

COMMUNICATIONS SYSTEMS INC  
Form 10-Q  
May 16, 2007

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

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**FORM 10-Q**

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(Mark  
One)

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

For the quarterly period ended **SEPTEMBER 30, 2006**  
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

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**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.)

213 South Main Street, Hector, MN

55342

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(Address of principal executive offices)

(Zip Code)

(320) 848-6231

Registrant's telephone number, including area code

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

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

Large Accelerated Filer o

Accelerated Filer o

Non-accelerated filer x

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

| Class                                   | Name of Exchange On Which Registered | Outstanding at October 31, 2006 |
|---|--------------------------------------|---------------------------------|
| Common Stock, par value \$.05 per share | American Stock Exchange              | 8,724,184                       |

Total Pages (25) Exhibit Index at (NO EXHIBITS)

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS  
(unaudited)

|  | September 30<br>2006 | December 31<br>2005 |
|--|----------------------|---------------------|
| <b>Assets:</b>                                     |                      |                     |
| <b>Current assets:</b>                             |                      |                     |
| Cash and cash equivalents                          | \$ 26,598,874        | \$ 26,660,533       |
| Trade receivables, net                             | 22,833,138           | 20,460,380          |
| Receivable from sale of discontinued operations    |                      | 1,102,881           |
| Related party receivables                          | 216,164              | 110,865             |
| Inventories  | 25,460,355           | 24,492,518          |
| Costs and estimated earnings in excess of billings | 1,084,551            | 1,233,368           |
| Deferred income taxes                              | 3,725,647            | 3,706,795           |
| Other current assets                               | 892,215              | 980,556             |
| <b>Total current assets</b>                        | <b>80,810,944</b>    | <b>78,747,896</b>   |
| Property, plant and equipment                      | 7,600,375            | 8,299,601           |
| <b>Other assets:</b>                               |                      |                     |
| Goodwill   | 5,264,095            | 5,264,095           |
| Deferred income taxes                              | 402,418              | 402,418             |
| Other assets                                       | 92,893               | 169,354             |
| <b>Total other assets</b>                          | <b>5,759,406</b>     | <b>5,835,867</b>    |

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Total Assets \$ 94,170,725 \$ 92,883,364

Liabilities and Stockholders Equity:

Current liabilities:

|                                   |              |              |
|-----------------------------------|--------------|--------------|
| Accounts payable                  | \$ 2,994,405 | \$ 5,188,316 |
| Accrued compensation and benefits | 3,185,635    | 3,072,768    |
| Other accrued liabilities         | 2,623,577    | 1,786,957    |
| Dividends payable                 | 785,180      | 698,616      |
| Income taxes payable              | 852,203      | 953,516      |

Total current liabilities 10,441,000 11,700,173

Long-term liabilities:

|                              |           |         |
|------------------------------|-----------|---------|
| Long-term compensation plans | 772,650   | 401,062 |
| Pension liabilities          | 1,029,930 | 930,953 |

Total long-term liabilities 1,802,580 1,332,015

Stockholders Equity 81,927,145 79,851,176

Total Liabilities and Stockholders Equity \$ 94,170,725 \$ 92,883,364

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

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

|  | Three Months Ended September 30 |               | Nine Months Ended September 30 |               |
|--|---------------------------------|---------------|--------------------------------|---------------|
|  | 2006                            | 2005          | 2006                           | 2005          |
| Sales from continuing operations             | \$ 30,692,833                   | \$ 31,403,872 | \$ 89,402,113                  | \$ 86,874,708 |
| Costs and expenses:                          |                                 |               |                                |               |
| Cost of sales                                | 20,239,406                      | 20,519,929    | 59,569,114                     | 58,217,181    |
| Selling, general and administrative expenses | 8,500,285                       | 7,822,174     | 25,587,189                     | 23,353,588    |
| Total costs and expenses                     | 28,739,691                      | 28,342,103    | 85,156,303                     | 81,570,769    |
| Operating income from continuing operations  | 1,953,142                       | 3,061,769     | 4,245,810                      | 5,303,939     |

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|   |              |              |              |              |
|---|--------------|--------------|--------------|--------------|
| Other income and (expenses):                          |              |              |              |              |
| Investment and other income                           | 182,405      | 139,072      | 539,293      | 336,219      |
| Interest expense                                      | (9,740)      | (8,728)      | (28,551)     | (23,470)     |
| Other income, net                                     | 172,665      | 130,344      | 510,742      | 312,749      |
| Income from continuing operations before income taxes |              |              |              |              |
|   | 2,125,807    | 3,192,113    | 4,756,552    | 5,616,688    |
| Income taxes  | 531,000      | 1,331,000    | 1,115,000    | 2,290,000    |
| Income from continuing operations                     | 1,594,807    | 1,861,113    | 3,641,552    | 3,326,688    |
| Discontinued operations                               |              |              |              |              |
| Loss from discontinued operations                     |              | (142,815)    |              | (557,349)    |
| Income tax benefit                                    |              | 59,000       |              | 212,000      |
| Loss from discontinued operations                     | 0            | (83,815)     | 0            | (345,349)    |
| Net Income  | 1,594,807    | 1,777,298    | 3,641,552    | 2,981,339    |
| Other comprehensive income (loss):                    |              |              |              |              |
| Foreign currency translation adjustment               | 121,223      | (34,368)     | 231,286      | (155,063)    |
| Comprehensive income                                  | \$ 1,716,030 | \$ 1,742,930 | \$ 3,872,838 | \$ 2,826,276 |
| Basic net income per share                            |              |              |              |              |
| Continuing operations                                 | \$ .18       | \$ .22       | \$ .42       | \$ .39       |
| Discontinued operations                               |              | (.01)        |              | (.04)        |
|   | \$ .18       | \$ .21       | \$ .42       | \$ .35       |
| Diluted net income per share                          |              |              |              |              |
| Continuing operations                                 | \$ .18       | \$ .21       | \$ .41       | \$ .38       |
| Discontinued operations                               |              | (.01)        |              | (.04)        |
|   | \$ .18       | \$ .20       | \$ .41       | \$ .34       |
| Cash dividends per share                              | \$ .09       | \$ .07       | \$ .25       | \$ .20       |
| Average Basic Shares Outstanding                      | 8,723,469    | 8,589,380    | 8,719,868    | 8,554,035    |
| Average Dilutive Shares Outstanding                   | 8,776,677    | 8,718,979    | 8,811,119    | 8,700,702    |

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

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

|  | Common Stock |            | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Cumulative<br>Other<br>Comprehensive<br>Income (Loss) | Total         |
|--|--------------|------------|----------------------------------|----------------------|---|---------------|
|  | Shares       | Amount     |                                  |                      |   |               |
| BALANCE AT DECEMBER 31,<br>2004                                | 8,502,700    | \$ 425,135 | \$ 30,803,482                    | \$ 45,456,339        | \$ 366,316  | \$ 77,051,272 |
| Net income   |              |            |                                  | 4,469,798            |   | 4,469,798     |
| Issuance of common stock under<br>Employee Stock Purchase Plan | 25,351       | 1,268      | 171,335                          |                      |   | 172,603       |
| Issuance of common stock to<br>Employee Stock Ownership Plan   | 32,484       | 1,624      | 392,113                          |                      |   | 393,737       |
| Issuance of common stock under<br>Employee Stock Option Plan   | 122,142      | 6,108      | 985,161                          |                      |   | 991,269       |
| Tax benefit from non-qualified<br>employee stock options       |              |            | 103,602                          |                      |   | 103,602       |
| Purchase of common stock                                       | (12,154)     | (608)      | (49,820)                         | (82,774)             |   | (133,202)     |
| Shareholder dividends  |              |            |                                  | (2,496,811)          |   | (2,496,811)   |
| Additional minimum pension<br>liability adjustment             |              |            |                                  |                      | (530,993)   | (530,993)     |
| Other comprehensive loss                                       |              |            |                                  |                      | (170,099)   | (170,099)     |
| BALANCE AT DECEMBER 31,<br>2005                                | 8,670,523    | \$ 433,527 | \$ 32,405,873                    | \$ 47,346,552        | \$ (334,776)  | \$ 79,851,176 |
| Net income   |              |            |                                  | 3,641,552            |   | 3,641,552     |
| Issuance of common stock under<br>Employee Stock Purchase Plan | 9,134        | 457        | 81,171                           |                      |   | 81,628        |
| Issuance of common stock to<br>Employee Stock Ownership Plan   | 31,551       | 1,578      | 385,872                          |                      |   | 387,450       |
| Issuance of common stock under<br>Employee Stock Option Plan   | 80,680       | 4,034      | 541,875                          |                      |   | 545,909       |
| Tax benefit from non-qualified<br>employee stock options       |              |            | 62,147                           |                      |   | 62,147        |
| Stock-based compensation                                       |              |            | 149,374                          |                      |   | 149,374       |
| Purchase of common stock                                       | (68,226)     | (3,411)    | (258,050)                        | (489,643)            |   | (751,104)     |
| Shareholder dividends  |              |            |                                  | (2,272,273)          |   | (2,272,273)   |
| Other comprehensive income                                     |              |            |                                  |                      | 231,286   | 231,286       |
| BALANCE AT SEPTEMBER 30,<br>2006                               | 8,723,662    | \$ 436,185 | \$ 33,368,262                    | \$ 48,226,188        | \$ (103,490)  | \$ 81,927,145 |

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

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(unaudited)

|   | <b>Nine Months Ended September 30</b> |                      |
|---|---------------------------------------|----------------------|
|   | <b>2006</b>                           | <b>2005</b>          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                       |                      |
| Net income  | \$ 3,641,552                          | \$ 2,981,339         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                       |                      |
| Depreciation and amortization   | 1,864,428                             | 1,459,427            |
| Stock based compensation  | 149,374                               |                      |
| Excess tax benefits from stock based compensation                                 | (62,147)                              |                      |
| Deferred taxes  | (18,852)                              |                      |
| Changes in assets and liabilities:  |                                       |                      |
| Trade and related party receivables   | (2,333,839)                           | (2,334,515)          |
| Inventories   | (854,707)                             | (534,493)            |
| Costs and estimated earnings in excess of billings                                | 148,817                               |                      |
| Other current assets  | 90,446                                | (448,099)            |
| Accounts payable  | (2,220,980)                           | (1,735,221)          |
| Accrued compensation and benefits   | 871,905                               | 904,699              |
| Other accrued expenses  | 825,877                               | 350,981              |
| Income taxes payable  | (39,166)                              | 673,687              |
| Pension liabilities   | 17,607                                |                      |
| Net cash provided by operating activities   | 2,080,315                             | 1,317,805            |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                       |                      |
| Capital expenditures  | (1,041,481)                           | (2,490,100)          |
| Proceeds from the sale of discontinued operations                                 | 1,102,881                             |                      |
| Net cash provided by (used in) investing activities                               | 61,400                                | (2,490,100)          |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                       |                      |
| Dividends paid  | (2,185,709)                           | (1,705,473)          |
| Proceeds from issuance of stock   | 627,537                               | 608,211              |
| Purchase of common stock  | (751,104)                             | (119,067)            |
| Excess tax benefits from stock based compensation                                 | 62,147                                |                      |
| Net cash used in financing activities   | (2,247,129)                           | (1,216,329)          |
| <b>EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH</b>                            | <b>43,755</b>                         | <b>73,389</b>        |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>                                  | <b>(61,659)</b>                       | <b>(2,315,235)</b>   |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>26,660,533</b>                     | <b>25,842,580</b>    |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                 | <b>\$ 26,598,874</b>                  | <b>\$ 23,527,345</b> |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>                         |                                       |                      |
| Income taxes paid   | \$ 1,165,218                          | \$ 1,616,313         |
| Interest paid   | 28,551                                | 23,470               |
| Dividends declared not paid   | 785,180                               | 601,691              |

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

COMMUNICATIONS SYSTEMS, INC.  
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of business

Communications Systems, Inc. (herein collectively called "CSI", "our" or the "Company") is a Minnesota corporation organized in 1969 which operates directly and through its subsidiaries located in the United States, Costa Rica and the United Kingdom. CSI is principally engaged through its Suttle and Austin Taylor business units in the manufacture and sale of modular connecting and wiring devices for voice and data communications, digital subscriber line filters, and structured wiring systems and through its Transition Networks business unit in the manufacture of media and rate conversion products for telecommunications networks. CSI also provides through its JDL Technologies business unit network design, training services, general contracting of computer infrastructure installations, provisioning of high-speed internet access and maintenance support of network operation centers for K-12 schools.

Financial statement presentation

The consolidated balance sheets as of September 30, 2006 and 2005 and the related consolidated statements of income and comprehensive income, consolidated statements of changes in stockholders' equity and the consolidated statements of cash flows for the nine-month periods ended September 30, 2006 and 2005 have been prepared by Communications Systems, Inc. and Subsidiaries (the "Company" or "we") without audit. 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 September 30, 2006 and 2005 and for the nine months 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. It is suggested these consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Company's December 31, 2006 and 2005 Annual Reports to Shareholders and forms 10-K. The results of operations for the periods ended September 30 are not necessarily indicative of the 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 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.

At December 31, 2005 the Company was in negotiations to sell Austin Taylor to prospective purchasers and expected to conclude a sale in 2006. However, due to uncertainties involving Austin Taylor's financial performance and issues involving its pension plans, the Company was unable to conclude a sale on satisfactory terms. As a result, the Company has reversed its decision to discontinue operations. The Company's financial statements including the December 31, 2005 balance sheet and the income statement for the periods ended June 30, 2005 have been adjusted to reflect the

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

reclassification of the operating results of Austin Taylor Communications Ltd. to continuing operations.



Revenue Recognition

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

JDL records revenue on service contracts on a straight-line basis over the contract period (unless evidence suggests that the revenue is earned or obligations are fulfilled in a different pattern). Each contract is individually reviewed to determine when the earnings process is complete. Contracts with the Virgin Islands Department of Education (VIDOE) are funded by the federal government's E-RATE program and must be approved by the Schools and Libraries Division (SLD) of the Universal Service Administration Company (USAC) before payment can be received. Due to our history of funding and our direct involvement in the application process we have enacted a policy to recognize revenue prior to funding approval being received from the SLD so long as we can conclude that it is remote that funding will not be approved.

In order to make the remote conclusion quarterly we made an assessment that included consideration of the following:

- Compliance with critical e-rate program requirements by JDL and the VIDOE
- Any program changes including but not limited to the following:
  - Priority of payments,
  - Allowance of retroactive payment for services provided, etc.
- Changes in funding levels for similar applicants
- Any indications that the contract prices are not fixed (the SLD would approve amounts different than those submitted)
- Significant changes to the prices or services provided from the services that were approved in the prior year
- Prior history of payments and funding terms
- Any changes to the probability of collecting for services provided

During the year ended December 31, 2005 we recognized revenue in advance of the funding approval by SLD because we had sufficient evidence to conclude that it was remote that funding would not be approved.

During 2006, as a result of its experience with the E-RATE funding process, it became apparent that JDL's ability to receive E-RATE funds was affected by actions that might have been taken by other individuals or companies involved with the VIDOE and E-RATE programs. This gave rise to the possibility that if the VIDOE were to be sanctioned by the E-RATE program due to the actions of others, JDL might be unable to collect for provided services even though JDL's conduct was compliant with the E-RATE program. It also became apparent in 2006 that JDL's contracts with the VIDOE

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

would not be approved for payment by the SLD until the SLD was satisfied that the VIDOE was operating within the E-RATE program's legal guidelines. Accordingly, after considering the uncertainties created by the DOJ investigation of VIDOE, SLD's review of VIDOE's compliance

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with the E-RATE program and JDL's inability to collect for services provided without SLD approval, the Company ceased revenue recognition on JDL's VIDOE contracts in 2006. The Company will maintain this approach into 2007 and beyond, until it becomes convinced that such approvals are routine and that it is remote funding will not be approved and that financial reports including such revenues can be relied upon as accurate.

Services provided by JDL to the VIDOE in the three month and nine month periods ended September 30, 2006 on contracts that had not been approved by the SLD that were not recognized in 2006 revenues were \$748,000 and \$1,923,000, respectively. Accounts receivable at June 30, 2006 and December 31, 2005 from the VIDOE for services provided and recognized in 2005 revenues under contracts not yet approved by the SLD totaled \$1,175,000.

In 2005, JDL entered into a long-term fixed-price contract with a large school district to install and upgrade its network equipment and infrastructure. Revenue under this contract was recognized on a percentage-of-completion basis under Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. The method used to determine the progress of completion for this contract is based on the ratio of costs incurred to total estimated costs.

### Comprehensive income

The components of accumulated other comprehensive income (loss) are as follows:

|                              | September 30<br>2006 | December 31<br>2005 |
|------------------------------|----------------------|---------------------|
| Foreign currency translation | \$ 427,503           | \$ 196,217          |
| Minimum pension liability    | (530,993)            | (530,993)           |
|                              | \$ (103,490)         | \$ (334,776)        |

### NOTE 2 - STOCK-BASED COMPENSATION

Common shares are reserved in connection with the Company's 1992 stock plan under which 2,500,000 shares of common stock may be issued pursuant to stock options, stock appreciation rights, restricted stock or deferred stock granted to officers and key employees. Exercise prices of stock options under the plan cannot be less than fair market value of the stock on the date of grant. Rules and conditions governing awards of stock options, stock appreciation rights and restricted stock are determined by the Compensation Committee of the Board of Directors, subject to certain limitations incorporated into the plan. At September 30, 2006, 962,749 shares remained available to be issued under the plan. The only awards under the 1992 stock plan that were not vested as of the adoption of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (123(R)), were stock options. The options expire five years from date of grant with one-third of the options vesting after six months and the remaining two-thirds vesting equally over the next two years.

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## COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

Shares of common stock are also reserved for issuance in connection with a nonqualified stock option plan under which up to 200,000 shares may be issued to nonemployee directors. The plan provides for the automatic grant of nonqualified options for 3,000 shares of common stock annually to each nonemployee director concurrent with the annual stockholders' meeting. Exercise price is the fair market value of the stock at the date of grant. Options granted under this plan vest when issued and expire 10 years from date of grant. At September 30, 2006, 32,000 shares are available to be issued under the plan.

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The Company also has an Employee Stock Purchase Plan (ESPP) for which 300,000 common shares have been reserved. Under the terms of the plan through December 31, 2005, employees could acquire shares of common stock, subject to limitations, through payroll deductions at 85% of the lower of fair market value for such shares on one of two specified dates in each plan year. Shares issued in January 2006 to employees under this plan were 9,134. Effective January 1, 2006, employees are able to acquire shares under new plan terms at 95% of the price at the end of the semi-annual plan term, which is December 31, 2006. This amended plan is non-compensatory under current rules and does not give rise to compensation cost under SFAS No. 123(R).

Prior to January 1, 2006, the Company applied Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, in accounting for these plans. No share-based compensation expense was recognized in our statements of earnings prior to fiscal 2006 for stock option awards, as the exercise price was equal to or greater than the market price of our stock on the date of grant. In addition, the Company did not recognize any stock-based compensation expense for our ESPP as the plan qualifies under Section 423 of the Internal Revenue Code of 1986, as amended.

On January 1, 2006, the Company adopted SFAS No. 123(R), requiring the Company to recognize expense related to the fair value of the stock-based compensation awards. We elected the modified prospective transition method as permitted by SFAS No. 123(R). Under this transition method, stock-based compensation expense subsequent to adoption, includes: (a) compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation; and (b) compensation expense for all stock-based compensation awards granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). We recognize compensation expense for stock options on a straight-line basis over the requisite service period of the award. The Company has elected the simplified method of calculating its additional paid-in capital (APIC) pool described in FASB Staff position No. 123(R)-3, Transition Election Related to the Accounting for the Tax Effects of Share-Based Payment Awards.

Total stock-based compensation expense included in the statement of income for the nine months ended September 30, 2006 was \$149,000 before income taxes and \$131,000 after income taxes. In accordance with the modified prospective transition method of SFAS No. 123(R), financial results for the prior periods have not been restated.

Prior to the adoption of SFAS No. 123(R), we reported all tax benefits resulting from the exercise of stock options as operating cash flows in our consolidated statements of cash flows. In accordance with SFAS No. 123(R), for the nine months ended September 30, 2006, we revised our statement of cash flows presentation to report the excess tax benefits from the exercise of stock options as financing cash flows. For the nine months ended September 30, 2006, \$62,000 of excess tax benefits were reported as financing cash flows rather than operating cash flows.

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#### COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

If the Company had recognized compensation cost for its stock-based transactions based on the fair value of the options method prescribed by SFAS No. 123, net income and net income per share for the respective periods of 2005 would have been as follows:

|                                      | <b>Three Months Ended<br/>September 30, 2005</b> | <b>Nine Months Ended<br/>September 30, 2005</b> |
|--------------------------------------|--|---|
| Net income as reported               | \$ 1,777,298                                     | \$ 2,981,339                                    |
| Compensation expense, net of tax (1) | (93,778)   | (187,556)                                       |
| <b>Pro forma</b>                     | <b>\$ 1,683,520</b>                              | <b>\$ 2,793,783</b>                             |

Earnings per share - Basic

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|                                     |    |     |    |     |
|-------------------------------------|----|-----|----|-----|
| As reported                         | \$ | .21 | \$ | .35 |
| Pro forma                           | \$ | .20 | \$ | .33 |
| <b>Earnings per share - Diluted</b> |    |     |    |     |
| As reported                         | \$ | .20 | \$ | .34 |
| Pro forma                           | \$ | .19 | \$ | .32 |

(1) The grant date fair value of the stock-based compensation was amortized to expense on a straight-line basis over the period it is vested or earned. Forfeitures were estimated based on historical experience.

The following table summarizes the stock option transactions for the nine months ended September 30 2006:

|             |                    | Options   | Weighted average exercise price per share | Weighted average remaining contractual term |
|-------------|--------------------|-----------|---|---|
| Outstanding | December 31, 2005  | 707,450   | \$ 9.39                                   | 2.9 years                                   |
| Granted     |                    | 18,000    | 9.60                                      |   |
| Exercised   |                    | (106,755) | 8.19                                      |   |
| Canceled    |                    | (42,965)  | 10.66                                     |   |
| Outstanding | September 30, 2006 | 575,730   | 9.52                                      | 2.8 years                                   |
| Exercisable | September 30, 2006 | 557,059   | \$ 9.44                                   | 2.6 years                                   |

18,000 director stock options were granted during the nine month period ended September 30, 2006. The aggregate intrinsic value of 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 September 30, 2006 was \$476,000. The intrinsic value of options exercised during the nine months ended September 30, 2006 was \$347,000.

The fair value of options issued was \$51,000 and \$86,000 in the nine month periods ended June 30, 2006 and 2005 respectively. The fair value of each stock option was estimated on the date of the grant using the Black-Scholes option-pricing model. The following table represents a summary of the significant assumptions used during the nine months ended September 30, 2006 to estimate the fair value of stock options.

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| Black-Scholes Option Valuation Assumptions (1) | 2006  | 2005  |
|--|-------|-------|
| Risk-free interest rate (2)                    | 5.1%  | 3.9%  |
| Expected dividend yield                        | 3.7%  | 3.3%  |
| Expected stock price volatility (3)            | 34.0% | 28.0% |
| Expected term of stock options (in years)(4)   | 7.0   | 7.0   |

- (1) Forfeitures are estimated based on historical experience.
- (2) Based on the five-year Treasury constant maturity interest rate whose term is consistent with the expected life of our stock options.
- (3) Volatility is based on historical data.

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(4) The expected life of stock options is estimated based upon historical experience.

Net cash proceeds from the exercise of stock options were \$546,000 and \$608,000 for the nine months ended September 30, 2006 and 2005, respectively.

The actual income tax benefit realized from stock option exercises totaled \$62,000 and \$0, for the nine months ended September 30, 2006, and 2005, respectively. As of September 30, 2006, there was \$8,000 of unrecognized compensation expense related to nonvested stock options that is expected to be recognized in the last quarter of 2006.

### NOTE 3 - INVENTORIES

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

|                | September 30<br>2006 | December 31<br>2005 |
|----------------|----------------------|---------------------|
| Finished Goods | \$ 16,830,278        | \$ 16,528,284       |
| Raw Materials  | 8,630,077            | 7,964,234           |
| Total          | \$ 25,460,355        | \$ 24,492,518       |

### NOTE 4 GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill represents the amount by which the purchase price and transaction costs of business the Company has acquired exceed the estimated fair value of the net tangible assets and separately identifiable assets of these businesses. Under Statement of Financial Accounting Standards (SFAS) No. 142 Goodwill and Other Intangible Assets goodwill and intangible assets with indefinite useful lives are not amortized, but are tested at least annually for impairment. We reassess the value of our business units and related goodwill balances at the beginning of the first quarter of each fiscal year and at other times if events have occurred or circumstances exist that indicate the carrying amount of goodwill may not be recoverable. Accordingly, we have determined that there was no impairment as of January 1, 2006 and no events occurred during the nine months ended September 30, 2006 that indicated our remaining goodwill was not recoverable. As of September 30, 2006 the Company had net goodwill of \$5,264,000.

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## COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

### NOTE 5 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 nine months ended September 30, 2006 and 2005, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

2006 2005

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|                            |            |            |
|----------------------------|------------|------------|
| Beginning Balance          | \$ 529,833 | \$ 910,350 |
| Actual warranty costs paid | (262,216)  | (37,265)   |
| Amounts charged to expense | 203,936    | (196,108)  |
| Ending balance             | \$ 471,553 | \$ 676,977 |

NOTE 6 DISCONTINUED OPERATIONS

Net income for the nine months ended September 30, 2005 includes the discontinued operations of Image Systems, a medical and technical imaging business unit located in Eden Prairie, Minnesota. Effective October 1, 2005, the Company negotiated an agreement to sell the inventory, equipment and all intangibles (trade names, intellectual property, etc.) of Image Systems to Richardson Electronics, Ltd. for approximately \$1.5 million. The Company recorded an after tax gain on the sale in the fourth quarter of 2005 of approximately \$222,000.

The results of discontinued operations for the three and nine months ended September 30, 2005 are summarized as follows:

|                                   | Three Months Ended<br>Sept 30, 2005 | Nine Months Ended<br>Sept 30, 2005 |
|-----------------------------------|-------------------------------------|------------------------------------|
| Revenues                          | \$ 882,325                          | \$ 3,285,728                       |
| Costs and expenses                | (1,025,140)                         | (3,843,077)                        |
| Operating loss                    | (142,815)                           | (557,349)                          |
| Income tax benefit                | 59,000                              | 212,000                            |
| Loss from discontinued operations | \$ (83,815)                         | \$ (345,349)                       |

The operations and assets of Austin Taylor Communications Ltd. which were previously classified and reported as discontinued operations in 2005 have been reclassified in continuing operations. The Company has ceased negotiations with prospective buyers for this business unit and has now reclassified results of operations previously reported in discontinued operations in income from continuing operations for all periods presented. As a result of the reclassification to continuing operations, 2006 expenses for Austin Taylor include a \$96,000 charge for catch-up depreciation costs that were not included in 2005 discontinued operations.

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

NOTE 7 CONTINGENCIES

In the ordinary course of business, the Company is exposed to legal actions and threatened claims and incurs costs to defend against such legal actions and claims. Company management is not aware of any such outstanding, pending or threatened action, claim or other circumstance that would materially affect the Company's financial position or results of operations, except as follows:

Department of Justice Investigation

Since April 2006 the Company's JDL Technologies, Inc. subsidiary (along with other parties) has been the subject of a civil investigation by the U.S. Department of Justice (DOJ) into whether false claims under the federal government's E-RATE program were made in connection with work performed for the Virgin Islands Department of Education (VIDOE). In addition to cooperating with DOJ investigators over the past 12

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months, the Company has conducted its own internal investigation of its business dealings with VIDOE and its compliance with the E-RATE program. While the DOJ investigation is continuing, no legal action has been initiated against the Company by the DOJ or any other agency as of the date of this report. In addition, as a result of its own investigation, the Company believes it has acted ethically and legally in its business dealings VIDOE and in its compliance with E-RATE program requirements and believes that the DOJ investigation will be resolved without material cost to the Company. However, the possibility exists that the DOJ may assert claims against JDL that, if proved, could result in materially adverse financial consequences to the Company. In addition, the Company's ability to receive E-RATE funds is affected by actions that might have been taken by other individuals or companies involved with the VIDOE and E-RATE programs. If the VIDOE were to be sanctioned by the E-RATE program, JDL may be unable to collect for provided services even though JDL's conduct is compliant with the E-RATE program.

### Other contingencies

A former officer of one of the Company's subsidiaries has made a claim for a supplemental retirement benefit from the Company in addition to the retirement benefit payable that is currently being provided. The amount of the supplemental benefit being sought is approximately \$100,000 per year and the claim is based on the former officer's allegations as to the meaning of terms in his employment contract with the subsidiary and in a side letter delivered by the Company when the employment agreement was signed. The Company has denied the former officer's claim for a supplemental retirement benefit. While the former officer has threatened to commence a lawsuit with respect to his claim since mid-2004, as of the date of this report, the Company has not received any formal notice that legal proceedings have been started. If the former officer initiates legal action, the Company will vigorously defend against any claims that may be asserted and believes the former officer's claims will be resolved without material cost to the Company.

### NOTE 8 SEGMENT INFORMATION

The Company classifies its businesses into four segments: *Suttle*, which manufactures U.S. standard modular connecting and wiring devices for voice and data communications; *Transition Networks* which designs and markets data transmission, computer network and media conversion products and print servers; and *JDL Technologies, (JDL)*, which provides telecommunications network design, specification and training services to educational institutions; *Austin Taylor*, which manufactures British standard line jacks, patch panels, wiring harness assemblies, metal boxes, distribution cabinets and central office frames; *Corporate* includes non allocated corporate general and administrative expenses. Management has chosen to organize the enterprise and disclose reportable segments based

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### COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

on products and services. There are no material intersegment revenues. Information concerning the Company's continuing operations in the various segments is as follows:

Information concerning the Company's operations in the various segments for the nine-month periods ended September 30, 2006 and 2005 is as follows:

|  | Suttle        | Transition<br>Networks | JDL<br>Technologies | Austin Taylor | Corporate | Consolidated  |
|--|---------------|------------------------|---------------------|---------------|-----------|---------------|
| <b>Nine Months Ended September 30, 2006:</b> |               |                        |                     |               |           |               |
| Sales  | \$ 32,607,789 | \$ 40,251,874          | \$ 11,081,266       | \$ 5,461,184  | \$        | \$ 89,402,113 |
| Cost of sales                                | 23,075,093    | 22,387,937             | 9,785,256           | 4,320,828     |           | 59,569,114    |
| Gross profit                                 | 9,532,696     | 17,863,937             | 1,296,010           | 1,140,356     |           | 29,832,999    |
|  | 4,743,435     | 13,795,885             | 3,840,669           | 984,149       | 2,223,051 | 25,587,189    |

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|  |               |               |                |              |                |               |
|--|---------------|---------------|----------------|--------------|----------------|---------------|
| Selling, general and administrative expenses |               |               |                |              |                |               |
| Operating income (loss)                      | \$ 4,789,261  | \$ 4,068,052  | \$ (2,544,659) | \$ 156,207   | \$ (2,223,051) | \$ 4,245,810  |
| Depreciation and amortization                | \$ 642,949    | \$ 331,461    | \$ 606,933     | \$ 215,585   | \$ 67,500      | \$ 1,864,428  |
| Capital expenditures                         | \$ 355,070    | \$ 215,676    | \$ 376,395     | \$ 22,616    | \$ 71,724      | \$ 1,041,481  |
| Assets                                       | \$ 37,601,523 | \$ 25,149,083 | \$ 14,501,100  | \$ 4,562,676 | \$ 12,356,343  | \$ 94,170,725 |

Nine Months Ended September 30, 2005:

|  |               |               |               |              |                |               |
|--|---------------|---------------|---------------|--------------|----------------|---------------|
| Sales  | \$ 35,851,485 | \$ 34,941,539 | \$ 11,902,736 | \$ 4,178,948 | \$             | \$ 86,874,708 |
| Cost of sales                                | 25,706,185    | 21,471,269    | 7,268,011     | 3,771,716    |                | 58,217,181    |
| Gross profit                                 | 10,145,300    | 13,470,270    | 4,634,725     | 407,232      |                | 28,657,527    |
| Selling, general and administrative expenses | 4,401,699     | 12,967,339    | 3,378,835     | 824,799      | 1,780,916      | 23,353,588    |
| Operating income (loss)                      | \$ 5,743,601  | \$ 502,931    | \$ 1,255,890  | \$ (417,567) | \$ (1,780,916) | \$ 5,303,939  |
| Depreciation and amortization                | \$ 808,625    | \$ 254,575    | \$ 160,000    | \$ 134,596   | \$ 101,631     | \$ 1,459,427  |
| Capital expenditures                         | \$ 606,674    | \$ 231,170    | \$ 1,592,071  | \$ 14,435    | \$ 45,750      | \$ 2,490,100  |
| Assets:                                      |               |               |               |              |                |               |
| Continuing operations                        | \$ 34,380,677 | \$ 22,483,703 | \$ 14,931,223 | \$ 4,307,910 | \$ 13,868,844  | \$ 89,972,357 |
| Discontinued operations                      |               |               |               |              | 1,244,042      | 1,244,042     |
|  | \$ 34,380,677 | \$ 22,483,703 | \$ 14,931,223 | \$ 4,307,910 | \$ 15,112,886  | \$ 91,216,399 |

Information concerning the Company's operations in the various segments for the three-month periods ended September 30, 2006 and 2005 is as follows:

**SEGMENT INFORMATION**

|  | Suttle        | Transition Networks | JDL Technologies | Austin Taylor | Corporate    | Consolidated  |
|--|---------------|---------------------|------------------|---------------|--------------|---------------|
| Three Months Ended September 30, 2006:       |               |                     |                  |               |              |               |
| Sales  | \$ 10,795,380 | \$ 14,225,729       | \$ 3,743,802     | \$ 1,927,922  | \$           | \$ 30,692,833 |
| Cost of sales                                | 7,703,395     | 7,771,856           | 3,221,128        | 1,543,027     |              | 20,239,406    |
| Gross profit                                 | 3,091,985     | 6,453,873           | 522,674          | 384,895       |              | 10,453,427    |
| Selling, general and administrative expenses | 1,454,585     | 4,865,603           | 1,211,766        | 283,289       | 685,042      | 8,500,285     |
| Operating income (loss)                      | \$ 1,637,400  | \$ 1,588,270        | \$ (689,092)     | \$ 101,606    | \$ (685,042) | \$ 1,953,142  |
| Depreciation and amortization                | \$ 107,502    | \$ 120,584          | \$ 202,311       | \$ 41,758     | \$ 22,500    | \$ 494,655    |
| Capital expenditures                         | \$ 7,062      | \$ 88,617           | \$ 43,501        | \$ 17,503     | \$ 30,703    | \$ 187,386    |



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## COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

|   | Suttle        | Transition<br>Networks | JDL<br>Technologies | Austin Taylor | Corporate    | Consolidated  |
|---|---------------|------------------------|---------------------|---------------|--------------|---------------|
| Three Months Ended<br>September 30, 2005:       |               |                        |                     |               |              |               |
| Sales   | \$ 11,776,562 | \$ 11,802,316          | \$ 6,529,533        | \$ 1,295,461  | \$           | \$ 31,403,872 |
| Cost of sales                                   | 8,136,635     | 6,722,294              | 4,496,661           | 1,164,339     |              | 20,519,929    |
| Gross profit                                    | 3,639,927     | 5,080,022              | 2,032,872           | 131,122       |              | 10,883,943    |
| Selling, general and<br>administrative expenses | 1,644,618     | 4,017,963              | 1,269,525           | 285,571       | 604,497      | 7,822,174     |
| Operating income (loss)                         | \$ 1,995,309  | \$ 1,062,059           | \$ 763,347          | \$ (154,449)  | \$ (604,497) | \$ 3,061,769  |
| Depreciation and amortization                   | \$ 269,600    | \$ 82,900              | \$ 100,000          | \$            | \$ 32,152    | \$ 484,652    |
| Capital expenditures                            | \$ 175,751    | \$ 79,912              | \$ 757,200          | \$            | \$ (23,534)  | \$ 989,329    |

## 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 temporary differences resulting from different treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. These assets and liabilities are analyzed regularly and management assesses the likelihood that deferred tax assets will be recovered from future taxable income.

During the fourth quarter of 2005, an examination by the Internal Revenue Service of the Company's federal income tax returns for the year ended December 31, 2002 was completed. Due to the favorable results, the Company reviewed and reduced its estimated accrued tax liabilities in 2005. In 2006 the Company reduced its estimate of its exposure to certain other state and foreign tax liabilities by an additional amount. These adjustments resulted in a significant reduction in the effective tax rate in fiscal 2006 and in the fourth quarter of 2005 in comparison to prior years. The Company's effective income tax rate was approximately 23% for the nine months ended September 30, 2006 which approximates the estimated annual effective tax rate compared to 38% for the first nine months of 2005 and 27% for all of 2005.

Distributions by Suttle Caribe, Inc. to the parent company of income earned prior to December 31, 2000 are subject to a tollgate tax at rates which, depending on various factors, range from 3.5% to 10%. The cumulative amount of prior earnings which has been distributed to the parent company on which no tollgate tax has been paid was approximately \$11,054,000 at December 31, 2005. Tollgate taxes, penalties and interest of approximately \$1,537,000 have been accrued and will likely be paid on these prior earnings in 2007.

## NOTE 10 NET INCOME PER SHARE

Basic net income per common share is based on the weighted average number of common shares outstanding during each year. Diluted net income per common share takes into effect the dilutive effect of potential common shares outstanding. The Company's only potential common shares outstanding are stock options. The following table shows the dilutive effect of stock options for the respective periods of 2006 and 2005:

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## COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

|      | Three Months Ended<br>September 30 | Nine Months Ended<br>September 30 |
|------|------------------------------------|-----------------------------------|
| 2006 | 53,208                             | 91,251                            |
| 2005 | 129,599                            | 146,667                           |

The number of shares not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of common stock during the period was 132,900 and 163,600 at September 30, 2006 and 2005, respectively. The Company calculates the dilutive effect of outstanding options using the treasury stock method.

## NOTE 11 SUBSEQUENT EVENT

In April and May 2007, JDL Technologies' contracts to provide maintenance, interconnection and internet access services to the U.S. Virgin Islands Department of Education for the 2005-2006 and 2006-2007 school years were approved by the Schools and Libraries Division (SLD) of the Universal Service Administration Company. The Company will recognize \$2,555,000 of revenue from these contracts in its second quarter 2007 financial statements.

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

Nine Months Ended September 30, 2006 Compared to  
Nine Months Ended September 30, 2005

Sales from continuing operations in 2006 increased 3% to \$89,402,000 compared to \$86,875,000 in 2005. Operating income from continuing operations in 2006 decreased 20% to \$4,246,000 compared to \$5,304,000 in the first nine months of 2005. Income from continuing operations increased 9% to \$3,642,000 from \$3,327,000 in 2005.

Suttle sales decreased to \$32,608,000 in the first nine months of 2006 compared to \$35,851,000 in the same period of 2005 due to decreased volumes with existing customers. Sales to the major telephone companies decreased 30% to \$13,944,000 in 2006 compared to \$19,904,000 in 2005. Sales to these customers accounted for 43% and 56% of Suttle's U.S. customer sales in 2006 and 2005, respectively. Sales to distributors, original equipment manufacturers (OEMs), and electrical contractors increased to \$12,626,000 in 2006 compared to \$9,798,000 in 2005.

Suttle's gross margins decreased to \$9,533,000 in the first nine months of 2006 compared to \$10,145,000 in the same period in 2005. The gross margin percentage was 29% in 2006 compared to 28% in 2005. The gross margin percentage increase was due to cost reductions from vendors, improved efficiencies in production and increased volume of higher margin product line sales compared to the prior year. The Company has continued to outsource more manufacturing to Asia and shifted manufacturing to a lower cost plant in Costa Rica. Selling, general and administrative expenses increased \$342,000 or 8% in the first nine months of 2006 compared to the same period in 2005 due to the addition of sales people and related compensation and more aggressive marketing and sales programs. Suttle's operating income was \$4,789,000 in the first nine months of 2006 compared to \$5,744,000 in the same period of 2005.

Transition Networks segment sales increased 15% to \$40,252,000 in the first nine months of 2006 compared to \$34,942,000 in the same period in 2005. The increase in sales was due to increased demand for media conversion products in 2006. Gross margin increased to \$17,864,000 in the first

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

nine months of 2006 from \$13,470,000 in 2005. The MiLAN Technology business unit in this segment recorded an inventory write-down adjustment of approximately \$1.1 million dollars in the second quarter of 2005. Gross margin as a percentage of sales was 44% in 2006 compared to 39% in 2005. Selling, general and administrative expenses increased 6% to \$13,796,000 in the first nine months of 2006 compared to \$12,967,000 in 2005 due to an increase in the sales force headcount and related compensation expense and an increase in marketing program expenses. Operating income for this segment increased to \$4,068,000 in the first nine months of 2006 compared to \$503,000 in the same period in 2005. On July 1, 2005, CSI consolidated the MiLAN and Transition Networks business units into one operating unit under the direction of the Transition Networks management.

Sales by JDL Technologies, Inc. were \$11,081,000 in the first nine months of 2006 compared to \$11,903,000 in the same period in 2005. In April 2006 JDL was notified by the U.S. Department of Justice ( DOJ ) that JDL (and other parties) was the subject of an investigation regarding false claims for E-RATE funding involving the VIDOE. As a result of the investigation process and due to the uncertainties created by the DOJ investigation and the E-RATE approval process and JDL's inability to collect for services provided without approval, the Company ceased revenue recognition on JDL's VIDOE contracts in 2006. The Company will maintain this approach into 2007 and beyond, until it becomes convinced that such approvals are routine and that it is remote that funding will not be approved and that financial reports including such revenues can be relied upon as accurate. (A further discussion of revenue recognition policies can be found in Note 1 to the consolidated financial statements.) Billings for services in the first nine months of 2006 to the VIDOE that went unrecognized in 2006 revenues totaled \$1,923,000.

In 2005, JDL entered into a fixed-price contract with a large school district to install and upgrade its network equipment and infrastructure. The total value of this contract was \$6,645,000. As of September 30, 2006, costs and estimated earnings under this contract recognized on a percentage-of-completion basis totaled \$6,561,000. Total billings for this contract were \$5,476,000. Revenue recognized in the first nine months of 2006 on this contract totaled \$3,023,000. The project was completed in the third quarter of 2006 except for final approvals. Final billing to the customer is expected in the fourth quarter of 2006. The method used to determine the progress of completion is based on the ratio of costs incurred to total estimated costs.

JDL gross margins decreased to \$1,296,000 in the first nine months of 2006 compared to \$4,635,000 in the same period in 2005. Gross margins in 2006 were negatively impacted by the absence of E-RATE revenues from JDL's VIDOE contracts. Margins were also negatively affected by increased depreciation charges on plant investments in the U.S. Virgin Islands and higher than anticipated costs on the Oakland project and on lower margin equipment sales to Broward County. Selling, general and administrative expenses increased in 2006 to \$3,841,000 compared to \$3,379,000 in 2005 due to legal and professional fees incurred in the Department of Justice investigation, higher sales headcount and increased marketing and administrative salaries including costs of expanding JDL's Florida operations. JDL reported an operating loss of \$2,545,000 in the first nine months of 2006 compared to operating income of \$1,256,000 in the first nine months of 2005.

Austin Taylor's sales increased to \$5,461,000 in 2006 compared to \$4,179,000 in 2005. 2006 gross margin improved to \$1,140,000 from \$407,000 in 2005. Operating income was \$156,000 in 2006 compared to an operating loss of \$418,000 in 2005.

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

Net investment and other income increased \$203,000 in the first nine months of 2006 compared to 2005 due to increased earnings on cash and money market balances. Income from continuing operations before income taxes decreased to \$4,757,000 in the first nine months of 2006 compared to \$5,617,000 in 2005. The Company's effective income tax rate was 23% in 2006 and 41% in 2005.

Net income for the nine months ended September 30, 2005 includes the discontinued operations of Image Systems, a medical and technical imaging business unit located in Eden Prairie, Minnesota. During the 2005 period Image Systems had a net of tax operating loss of \$345,000 on

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sales of \$3,286,000. Effective October 1, 2005, the Company negotiated an agreement to sell the inventory, equipment and all intangibles (trade names, intellectual property, etc.) of Image Systems to Richardson Electronics, Ltd. Net income in 2006 was \$3,642,000 compared to \$2,981,000 in 2005.

### Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005

Sales from continuing operations decreased 2% to \$30,693,000 in the three-month period ended September 30, 2006 compared to \$31,404,000 in the same period in 2005. Operating income from continuing operations decreased 36% to \$1,953,000 in the three months ended September 30, 2006 compared to \$3,062,000 in the same period in 2005. Income from continuing operations decreased 14% to \$1,595,000 in 2006 compared to \$1,861,000 in 2005.

Subtle sales decreased 8% to \$10,795,000 in 2006 compared to \$11,777,000 in 2005 due to decreased volumes in traditional telephony products and DSL filters. Subtle's gross margins decreased to \$3,092,000 in 2006 compared to \$3,640,000 in 2005 due to lower volumes. The gross margin percentage declined to 29% for the three month period in 2006 compared to 31% for 2005. Selling, general and administrative expenses decreased 12% to \$1,455,000 in the third quarter of 2006 compared to \$1,645,000 incurred in the same period of 2005. The decrease was primarily due to lower compensation costs. Subtle operating income decreased 18% to \$1,637,000 in the third quarter of 2006 compared to operating income of \$1,995,000 in the same period in 2005.

Transition Networks segment sales increased 21% to \$14,226,000 in the third quarter of 2006 compared to \$11,802,000 in the same period in 2005 due to higher market demand for media conversion and network switching products. Gross margin increased 27% to \$6,454,000 in 2006 from \$5,080,000 in 2005. Gross margin as a percentage of sales increased to 45% in 2006 compared to 43% in 2005. The gross margin percentage increase was due primarily to higher volumes, reductions in material and product component costs in manufacturing and through efficiencies gained by combining the Transition Networks and MiLAN Technology business units in 2005. Selling, general and administrative expenses increased to \$4,866,000 in 2006 compared to \$4,018,000 in 2005. Operating income increased to \$1,588,000 in the third quarter of 2006 compared to \$1,062,000 in the same period of 2005.

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### COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

Sales by JDL Technologies, Inc. were \$3,744,000 in the third quarter of 2006 compared to \$6,530,000 in the same period in 2005 due to lower sales of network equipment and connectivity services. In April 2006 JDL was notified by the U.S. Department of Justice (DOJ) that JDL (and other parties) was the subject of an investigation regarding false claims for E-RATE funding involving the VIDOE. As a result of the investigation process and due to the uncertainties created by the DOJ investigation and the E-RATE approval process and JDL's inability to collect for services provided without approval, the Company ceased revenue recognition on JDL's VIDOE contracts in 2006. The Company will maintain this approach into 2007 and beyond, until it becomes convinced that such approvals are routine and that it is remote that funding will not be approved and that financial reports including such revenues can be relied upon as accurate. (A further discussion of revenue recognition policies can be found in Note 1 to the consolidated financial statements.) Billings for services in the third quarter of 2006 to the VIDOE that went unrecognized in 2006 revenues totaled \$748,000.

In 2005, JDL entered into a fixed-price contract with a large school district to install and upgrade its network equipment and infrastructure. The total value of this contract was \$6,645,000. As of June 30, 2006, costs and estimated earnings under this contract recognized on a percentage-of-completion basis totaled \$5,469,000. Total billings for this contract were \$3,460,000. Revenue recognized in the third quarter of 2006 on this contract was \$891,000. The project was completed in the third quarter of 2006 except for final approvals. Final billing to the customer is expected in the fourth quarter of 2006. The project is expected to be completed in the third quarter of 2006.

JDL gross margins decreased to \$523,000 in the third quarter of 2006 compared to \$2,033,000 in the same period in 2005. Gross margins in 2006 were negatively impacted by the absence of E-RATE revenues from JDL's VIDOE contracts. Margins were also negatively affected by increased depreciation charges on plant investments in the U.S. Virgin Islands and higher than anticipated costs on the Oakland project and on lower margin equipment sales to Broward County. Selling, general and administrative expenses decreased in 2006 to \$1,212,000 compared to \$1,269,000 in 2005 due to lower compensation costs which offset legal and professional fees incurred in the Department of Justice investigation.

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JDL reported an operating loss of \$689,000 in the third quarter of 2006 compared to operating income of \$763,000 in the third quarter of 2005.

Austin Taylor's sales increased to \$1,928,000 in 2006 compared to \$1,295,000 in 2005. 2006 gross margin improved to \$385,000 from \$131,000 in 2005. Operating income was \$102,000 in 2006 compared to an operating loss of \$154,000 in 2005.

Investment income net of interest expense was \$173,000 in 2006 compared to \$130,000 in 2005 due to increased cash and investment balances and higher rates earned on funds invested. Income from continuing operations before income taxes decreased to \$2,126,000 in 2006 compared to \$3,192,000 in 2005. The Company's effective income tax rate was 25% in 2006 and 42% in 2005.

Net income for the three months ended September 30, 2005 includes the discontinued operations of Image Systems, a medical and technical imaging business unit located in Eden Prairie, Minnesota. During the 2005 period Image Systems had a net of tax operating loss of \$84,000 on sales of \$883,000. Effective October 1, 2005, the Company negotiated an agreement to sell the inventory, equipment and all intangibles (trade names, intellectual property, etc.) of Image Systems to Richardson Electronics, Ltd. Net income in 2006 was \$1,595,000 compared to \$1,777,000 in 2005.

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## COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

### Liquidity and Capital Resources

At September 30, 2006, the Company had \$26,599,000 of cash and cash equivalents compared to \$26,661,000 of cash and cash equivalents at December 31, 2005. The Company had working capital (current assets minus current liabilities) of approximately \$70,370,000 and a current ratio of 7.7 to 1 compared to working capital of \$67,048,000 and a current ratio of 6.7 to 1 at the December 31, 2005.

Net cash provided by operating activities was \$2,080,000 in the first nine months of 2006 compared to net cash provided by operating activities of \$1,318,000 in the same period in 2005. The cash flow increase was due primarily to an increase in net income and the level of accruals and income tax payable attributable to normal fluctuations in timing of expenses and purchases.

Net cash provided by investing activities was \$61,000 in the first nine months in 2006 compared to net cash used of \$2,490,000 in the same period in 2005. In the first nine months of 2006 the Company collected proceeds from the sale of discontinued operations of \$1,103,000. Cash investments in new plant and equipment totaled \$1,041,000 compared to \$2,490,000 in 2005. Plant and equipment purchases in both years were financed by internal cash flows. The Company expects to spend approximately \$2,500,000 in total on capital additions in 2006, principally to support JDL's operations in the U.S. Virgin Islands.

Net cash used in financing activities was \$2,247,000 in the first nine months of 2006 compared to net cash used in financing activities in 2005 of \$1,216,000. At September 30, 2006 Board authorizations are outstanding to purchase an additional 202,000 shares. Cash dividends paid in the first nine months of 2006 was approximately \$2,186,000 compared to \$1,705,000 in the same period in 2005. There were no borrowings on the line of credit during the first nine months of 2006.

In the opinion of management, based on the Company's current financial and operating position and projected future expenditures, sufficient funds are available to meet the Company's anticipated operating and capital expenditure needs.

### Critical Accounting Policies

Our critical accounting policies, including the assumptions and judgments underlying them, are discussed in our 2006 and 2005 Form 10-K in Note 1 Summary of Significant Accounting Policies included in our Consolidated Financial Statements. As discussed in Note 1, the Company has reevaluated its revenue recognition policies with regard to contracts with the U.S. Virgin Islands Department of Education (VIDOE) that are subject to E-RATE funding. The Company has deferred recognition of these revenues in 2006 until its contracts with the VIDOE have been approved by government funding authorities. The Company will continue this policy in force until it becomes convinced that such funding approvals are routine and that it is remote that funding will not be approved. Effective January 1, 2006, the Company also adopted the provisions

of adopted SFAS No. 123(R), requiring the Company to recognize expense related to the fair value of the stock-based compensation awards, as discussed in Note 2. There were no other significant changes to our critical accounting policies during the nine months ended September 30, 2006.

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

The Company's accounting policies have been consistently applied in all material respects and disclose such matters as allowance for doubtful accounts, sales returns, inventory valuation, warranty expense, income taxes, revenue recognition, asset and goodwill impairment recognition and foreign currency translation. On an ongoing basis, we evaluate our estimates based on historical experience and on various other assumptions that are believed 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 on an ongoing basis reviews these estimates and judgments.

Recently Issued Accounting Pronouncements

In July 2006 the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), Accounting for Income Taxes an interpretation of FASB Statement No. 109, which clarifies accounting for uncertain tax positions. FIN 48 requires the Company to recognize the impact of a tax position in the Company's financial statements if that position is likely to be sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective for the Company beginning January 1, 2007. The Company has not determined the impact of the adoption of FIN 48 will have on the Company's consolidated financial statements.

In September 2006 the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands fair value disclosure requirements. SFAS No. 157 applies whenever another accounting standard requires (or permits) assets or liabilities to be measured at fair value, but does not expand the use of fair value to new circumstances. SFAS No. 157 is effective beginning in 2008. The Company has not yet determined the effect SFAS No. 157 will have on its financial statements.

The Company adopted SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Post Retirement Plans on December 31, 2006. SFAS No. 158 requires the Company to recognize the funded status of its post retirement plans on the balance sheet and recognize as a component of accumulated other comprehensive income the gains and losses, prior service costs or credits that occur during the financial year but are not recognized as components of the Company's pension costs. The adoption of SFAS No. 158 caused the Company to adjust its December, 2006 financial statements to include \$200,000 of previously unrecognized actuarial gains in Austin Taylor's pension plan funds.

In February 2007 the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The amendment to SFAS No. 115 applies to all entities with investments in available-for-sale or trading securities. The statement is effective for fiscal years beginning after November 15, 2007. The Company has not yet determined the effect SFAS No. 159 will have on its financial statements.

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.

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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 September 30, 2006 our bank line of credit carried a variable interest rate based on the London Interbank Offered Rate (Libor) plus 2%. The Company's investments are money market type of investments that earn interest at prevailing market rates and as such do not have material risk exposure.

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

Item 4. Controls and Procedures

The Company, under the supervision and with the participation of management, including the Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on that evaluation, the CEO and CFO concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were not effective due to the controls over the financial close and reporting processes at the Company's JDL Technologies subsidiary which, in part, caused us to not be able to file this report within the time period specified in the Securities and Exchange Commission's rules and forms. The internal controls over financial close and reporting processes at JDL did not adequately provide for (1) timely, properly performed reconciliations for all significant accounts and (2) timely, appropriate application of the entity's accounting policies to events or transactions that were appropriately documented by knowledgeable and qualified personnel using approved methods and formats.

During the period covered by this Report there was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

From time to time in reports filed with the Securities and Exchange Commission, in press releases, and in other communications to shareholders and the investing public, the Company may make statements regarding the Company's future financial performance. Such forward looking statements are subject to risks and uncertainties, including but not limited to, the effects of the Telecommunications Act, new technological developments which may reduce barriers for competitors entering the Company's local exchange or cable television markets, higher than expected expenses and other risks involving the telecommunications industry generally. All such forward-looking statements should be considered in light of such risks and uncertainties.

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

PART II. OTHER INFORMATION

Items 1 - 4. Not Applicable

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K.

(a) 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).

(b) Reports on Form 8-K.

On August 15, 2006, Communications Systems, Inc. (the Company) issued a press release reporting its operating results for the quarter and six months ended June 30, 2006. In its press release the Company also reported on issues and uncertainties affecting its JDL Technologies subsidiary, that due to such issues and uncertainties the Company is unable to complete and file the Company's Quarterly Report on Form 10-Q for the quarter and six months ended June 30, 2006 and that the Company continues to be out of compliance with rules of the American Stock Exchange.

On September 14, 2006, the Company reported that it continued to be unable to complete and file Form 10-Q reports due for the three month period ended March 31, 2006 and the six month period ended June 30, 2006 (the 2006 Form 10-Q Reports) due to risks and uncertainties arising from a civil investigation of the Company's JDL Technologies subsidiary initiated by the U.S. Department of Justice (DOJ) and the Company's continued assessment of uncollected receivables totaling approximately \$3.5 million related to work performed for the U.S. Virgin Islands Department of Education (VIDOE). The Company also reported on September 14, 2006 that, while not filing the 2006 Form 10-Q Reports caused the Company to be out of compliance with the applicable listing standards of the American Stock Exchange (AMEX), on July 7, 2006 AMEX granted the Company an extension to September 6, 2006 to achieve compliance with the listing standards. Finally, on September 14, 2006, the Company reported that it had submitted a written request to AMEX on September 6, 2006 for additional time in which to file the 2006 Form 10-Q Reports and thereby regain compliance with the AMEX listing standards.

On September 29, 2006 the Company supplemented its September 6, 2006 communication to AMEX and provided AMEX with an amended plan with respect to its efforts to achieve compliance with AMEX's listing standards by November 30, 2006. In its September 29 communication, the Company explained it believed a further extension to November 30 would

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

provide sufficient time for the Company to complete management's assessment of the uncollected receivables and pending DOJ investigation for purposes of finalizing the 2006 Form 10-Q reports. The Company advised AMEX that this would also provide sufficient time for the Company's Audit Committee to complete an independent review of certain matters arising from the DOJ investigation.

On October 9, 2006, the Company received notification from AMEX that the Company's amended plan and supporting documentation (the Revised Plan) made a reasonable demonstration of the Company's ability to regain compliance with AMEX's continued listing standards. Based upon the Revised Plan, AMEX staff, subject to certain conditions, granted the Company an extension until November 30, 2006 to file the 2006 Form 10-Q reports. In its letter, AMEX also stated it expected the Company to be in compliance with the continued listing standards of AMEX by November 30, 2006 and that failure to achieve compliance by that date would likely result in the



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initiation of delisting proceedings by AMEX staff.

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/ Curtis A. Sampson

Date: May 15, 2007

Curtis A. Sampson  
Chairman and  
Chief Executive Officer

/s/ Paul N. Hanson

Date: May 15, 2007

Paul N. Hanson  
Vice President and  
Chief Financial Officer