licenses***

The names *Electro-Sensors* and *AutoData* are trademarks registered with the U.S. Patent and Trademark Office, respectively as Reg. No. 1,142,310 and Reg. No. 1,874,543. The Company believes its trademarks have been and will continue to be useful in developing and protecting market recognition for its products.

The Company holds one patent relating to its Production Monitoring Systems, and has obtained six patents related to its Character Recognition technology. The Company has also entered into a license agreement with MKS Maschinen Kontroll Systeme GmbH ( *MKS* ), a manufacturer of a Synchronous Drive Controller ( *SDC* ) product line, which grants the Company exclusive rights to distribute in the United States the drive control products manufactured by MKS.

PPT Vision, Inc. has granted the Company an exclusive license that allows the Company to incorporate a patented neural network algorithm in its products. The initial use of this algorithm has been in the Company's *AutoData® Systems Division*.

***Governmental Approvals***

The Company is not required to obtain governmental approval of its products.

***Effect of Governmental Regulations***

The Company does not believe that any existing or proposed governmental regulations will have a material effect on its business.

***Research and Development***

The Company invests in research and development programs to develop new products in related markets and to integrate state of the art technology into existing products.

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Research and development expense (by division) during the past two fiscal years was:

*Controls Division:*

2004: \$ 357,000  
2003: \$ 440,000

The Company's development projects for this division are undertaken based upon the identified specific needs of the Company's customer base.

*AutoData® Systems:*

2004: \$ 405,000  
2003: \$ 332,000

The Company has continued to fund this Division's development activities. The goal is to create low-cost software based systems that enable accurate reading of hand-printed characters. Towards this effort, the Company acquired an exclusive license from PPT Vision, Inc. ( PPT ) in January of 1992, offering the Company protection of the algorithm necessary for the reading technology. The Company has also developed two character recognition patents.

The Company's future success is dependent in part upon its ability to develop new products in its varying segments. Difficulties or delays in the Company's ability to develop, produce, test and market new products could have a material adverse effect on future sales growth. We have budgeted \$383,000 for 2005 research and development costs for the controls division and \$405,000 for AutoData Systems research and development costs for 2005.

***Compliance with Environmental Laws***

Compliance with federal, state and local environmental provisions has only a nominal effect on current or anticipated capital expenditures and has had no material effect on earnings or on the competitive position of the Company.

***Employees***

As of March 25, 2005, the Company had 34 employees, all of which are full-time. The Company believes that its relations with its employees are good.

The Company's ability to maintain a competitive position and to continue to develop and market new products depends, in part, on its ability to retain key employees and qualified personnel. If the Company is unable to retain and/or recruit key employees, product development, marketing and sales could be negatively impacted.

***Cautionary Statements***

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements made by the Company or on its behalf. The Company has made, and may continue to make, various written or verbal forward-looking statements with respect to business and financial matters, including statements contained in this document, other filings with the Securities and Exchange Commission, and reports to stockholders. Forward-looking statements generally include discussion of current expectations or forecasts of future events and can be identified by the use of terminology such as believe, estimate, expect, intend, may, could, will, and similar words or expressions. Any statement not relate solely to historical fact should be considered forward-looking. Electro-Sensors' forward-looking statements generally relate to its growth strategy, financial results, product development and sales efforts. Forward-looking statements cannot be guaranteed and actual results may vary materially due to the uncertainties and risks, known and unknown, associated with such statements. The Company undertakes no obligations to update any forward-looking statements. The Company wishes to caution investors that the following important factors, among others, in some cases have affected and in the future could affect the Company's actual results of operations and cause such results to differ materially from those anticipated in forward-looking statements made in this document and elsewhere by or on behalf of the Company. It is not possible to foresee or identify all factors that could cause actual results to differ from expected or historical results. As such, investors should not consider any list of such factors to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions.

***Fluctuations in Operating Results.*** ESI has experienced fluctuations in its operating results in the past, and may experience fluctuations in the future, which may affect the market price of its Common Stock. Sales can fluctuate as a result of a variety of factors, many of which are beyond the Company's control. Some of these factors are: product competition and acceptance, timing of customer orders, cancellation of orders, the mix of products sold, downturns in the market and economic disruptions.

Because fluctuations can happen, the Company believes that comparisons of the results of its operations for preceding quarters should not be relied upon by investors as an indication of how the Company will perform in the future. There can be no assurance that the Company's earnings

growth will equal that of prior years.

Further, investments by the Company's subsidiary, ESI Investment Company, are subject to significant positive and negative changes in value. In particular, significant investments in PPT Vision, Inc. and August Technology, Inc. have experienced substantial value fluctuations, which are expected to continue. The Company's current intention is to continue to gradually liquidate its investment securities to finance expansion of its operating activities.

***Expending Funds for Changes in Industry Standards, Customer Preferences or Technology.*** The Company's business depends upon continually introducing new and enhanced products and solutions for customer needs. The development of products requires the Company to commit financial resources, personnel and time, usually in advance of significant market development for such products. In order to compete, the Company must anticipate both future demand and the technology available to meet that demand.

**Item 2 Description of Property**

The Company owns and occupies a 25,400 square foot facility at 6111 Blue Circle Drive, Minnetonka, Minnesota 55343. All operating entities are located within this facility. The facilities are adequate and are anticipated to be adequate for our needs in 2005.

**Item 3 Legal Proceedings**



The Company was not the subject of any legal proceedings as of the date of this filing. The Company is not aware of any threatened litigation.

**Item 4 Submission of Matters to a Vote of Security Holders**

There were no matters submitted to a vote of security holders during the last quarter of the fiscal year ended December 31, 2004.

**PART II**

**Item 5 Market for Common Equity, Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities**

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The Company's Common Stock trades on the Nasdaq SmallCap tier of The Nasdaq Stock Market® under the symbol ELSE. The following table sets forth the quarterly high and low reported last sales prices for the Company's Common Stock for each period indicated as reported on the Nasdaq system.

	Period		High		Low
<b>2004</b>	First Quarter	\$	6.40	\$	3.85
	Second Quarter	\$	5.16	\$	4.11
	Third Quarter	\$	4.70	\$	4.00
	Fourth Quarter	\$	5.60	\$	3.46
<b>2003</b>	First Quarter	\$	3.01	\$	2.11
	Second Quarter	\$	3.15	\$	2.35
	Third Quarter	\$	3.50	\$	3.03
	Fourth Quarter	\$	4.34	\$	3.75

Based on data provided by the Company's transfer agent, management believes that as of February 21, 2005, the number of share owner accounts of record was approximately 149.

The Company paid cash dividends on its common stock of \$0.16 per share in 2004 and \$0.13 per share in 2003 on a quarterly basis.

The Company did not repurchase any equity securities during the quarter ended December 31, 2004.

**Item 6 Management's Discussion and Analysis or Plan of Operation**

The Company's critical accounting policies, including the assumptions and judgments underlying them, are disclosed in the Note 1 to the Consolidated Financial Statements. These policies have been consistently applied in all material respects for the periods presented and address such matters as revenue recognition, depreciation and amortization methods, asset impairment recognition, deferred tax valuation allowance, and business combination accounting. While the estimates and judgments associated with the application of these policies may be affected by different assumptions or conditions, the Company believes the estimates and judgments associated with the reported amounts are appropriate in the circumstances.

**RESULTS OF OPERATIONS**

**Comparison of Fiscal Year 2004 vs. Fiscal Year 2003**

*Net Revenues*

Net revenues for fiscal year 2004 increased \$441,000 to \$4,799,000, or 10.1% when compared to net revenues for fiscal year 2003.

Of this increase, the Controls Division contributed an increase in net sales of \$287,000, or 7.6% when comparing fiscal year 2004 to fiscal year 2003. Sales calls by internal staff and our new manufacturers representatives led to an increase in quoting activity as the economic conditions improved in the market place. Customer projects that had been on hold were approved and started. We have increased and will continue to increase our use of channel partnerships through independent representatives and distributors. New products being developed complement our existing product line and expand our core sensing area beyond speed sensing. Some of these products have bus communication interfaces that allow them to connect directly to control systems that have multiple types of sensors or controls attached to the bus. We are taking steps in developing additional channel partners in the form of distributors and independent representatives, with the goal of finding new applicants and customers.

The AutoData® Systems Division had an increase in net sales of \$154,000 or 25.7% when comparing fiscal year 2004 to fiscal year 2003. This increase is primarily due to sales of the Expertsan product. There was also an increase in support renewals due to contacting customers via email with renewal reminders. The AutoData® Systems Division also noticed an increase in quoting activities as a result of the improving economic conditions.

*Cost of Sales*

The Company's cost of sales increased from \$1,700,000 to \$1,821,000, a difference of \$121,000 or 7.1%. Cost of sales increased in line with the sales increase. The Company continues efforts to maintain or reduce production costs.

*Gross Margins*

Gross margins for the fiscal year 2004 were 62.1% versus 61.0% for the prior fiscal year. In addition to the increase resulting from the higher sales volume, gross margins increased as a result of the Company's efforts to reduce production costs.

*Operating Expenses*

Total operating expenses increased by \$24,000, or 0.8% when comparing fiscal year 2004 to the prior fiscal year.

Selling and marketing costs increased by \$39,000, or 3.2%. Of this increase, the Controls Division had an increase of \$70,000 or 8.1%. The AutoData® Systems Division had a decrease of \$31,000 or 8.9%. The increase from the Controls Division is due to increased efforts in marketing their product thru manufacturer's representatives. The decrease from the AutoData® Systems Division is due to re-evaluating the sales and marketing costs and targeting the marketing efforts.

General and administrative costs decreased by \$5,000, or 0.5%. Of this decrease, the Controls Division had a decrease of \$18,000, or 1.9%. This decrease is due to our efforts in keeping overhead costs low. The AutoData® Systems Division had an increase of \$13,000. The increase for the AutoData® Systems Division is due to a change in allocating expenses between the controls and AutoData® Systems Divisions.

Research and development costs decreased \$10,000 or 1.3% when compared with the prior year. The Controls Division decreased \$83,000, or 18.9%, offset by an increase from the AutoData® Systems Division of \$73,000. In April 2003, the AutoData® Systems Division hired a software development associate to lower their outsourcing costs associated with developing and maintaining their products. In the Controls Division, the costs declined due to fewer personnel.

***Operating Income (Loss)***

The operating loss for fiscal year 2004 was \$61,000, compared to last year's operating loss of \$357,000, an increase of \$296,000 or 82.9%.

The Controls division had an operating income of \$257,000 compared to the income of \$1,000 in 2003, an increase of \$256,000. This increase in operating income is a result of increased sales and our efforts to reduce operating costs.

The AutoData® Systems Division had a 2004 operating loss of \$224,000 compared to a loss of \$277,000 for 2003, a decrease of \$53,000 or 19.1%. This decrease is a result of the company's efforts in reducing operating costs.

***Non-Operating Income***

ESI Investment Company continues to provide an alternative source of earnings for the Company through investments in available for sale securities; however, the Company's intent is to remain an operations-based Company. The Company's investments in available for sale securities are subject to significant positive and negative changes in value. In addition to income from the sale of investments, the Company also realizes interest income from its short-term holdings.

Investment income for the fiscal year 2004 decreased by \$198,000 to a loss of \$121,000. This decrease was primarily due to reduced sales of investment securities. The increase of 38.7% or \$24,000 in interest income earned on temporary cash investments is a result of the maturity timing of T-Bills comparing fiscal year 2003 to 2004.

Available-for-sale securities are stated at fair value, and unrealized holding gains and losses, net of the related deferred tax effect, are reported as a separate component of stockholders' equity. Dividends on marketable equity securities are recognized in income when declared. Investments in unregistered securities are reported at original cost.

Realized gains and losses, including losses from declines in value of specific securities determined by management to be other-than-temporary, are included in income. Realized gains and losses are determined on the basis of the specific securities sold.





*Net Income After Tax*

We reported a net income after tax for fiscal year 2004 of \$172,000 compared to net loss of \$144,000 in 2003, an increase of \$316,000 or 219.4%. Loss per share was \$0.05 in 2003 compared to earnings per share of \$0.05 in 2004.

***Balance Sheet***

The current assets at the end of 2004 decreased to \$15,362,000 from \$23,236,000 at the end of 2003. This decrease is primarily due to the decrease in market value of the August Technology Corporation shares held while other current and long term assets remained relatively constant. There is a corresponding decrease in tax deferred liability associated with the decrease in the market value of these shares.

**OFF-BALANCE SHEET ARRANGEMENTS**

The Company is not a party to any off-balance sheet transactions, arrangements or obligations that have, or are reasonably likely to have, a material effect on the Company's financial condition, changes in the financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

## LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were \$6,464,000 at December 31, 2004 and \$6,863,000 at December 31, 2003. Cash used in operating activities of \$278,000 for the twelve months ended December 31, 2004 was primarily a result of our net income adjusted for non-cash charges.

Cash provided by investing activities was \$283,000 for the twelve-month period ended December 31, 2004 and \$791,000 for the year ended December 31, 2003. Cash used for capital expenditures was \$19,000 and \$25,000 for the twelve months ended December 31, 2004 and 2003, respectively. Proceeds from the sale of investments for the twelve months ended December 31, 2004 declined to \$326,000 from \$591,000 when compared to the same period in 2003.

Cash used in financing activities was \$404,000 and \$376,000 for the twelve months ended December 31, 2004 and 2003, respectively. During the twelve months ended December 31, 2004 and 2003, the Company paid aggregate dividends of \$513,000 and \$411,000, respectively.

Our ongoing cash requirements will be primarily for capital expenditures, acquisitions, research and development and working capital. Management believes that cash on hand and any cash provided by operations will be sufficient to meet our cash requirements through at least the next 12 months. We anticipate that dividends will be paid in 2005.

The primary investments in the Investment division are 669,715 shares of August Technology Corporation and 2,207,036 shares of PPT Vision, Inc both of which are traded on the Nasdaq Stock Exchange. The PPT Vision investment is accounted for under the equity method of accounting. These stocks are subject to fluctuations in price and could have a negative effect on the liquidity of the Company. Investment Division holdings are periodically sold as deemed appropriate by management.

**Item 7 Financial Statements and Supplementary Data**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

Report of Registered Independent Public Accounting Firm  
Financial Statements  
Consolidated Balance Sheets  
Consolidated Statements of Operations  
Consolidated Statements of Changes in Stockholder's Equity  
Consolidated Statements of Cash Flows  
Notes to Consolidated Financial Statements

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders  
Electro-Sensors, Inc.  
Minneapolis, Minnesota

We have audited the accompanying consolidated balance sheet of Electro-Sensors, Inc. and Subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for the years ended December 31, 2004 and 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Electro-Sensors, Inc. and Subsidiaries as of December 31, 2004, and 2003, and the results of their operations and their cash flows for the years ended December 31, 2004, and 2003 in conformity with accounting principles generally accepted in the United States of America.

VIRCHOW, KRAUSE & COMPANY, LLP

Minneapolis, Minnesota  
January 28, 2005

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders

Electro-Sensors, Inc.

Minneapolis, Minnesota

We have audited Electro-Sensors, Inc. and Subsidiaries statements of income, changes in stockholders' equity, and cash flows for the period ended December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Electro-Sensors, Inc. and Subsidiaries, the results of their operations and their cash flows for the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America.

MAYER HOFFMAN MCCANN P.C. (formerly known as SCHWEITZER, KARON & BREMER, LLC)

Certified Public Accountants

Minneapolis, Minnesota

March 14, 2005



**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2004	2003
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 6,464,000	\$ 6,863,000
Available for sale securities	7,334,000	13,416,000
Trade receivables, less allowance for doubtful accounts, 2004: \$6,000 and 2003: \$6,000	559,000	515,000
Inventories	810,000	758,000
Other current assets	68,000	62,000
Prepaid income taxes	127,000	0
<b>Total current assets</b>	<b>15,362,000</b>	<b>21,614,000</b>
<b>PROPERTY AND EQUIPMENT, net</b>	<b>1,402,000</b>	<b>1,470,000</b>
<b>INVESTMENT IN EQUITY METHOD INVESTEE</b>	<b>140,000</b>	<b>152,000</b>
<b>TOTAL ASSETS</b>	<b>\$ 16,904,000</b>	<b>\$ 23,236,000</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 162,000	\$ 106,000
Accrued expenses	248,000	263,000
Accrued income taxes	0	96,000
Deferred income tax	2,623,000	4,795,000
Deferred revenue	68,000	48,000
<b>Total current liabilities</b>	<b>3,101,000</b>	<b>5,308,000</b>
<b>DEFERRED INCOME TAXES</b>	<b>0</b>	<b>26,000</b>
<b>COMMITMENTS AND CONTINGENCIES (Notes 6 and 8)</b>		
<b>STOCKHOLDERS EQUITY</b>		
Common stock, par value \$0.10 per share; authorized 10,000,000 shares; issued 3,218,345 and 3,174,522 shares, respectively	322,000	317,000
Additional paid-in capital	1,104,000	1,000,000
Retained earnings	7,964,000	8,305,000
Accumulated other comprehensive income	4,413,000	8,280,000
<b>Total stockholders equity</b>	<b>13,803,000</b>	<b>17,902,000</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 16,904,000</b>	<b>\$ 23,236,000</b>

See Notes to Consolidated Financial Statements



**ELECTRO-SENSORS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS**

	2004	Years Ended December 31,		2002
		2003		
<b>Net Sales</b>	\$ 4,799,000	\$ 4,358,000	\$ 4,478,000	
<b>Cost of Goods Sold</b>	1,821,000	1,700,000	1,858,000	
<b>Gross Profit</b>	2,978,000	2,658,000	2,620,000	
<b>Operating Expenses:</b>				
Selling and Marketing	1,251,000	1,212,000	1,138,000	
General and Administrative	1,026,000	1,031,000	983,000	
Research and Development	762,000	772,000	1,090,000	
<b>Total Operating Expenses</b>				