COMMUNICATIONS SYSTEMS INC
Form 10-Q
May 07, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2015

OR

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

For the transition period from ____________________ to ____________________

Commission File Number: 001-31588

COMMUNICATIONS SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Name of Exchange On Which Registered	Outstanding at May 1, 2015
Common Stock, par value $.05 per share	NASDAQ	8,712,330

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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

	March 31 2015	December 31 2014
CURRENT ASSETS:		
Cash and cash equivalents	$9,149,624	$13,736,857
Investments	4,878,321	4,602,717
Trade accounts receivable, less allowance for doubtful accounts of $145,000 and $22,000, respectively	10,877,375	13,839,662
Inventories	32,478,501	31,109,653
Prepaid income taxes	3,814,609	2,317,688
Other current assets	1,318,797	1,050,000
Deferred income taxes	3,250,106	3,249,164
TOTAL CURRENT ASSETS	65,767,333	69,905,741
PROPERTY, PLANT AND EQUIPMENT, net	18,437,556	18,153,152
OTHER ASSETS:		
Investments	10,585,239	11,540,261
Funded pension assets	152,010	172,405
Other assets	857,794	514,676
TOTAL OTHER ASSETS	11,595,043	12,227,342
TOTAL ASSETS	$95,799,932	100,286,235
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	$500,096	$524,220
Accounts payable	6,462,791	5,180,631
Accrued compensation and benefits	2,935,454	3,696,930
Other accrued liabilities	2,391,084	2,146,582
Dividends payable	1,463,075	1,446,498
TOTAL CURRENT LIABILITIES	13,752,500	12,994,861
LONG TERM LIABILITIES:		
Uncertain tax positions	77,823	77,279
Deferred income taxes	1,001,688	1,089,994
Long-term debt - mortgage payable	—	103,603
TOTAL LONG-TERM LIABILITIES	1,079,511	1,270,876
COMMITMENTS AND CONTINGENCIES (Footnote 7)		
STOCKHOLDERS' EQUITY		
Preferred stock, par value $1.00 per share; 3,000,000 shares authorized; none issued		
Common stock, par value $.05 per share; 30,000,000 shares authorized; 8,707,564 and 8,654,756 shares issued and outstanding, respectively	435,378	432,738
Additional paid-in capital	39,232,052	38,593,230
Retained earnings	42,083,492	47,689,688

Accumulated other comprehensive loss	(783,001)	(695,158)
TOTAL STOCKHOLDERS' EQUITY	80,967,921	86,020,498
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$95,799,932	$100,286,235

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

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

	Three Months Ended March 31	
	2015	2014
Sales	$ 19,544,936	$ 25,198,406
Costs and expenses:		
Cost of sales	14,657,998	16,210,390
Selling, general and administrative expenses	10,578,176	9,002,112
Restructuring expense	—	237,838
Total costs and expenses	25,236,174	25,450,340
Operating loss	(5,691,238)	(251,934)
Other income and (expenses) :		
Investment and other income	62,963	5,960
Gain on sale of assets	4,285	5,740
Interest and other expense	(13,218)	(24,655)
Other income (expense), net	54,030	(12,955)
Loss from operations before income taxes	(5,637,208)	(264,889)
Income tax benefit	(1,473,732)	(124,306)
Net loss	(4,163,476)	(140,583)
Other comprehensive loss, net of tax:		
Additional minimum pension liability adjustments	(12,646)	(87,343)
Unrealized gain/(loss) on available-for-sale securities	55,120	(22,890)
Foreign currency translation adjustment	(130,317)	26,550
Total other comprehensive loss	(87,843)	(83,683)
Comprehensive loss	$ (4,251,319)	$ (224,266)
Basic net loss per share:	$ (0.48)	$ (0.02)
Diluted net loss per share:	$ (0.48)	$ (0.02)
Weighted Average Basic Shares Outstanding	8,660,819	8,565,426
Weighted Average Dilutive Shares Outstanding	8,660,819	8,565,426
Dividends declared per share	$ 0.16	$ 0.16

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

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

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total
BALANCE AT DECEMBER 31, 2014	8,654,756	$432,738	$38,593,230	$47,689,688	$ (695,158)	$86,020,498
Net loss				(4,163,476)		(4,163,476)
Issuance of common stock under Employee Stock Purchase Plan	4,028	201	42,093			42,294
Issuance of common stock to Employee Stock Ownership Plan	36,707	1,835	383,588			385,423
Issuance of common stock under Executive Stock Plan	16,440	822	0			822
Tax benefit from stock based payments			(5,712)			(5,712)
Share based compensation			238,349			238,349
Purchase of common stock	(4,367)	(218)	(19,496)	(30,943)		(50,657)
Shareholder dividends				(1,411,777)		(1,411,777)
Other comprehensive loss					(87,843)	(87,843)
BALANCE AT MARCH 31, 2015	8,707,564	$435,378	$39,232,052	$42,083,492	$ (783,001)	$80,967,921

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

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

	Three Months Ended March 31	
	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (4,163,476)	$ (140,583)
Adjustments to reconcile net loss to		
net cash provided by operating activities:		
Depreciation and amortization	780,477	560,622
Share based compensation	238,349	48,281
Deferred taxes	(89,248)	91,364
Gain on sale of assets	(4,285)	(5,740)
Excess tax benefit from share-based payments	5,712	9,067
Changes in assets and liabilities:		
Trade receivables	2,956,932	6,686,463
Inventories	(1,398,048)	(733,914)
Prepaid income taxes	(1,496,921)	(225,644)
Other assets	(657,485)	14,645
Accounts payable	1,071,831	617,539
Accrued compensation and benefits	(371,707)	(996,144)
Other accrued liabilities	256,330	(98,905)
Income taxes payable	(5,168)	(3,663)
Net cash (used in) provided by operating activities	(2,876,707)	5,823,388
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(853,074)	(823,633)
Purchases of investments	—	(6,539,789)
Proceeds from the sale of fixed assets	22,853	5,740
Proceeds from the sale of investments	734,537	1,380,000
Net cash used in investing activities	(95,684)	(5,977,682)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Cash dividends paid	(1,395,200)	(1,368,532)
Mortgage principal payments	(127,727)	(119,318)
Proceeds from issuance of common stock, net of shares withheld	(7,541)	35,686
Excess tax benefit from share-based payments	(5,712)	(9,067)
Payment of contingent consideration related to acquisition	—	(565,647)
Net cash used in financing activities	(1,536,180)	(2,026,878)
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	(78,662)	9,368
NET DECREASE IN CASH AND CASH EQUIVALENTS	(4,587,233)	(2,171,804)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	13,736,857	20,059,120

CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 9,149,624	$ 17,887,316
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Income taxes paid	$ 500	$ 14,613
Interest paid	13,121	18,405
Dividends declared not paid	1,463,075	1,454,417
Capital expenditures in accounts payable	218,019	237,330

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

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COMMUNICATIONS SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Communications Systems, Inc. (herein collectively called "CSI" or the "Company") is a Minnesota corporation organized in 1969 that operates primarily as a holding company conducting its business through three business units having operations in the United States, Costa Rica, and the United Kingdom. Through its Suttle business unit, the Company is principally engaged in the manufacture and sale of copper and fiber connectivity systems, enclosure systems, and active technologies for voice, data and video communications. Through its Transition Networks business unit, the Company is engaged in the manufacture of media converters, network interface devices, network interface cards, Ethernet switches and other connectivity products that offer the ability to affordably integrate the benefits of fiber optics into any data network. Through its JDL Technologies business unit, the Company provides technology solutions including virtualization, managed services, wired and wireless network design and implementation, HIPAA-compliant IT services, and converged infrastructure configuration and deployment.

Financial Statement Presentation

The condensed consolidated balance sheets and condensed consolidated statement of changes in stockholders' equity as of March 31, 2015 and the related condensed consolidated statements of loss and comprehensive loss, and the condensed consolidated statements of cash flows for the periods ended March 31, 2015 and 2014 have been prepared by Company management. In the opinion of management, all adjustments (which include only normal recurring adjustments, except where noted) necessary to present fairly the financial position, results of operations, and cash flows at March 31, 2015 and 2014 and for the periods then ended have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted. We recommend these condensed consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Company's December 31, 2014 Annual Report to Shareholders on Form 10-K. The results of operations for the period ended March 31, 2015 are not necessarily indicative of operating results for the entire year.

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

Except to the extent updated or described below, the significant accounting policies set forth in Note 1 to the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2014, appropriately represent, in all material respects, the current status of accounting policies, and are incorporated herein by reference.

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Accumulated Other Comprehensive Loss

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

	March 31 2015	December 31 2014
Foreign currency translation	$(2,735,000)	$(2,605,000)
Unrealized gain/(loss) on available-for-sale investments	14,000	(41,000)
Pension liability adjustment	1,938,000	1,951,000
	$(783,000)	$(695,000)

NOTE 2 – CASH EQUIVALENTS AND INVESTMENTS

The following tables show the Company's cash equivalents and available-for-sale securities' amortized cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category recorded as cash and cash equivalents or short and long term investments as of March 31, 2015 and December 31, 2014:

March 31, 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash Equivalents	Short-Term Investments	Long-Term Investments
Cash equivalents:							
Money Market funds	$442,000	$—	$—	$442,000	$442,000	$	$
Subtotal	442,000	—	—	442,000	442,000	—	—
Investments:							
Certificates of deposit	6,693,000	9,000	(3,000)	6,699,000	—	1,683,000	5,016,000
Corporate Notes/Bonds	8,763,000	7,000	(6,000)	8,764,000	—	3,195,000	5,569,000
Subtotal	15,456,000	16,000	(9,000)	15,463,000	—	4,878,000	10,585,000
Total	$15,898,000	$16,000	$(9,000)	$15,905,000	$442,000	$4,878,000	$10,585,000

December 31, 2014

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

Cash equivalents:							
Money Market funds	$1,073,000	$—	$—	$1,073,000	$1,073,000	$	$
Subtotal	1,073,000	—	—	1,073,000	1,073,000	—	—
Investments:							
Certificates of deposit	7,414,000	1,000	(32,000)	7,383,000	—	1,920,000	5,463,000
Corporate Notes/Bonds	8,777,000	6,000	(23,000)	8,760,000	—	2,683,000	6,077,000
Subtotal	16,191,000	7,000	(55,000)	16,143,000	—	4,603,000	11,540,000
Total	$17,264,000	$7,000	$(55,000)	$17,216,000	$1,073,000	$4,603,000	$11,540,000

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The Company tests for other than temporary losses on a quarterly basis and has considered the unrealized losses indicated above to be temporary in nature. The Company intends to hold the investments until it can recover the full principal amount and has the ability to do so based on other sources of liquidity. The Company expects these recoveries to occur prior to the contractual maturities. All unrealized losses as of March 31, 2015 were in a continuous unrealized loss position for less than twelve months and are not deemed to be other than temporarily impaired as of March 31, 2015.

The following table summarizes the estimated fair value of our investments, designated as available-for-sale and classified by the contractual maturity date of the securities as of March 31, 2015:

	Amortized Cost	Estimated Market Value
Due within one year	$ 4,634,000	$ 4,878,000
Due after one year through five years	10,582,000	10,585,000
	$ 15,216,000	$ 15,463,000

The Company did not recognize any gross realized gains, and gross realized losses were immaterial, during the three-month periods ending March 31, 2015 and 2014, respectively. If the Company had realized gains or losses, they would be included within investment and other income in the accompanying consolidated results of operations.

NOTE 3 - STOCK-BASED COMPENSATION

Employee Stock Purchase Plan

Under the Company's Employee Stock Purchase Plan ("ESPP"), employees are able to acquire shares of common stock at 85% of the price at the end of each current quarterly plan term. The most recent term ended March 31, 2015. The ESPP is considered compensatory under current Internal Revenue Service rules. At March 31, 2015, after giving effect to the shares issued as of that date, 17,455 shares remain available for purchase under the ESPP. On April 3, 2015, the Company's Board of Directors amended the ESPP to increase the authorized shares by 100,000 to 600,000, subject to approval at the Company's Annual Meeting of Shareholders to be held on May 21, 2015.

2011 Executive Incentive Compensation Plan

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

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During 2015, stock options covering 105,279 shares were awarded to key executive employees and directors, which options expire seven years from the date of award and vest 25% each year beginning one year after the date of award. The Company also granted deferred stock awards of 100,017 shares to key employees during the first quarter under the Company's long-term incentive plan for performance over the 2015 to 2017 period. The actual number of shares of deferred stock, if any, that are earned by the respective employees will be determined based on achievement against performance goals for each of the three years ending December 31, 2017 and the shares earned will be issued in the first quarter of 2018 to those key employees still with the Company at that time.

At March 31, 2015, 65,651 shares have been issued under the 2011 Incentive Plan, 801,293 shares are subject to currently outstanding options, deferred stock awards, and unvested restricted stock units, and 133,056 shares are eligible for grant under future awards. On April 3, 2015, the Company's Board of Directors amended the 2011 Stock Incentive plan to increase the authorized shares by 1,000,000 to 2,000,000, subject to approval at the Company's Annual Meeting of Shareholders to be held on May 21, 2015.

Stock Option Plan for Directors

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

No options were granted under the Director Plan in 2014 or 2015. The Director Plan was amended as of May 19, 2011 to prohibit option grants in 2011 and future years.

1992 Stock Plan

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

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At March 31, 2015, after reserving for stock options and deferred stock awards granted in prior years and adjusting for forfeitures and issuances during the year, there were 22,008 shares reserved for issuance under the Stock Plan. The Company has not awarded stock options or deferred stock under this plan in 2015.

Changes in Stock Options Outstanding

The following table summarizes changes in the number of outstanding stock options under the 2011 Incentive Plan, the Director Plan and Stock Plan over the period December 31, 2014 to March 31, 2015:

	Options	Weighted average exercise price per share	**Weighted average remaining contractual term**
Outstanding – December 31, 2014	540,404	$ 11.90	5.13
Awarded	105,279	11.65	
Exercised	—	—	
Forfeited	(10,433)	11.97	
Outstanding – March 31, 2015	635,250	11.86	5.22
Exercisable at March 31, 2015	237,409	$ 11.64	3.49
Expected to vest March 31, 2015	635,250	11.86	5.22

The aggregate intrinsic value of all options (the amount by which the market price of the stock on the last day of the period exceeded the market price of the stock on the date of grant) outstanding at March 31, 2015 was $158,000. The intrinsic value of all options exercised during the three months ended March 31, 2015 was $0. Net cash proceeds from the exercise of all stock options were $0 for the three months ended March 31, 2015 and 2014.

Changes in Deferred Stock Outstanding

The following table summarizes the changes in the number of deferred stock shares under the Stock Plan and 2011 Incentive Plan over the period December 31, 2014 to March 31, 2015:

	Shares	Weighted Average Grant Date Fair Value
Outstanding – December 31, 2014	161,314	$ 10.87
Granted	100,017	11.59
Vested	(16,440)	12.55
Forfeited	(5,991)	10.26
Outstanding – March 31, 2015	238,900	11.07

Changes in Restricted Stock Units Outstanding

The following table summarizes the changes in the number of restricted stock units under the 2011 Incentive Plan over the period December 31, 2014 to March 31, 2015:

	Shares	Weighted Average Grant Date Fair Value
Outstanding – December 31, 2014	39,151	$ 10.67
Granted	—	—
Vested	—	—
Forfeited	—	—
Outstanding – March 31, 2015	39,151	10.67

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Compensation Expense

Share-based compensation expense recognized for the three-month period ended March 31, 2015 was $238,000 before income taxes and $155,000 after income taxes. Share-based compensation expense recognized for the three-month period ended March 31, 2014 was $48,000 before income taxes and $31,000 after income taxes. Unrecognized compensation expense for the Company's plans was $1,204,000 at March 31, 2015 and is expected to be recognized over a weighted-average period of 2.7 years. Excess tax benefits from the exercise of stock options and issuance of stock included in financing cash flows for the three month periods ended March 31, 2015 and 2014 were $ (6,000) and $ (9,000), respectively. Share-based compensation expense is recorded as a part of selling, general and administrative expenses.

NOTE 4 - INVENTORIES

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

	March 31 2015	December 31 2014
Finished goods	$ 19,661,000	$ 19,208,000
Raw and processed materials	12,818,000	11,902,000
	$ 32,479,000	$ 31,110,000

NOTE 5 – INTANGIBLE ASSETS

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

	March 31, 2015			
	Gross Carrying Amount	Accumulated Amortization	Foreign Currency Translation	Net
Trademarks	91,000	(39,000)	(8,000)	44,000
Customer relationships	491,000	(163,000)	(46,000)	282,000
Technology	229,000	(152,000)	(21,000)	56,000
	811,000	(354,000)	(75,000)	382,000

	December 31, 2014			
	Gross Carrying Amount	Accumulated Amortization	Foreign Currency Translation	Net
Trademarks	91,000	(38,000)	(4,000)	49,000
Customer relationships	491,000	(159,000)	(26,000)	306,000
Technology	229,000	(149,000)	(11,000)	69,000
	811,000	(346,000)	(41,000)	424,000

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Amortization expense on these identifiable intangible assets was $24,000 and $27,000 for the three months ended 2015 and 2014, respectively. The amortization expense is included in selling, general and administrative expenses. At March 31, 2015, the estimated future amortization expense for definite-lived intangible assets for the remainder of 2015 and all of the following four fiscal years is as follows:

Year Ending December 31:	
2015	$ 75,000
2016	83,000
2017	58,000
2018	53,000
2019	46,000

NOTE 6 – WARRANTY

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

The following table presents the changes in the Company’s warranty liability for the three-month periods ended March 31, 2015 and 2014, respectively, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

	2015	2014
Beginning balance	$434,000	$564,000
Amounts charged to expense	142,000	12,000
Actual warranty costs paid	(22,000)	(50,000)
Ending balance	$554,000	$526,000

NOTE 7 – CONTINGENCIES

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

NOTE 8 – INCOME TAXES

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

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At March 31, 2015 there was $76,000 of net uncertain tax benefit positions that would reduce the effective income tax rate if recognized. The Company records interest and penalties related to income taxes as income tax expense in the Condensed Consolidated Statements of Income.

The Company is subject to U.S. federal income tax as well as income tax of multiple state and foreign jurisdictions. The tax years 2011-2013 remain open to examination by the Internal Revenue Service and the years 2010-2013 remain open to examination by various state tax departments. The tax years from 2011-2013 remain open in Costa Rica.

The Company's effective income tax rate was 26.1% for the first three months of 2015. The effective tax rate differs from the federal tax rate of 35% due to state income taxes, foreign tax rate differences, foreign losses not deductible for U.S. income tax purposes and expenses not deductible for tax purposes. The foreign operating losses may ultimately be deductible in the countries in which they occurred; however the Company has not recorded a deferred tax asset for these losses due to uncertainty regarding the eventual realization of the benefit. The effect of the foreign operations was an overall rate increase of approximately 4.2% for the three months ended March 31, 2015. There were no additional uncertain tax positions identified in the first three months of 2015. The Company's effective income tax rate for the three months ended March 31, 2014 was 46.9%, and differed from the federal tax rate due to state income taxes, foreign losses not deductible for U.S. income tax purposes and provisions for interest charges.

NOTE 9 – SEGMENT INFORMATION

The Company classifies its businesses into three segments as follows:

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

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

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

Management has chosen to organize the enterprise and disclose reportable segments based on our products and services. There are no material inter-segment revenues.

Information concerning the Company's continuing operations in the various segments for the three month periods ended March 31, 2015 and 2014 is as follows:

	Suttle	Transition Networks	JDL Technologies	Other	Total
Three Months Ended March 31, 2015					
Sales	$10,590,000	$8,090,000	$ 865,000	$—	$19,545,000
Cost of sales	9,149,000	4,685,000	824,000	—	14,658,000
Gross profit	1,441,000	3,405,000	41,000	—	4,887,000
	4,306,000	5,462,000	810,000	—	10,578,000

Selling, general and administrative expenses					
Operating loss	$(2,865,000)	$(2,057,000)	$ (769,000)	$—	$(5,691,000)
Depreciation and amortization	$507,000	$247,000	$ 26,000	$—	$780,000
Capital expenditures	$649,000	$86,000	$ 44,000	$74,000	$853,000
Assets	$40,210,000	$26,870,000	$ 4,367,000	$24,353,000	$95,800,000

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	Suttle	Transition Networks	JDL Technologies	Other	Total
Three Months Ended March 31, 2014					
Sales	$12,882,000	$9,749,000	$ 2,567,000	$—	$25,198,000
Cost of sales	9,392,000	5,043,000	1,775,000	—	16,210,000
Gross profit	3,490,000	4,706,000	792,000	—	8,988,000
Selling, general and administrative expenses	3,137,000	5,180,000	685,000	—	9,002,000
Restructuring expense					