

ELECTRO SENSORS INC  
Form 10-Q  
November 12, 2009  
[Table of Contents](#)

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**Form 10-Q**



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

**For the quarterly period ended September 30, 2009**

**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 0-9587**

**ELECTRO-SENSORS, INC.**



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(Exact name of registrant as specified in its charter)

**Minnesota**

(State or other jurisdiction of incorporation or organization)

**41-0943459**

(IRS Employer Identification No.)

**6111 Blue Circle Drive**

**Minnetonka, Minnesota 55343-9108**

(Address of principal executive offices)

**(952) 930-0100**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

The number of shares outstanding of the registrant's common stock, \$0.10 par value, on November 9, 2009 was 3,372,294.

**ELECTRO-SENSORS, INC.**

**Form 10-Q**

**For the Period Ended September 30, 2009**

**TABLE OF CONTENTS**

**PART I FINANCIAL INFORMATION**

Item 1. Financial Statements:

|   |   |
|---|---|
| <u>Condensed Consolidated Balance Sheet As of September 30, 2009 and December 31, 2008</u>  | 3 |
| <u>Condensed Consolidated Statements of Operations<br/>For the Three and Nine-Month Periods Ended September 30, 2009 and September 30, 2008</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows<br/>For the Nine-Month Periods Ended September 30, 2009 and September 30, 2008</u>           | 5 |
| <u>Notes to Condensed Consolidated Financial Statements</u>   | 6 |

|  |    |
|--|----|
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 11 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>                            | 14 |
| <u>Item 4(T). Controls and Procedures</u>  | 15 |

**PART II OTHER INFORMATION**

|  |    |
|--|----|
| <u>Item 1. Legal Proceedings</u>   | 15 |
| <u>Item 1A. Risk Factors</u>   | 15 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 15 |
| <u>Item 3. Defaults Upon Senior Securities</u>                             | 15 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u>         | 15 |
| <u>Item 5. Other Information</u>   | 15 |
| <u>Item 6. Exhibits</u>  | 15 |

|                          |    |
|--------------------------|----|
| <b><u>SIGNATURES</u></b> | 16 |
|--------------------------|----|

|                        |    |
|------------------------|----|
| <b><u>EXHIBITS</u></b> | 17 |
|------------------------|----|

2

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Table of Contents

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**

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**CONDENSED CONSOLIDATED BALANCE SHEET**

(in thousands except share and per share amounts)

|  | <b>September 30,<br/>2009<br/>(unaudited)</b> | <b>December 31,<br/>2008</b> |
|--|---|------------------------------|
| <b>ASSETS</b>  |   |                              |
| <b>Current assets</b>  |   |                              |
| Cash and cash equivalents  | \$ 677  | \$ 5,529                     |
| Treasury bills   | 4,979   | 0                            |
| Available for sale securities  | 2,545   | 1,215                        |
| Trade receivables, less allowance for doubtful accounts of \$12 and \$8, respectively  | 681   | 575                          |
| Inventories  | 1,010   | 1,239                        |
| Income tax receivable  | 19  | 117                          |
| Other current assets   | 92  | 87                           |
| <b>Total current assets</b>  | <b>10,003</b>                                 | <b>8,762</b>                 |
| <b>Property and equipment, net</b>   | <b>1,252</b>                                  | <b>1,336</b>                 |
| <b>Total assets</b>  | <b>\$ 11,255</b>                              | <b>\$ 10,098</b>             |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |   |                              |
| <b>Current liabilities</b>   |   |                              |
| Accounts payable   | \$ 93   | \$ 59                        |
| Accrued expenses   | 229   | 155                          |
| Deferred revenue   | 75  | 86                           |
| Deferred income tax  | 981   | 475                          |
| <b>Total current liabilities</b>   | <b>1,378</b>                                  | <b>775</b>                   |
| <b>Commitments and contingencies</b>   |   |                              |
| <b>Stockholders equity</b>   |   |                              |
| Common stock par value \$0.10 per share; authorized 10,000,000 shares; issued and outstanding:<br>3,372,294 and 3,366,880 shares, respectively | 337   | 337                          |
| Additional paid-in capital   | 1,523   | 1,513                        |
| Retained earnings  | 6,503   | 6,783                        |
| Accumulated other comprehensive income (unrealized gain on available for sale securities, net of<br>income tax)                                | 1,514   | 690                          |
| <b>Total stockholders equity</b>   | <b>9,877</b>                                  | <b>9,323</b>                 |
| <b>Total liabilities and stockholders equity</b>   | <b>\$ 11,255</b>                              | <b>\$ 10,098</b>             |

See accompanying notes to condensed consolidated financial statements

Table of Contents**ELECTRO-SENSORS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands except share and per share amounts)

(unaudited)

|  | Three Months Ended    |           | Nine Months Ended     |           |
|--|-----------------------|-----------|-----------------------|-----------|
|  | September 30,<br>2009 | 2008      | September 30,<br>2009 | 2008      |
| <b>Net sales</b>   | <b>\$1,711</b>        | \$ 1,831  | <b>\$4,252</b>        | \$5,377   |
| <b>Cost of goods sold</b>                                    | <b>702</b>            | 708       | <b>1,745</b>          | 2,000     |
| <b>Gross profit</b>  | <b>1,009</b>          | 1,123     | <b>2,507</b>          | 3,377     |
| <b>Operating expenses:</b>                                   |                       |           |                       |           |
| Selling and marketing  | <b>343</b>            | 358       | <b>994</b>            | 1,148     |
| General and administrative                                   | <b>265</b>            | 260       | <b>856</b>            | 884       |
| Research and development                                     | <b>144</b>            | 144       | <b>472</b>            | 467       |
| <b>Total operating expenses</b>                              | <b>752</b>            | 762       | <b>2,322</b>          | 2,499     |
| <b>Operating income</b>                                      | <b>257</b>            | 361       | <b>185</b>            | 878       |
| <b>Non-operating income (expense):</b>                       |                       |           |                       |           |
| Gain (loss) on disposal of investment securities             | <b>5</b>              | 2         | <b>5</b>              | (33 )     |
| Interest income  | <b>3</b>              | 29        | <b>10</b>             | 88        |
| Loss on disposal of fixed assets                             | <b>(1 )</b>           | 0         | <b>(1 )</b>           | 0         |
| Other income   | <b>2</b>              | 3         | <b>7</b>              | 8         |
| <b>Total non-operating income</b>                            | <b>9</b>              | 34        | <b>21</b>             | 63        |
| <b>Income before income taxes</b>                            | <b>266</b>            | 395       | <b>206</b>            | 941       |
| <b>Income taxes</b>  | <b>106</b>            | 158       | <b>82</b>             | 352       |
| <b>Net income</b>  | <b>\$160</b>          | \$237     | <b>\$124</b>          | \$589     |
| <b>Other comprehensive income/(loss):</b>                    |                       |           |                       |           |
| Change in unrealized value of investments, net of income tax | <b>\$400</b>          | \$144     | <b>\$824</b>          | \$(605 )  |
| <b>Total comprehensive income/(loss)</b>                     | <b>\$560</b>          | \$381     | <b>\$948</b>          | \$(16 )   |
| <b>Net Income per Share Data:</b>                            |                       |           |                       |           |
| <b>Basic</b>   |                       |           |                       |           |
| Net income per share   | <b>\$0.05</b>         | \$0.07    | <b>\$0.04</b>         | \$0.17    |
| Weighted average shares                                      | <b>3,370,997</b>      | 3,366,864 | <b>3,369,279</b>      | 3,366,363 |
| <b>Diluted</b>   |                       |           |                       |           |
| Net income per share   | <b>\$0.05</b>         | \$0.07    | <b>\$0.04</b>         | \$0.17    |
| Weighted average shares                                      | <b>3,401,549</b>      | 3,397,644 | <b>3,399,982</b>      | 3,397,143 |
| <b>Dividends paid per share</b>                              | <b>\$.04</b>          | \$.04     | <b>\$.12</b>          | \$.12     |

See accompanying notes to unaudited condensed consolidated financial statements

4

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Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

|  | <b>Nine Months Ended</b> |               |
|--|--------------------------|---------------|
|  | <b>September 30,</b>     |               |
|  | <b>2009</b>              | <b>2008</b>   |
| <b>Cash flows from operating activities</b>  |                          |               |
| <b>Net income</b>  | <b>\$ 124</b>            | <b>\$ 589</b> |
| Adjustments to reconcile net income to net cash from (used in) operating activities: |                          |               |
| Depreciation   | 85                       | 90            |
| Provision for losses on trade receivables  | 3                        | 0             |
| Interest accrued on investments  | (10)                     | 0             |
| Realized (gain) loss on disposal of available for sale securities                    | (5)                      | 33            |
| Loss on disposal of fixed assets   | 1                        | 0             |
| (Increase)/decrease in:  |                          |               |
| Trade receivables  | (109)                    | (49)          |
| Inventories  | 229                      | (244)         |
| Other current assets   | (5)                      | 25            |
| Income taxes receivable  | 98                       | 0             |
| Accounts payable   | 34                       | 60            |
| Accrued expenses   | 74                       | (19)          |
| Deferred revenue   | (11)                     | (1)           |
| Accrued income taxes   | 0                        | (253)         |
| <b>Net cash from operating activities</b>  | <b>508</b>               | <b>231</b>    |
| <b>Cash flows from (used in) investing activities</b>                                |                          |               |
| Proceeds from sale of available for sale securities                                  | 5                        | 5             |
| Purchase of treasury bills   | (9,949)                  | 0             |
| Proceeds from the sale of treasury bills   | 4,980                    | 0             |
| Purchase of property and equipment   | (2)                      | 0             |
| <b>Net cash provided by (used in) investing activities</b>                           | <b>(4,966)</b>           | <b>5</b>      |
| <b>Cash flows from (used in) financing activities</b>                                |                          |               |
| Proceeds from issuance of stock  | 10                       | 6             |

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|   |                |          |              |          |
|---|----------------|----------|--------------|----------|
| Dividends paid  | (404)          | )        | (404)        | )        |
| <b>Net cash used in financing activities</b>                                | <b>(394)</b>   | <b>)</b> | <b>(398)</b> | <b>)</b> |
| <b>Net decrease in cash and cash equivalents</b>                            | <b>(4,852)</b> | <b>)</b> | <b>(162)</b> | <b>)</b> |
| Cash and cash equivalents, beginning  | 5,529          |          | 5,779        |          |
| Cash and cash equivalents, ending   | \$677          |          | \$5,617      |          |
| <b>Supplemental schedule of non-cash investing and financing activities</b> |                |          |              |          |
| Net change in unrealized loss on available for sale securities              | \$824          |          | \$(605)      | )        |
| Cash paid for income taxes  | \$0            |          | \$616        |          |

See accompanying notes to unaudited condensed consolidated financial statements

5

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### Table of Contents

## **ELECTRO-SENSORS, INC. AND SUBSIDIARIES**

### **NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(unaudited)

#### **Note 1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions and regulations of the Securities and Exchange Commission to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

This report should be read together with the Company's annual report on Form 10-K for the year ended December 31, 2008, including the audited financial statements and footnotes therein.

It is the opinion of management that the unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring accruals, necessary to fairly state the financial position and results of operations for the nine months ended September 30, 2009. The results of interim periods may not be indicative of results to be expected for the year.

#### **Revenue Recognition**

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In recognizing revenue, the Company applies the provisions of the Securities and Exchange Commission Staff Accounting Bulletin (SAB) No. 101 (as amended by SAB No. 104), Revenue Recognition. In some situations, the Company receives advance payments from its customers. Revenue associated with these advance payments is deferred until the product is shipped or services performed.

### **Revenue recognition of production monitoring equipment**

The Company recognizes revenue from the sale of its production monitoring equipment when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed and determinable and collection of the resulting receivable is reasonably assured. The Company may offer discounts to its distributors or quantity discounts that are recorded at the time of sale. The Company recognizes revenue on products sold to customers and distributors upon shipment because the contracts do not include post-shipment obligations. In addition to exchanges and warranties, customers have refund rights. Our standard products are used in a wide variety of industries, returns are minimal and insignificant to the consolidated financial statements (currently approximately .8% of net sales) and are recognized when the returned product is received by the Company.

### **Software revenue recognition**

The Company recognizes revenue upon shipment of its automated data collection software. The product is sold to the end user and risk of loss is transferred, and the Company has no continuing obligations, once its products are delivered to the shipper. To recognize revenue, it must also be probable that the Company will collect the accounts receivable from its customers. AutoData customers pay an annual maintenance fee for software support, which is recorded as deferred revenue on the balance sheet and is recognized in income, on a monthly basis, over the life of the contract.

### **Available for Sale Securities**

ESI Investment Company's investments consist of equity securities, primarily common stocks, government debt securities and money market funds. The estimated fair value of publicly traded equity securities (other than those accounted for based upon the equity method of accounting) is based on quoted market prices, and therefore subject to the inherent risk of market fluctuations. Management determines the appropriate classification of securities at the date individual investments are acquired, and evaluates the appropriateness of such classification at each balance sheet date.

Since the Company generally does not make investments in anticipation of short-term fluctuations in market prices, investments in equity securities are classified as available-for-sale (unless accounted for on the equity method of accounting). Available-for-sale securities with readily determinable values are stated at fair value, and unrealized holding gains and losses, net of the related deferred tax effect, are reported as separate component of stockholders' equity.

Realized gains and losses on securities, including losses from declines in value of specific securities determined by management to be other-than-temporary (unless accounted for on the equity method of accounting), are included in income in the period realized.



Table of Contents

**Income taxes**

Deferred income taxes are provided on an asset and liability approach to financial accounting and reporting for income taxes. Deferred income tax assets and liabilities are computed for those differences that have future tax consequences using the currently enacted tax laws and rates that apply to the periods in which they are expected to affect taxable income. Income tax expense is the current tax payable or refundable for the period plus or minus the net change in the deferred tax assets and liabilities, excluding the portion of the deferred liability allocated to other comprehensive income. Deferred taxes are reduced by a valuation allowance to the extent that realization of the related deferred tax asset is not assured.

**Use of Estimates**

The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Significant estimates, including the underlying assumptions, consist of economic lives of property and equipment, realizability of accounts receivable, valuation of deferred tax liabilities, valuation of inventory, and valuation of investments. It is at least reasonably possible that these estimates may change in the near term.

**Subsequent Events**

The Company has evaluated subsequent events through November 12, 2009, the date which the financial statements were available to be issued.

**Note 2. Nature of Business**

The accompanying condensed consolidated financial statements include the accounts of Electro-Sensors, Inc. and its wholly-owned subsidiaries, ESI Investment Company and Senstar Corporation. Senstar has no operations. Intercompany accounts, transactions and earnings have been eliminated in consolidation. The consolidated entity is referred to as the Company .

Electro-Sensors, Inc. operates two distinct businesses. The first is the Production Monitoring Division, which manufactures and markets a complete line of speed monitoring and motor control systems for industrial machinery. The division utilizes leading-edge technology to continuously improve its products and make them easier to use. The division's goal is to manufacture the industry-preferred product for every market served. These products are sold through an internal sales staff, manufacturer's representatives, and distributors to a wide variety of manufacturers, OEM's and processors to monitor process machinery operations. The division markets its products to a number of different industries located throughout the United States and abroad.

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The second business is the AutoData Systems Division. The division designs and markets desktop software based systems that read hand printed characters, checkmarks and bar code information from scanned or faxed forms, in addition to collecting and reporting data from web forms. The division's products are designed to provide capabilities to automate data collection and are sold by internal sales staff to end users, resellers and developers in the United States, Canada, Europe and Asia.

In addition, through its subsidiary ESI Investment Company, the Company periodically makes strategic investments in other businesses and companies, primarily when the Company believes that such investments will facilitate development of technology complementary to the Company's products. Although ESI, through ESI Investment Company, invests in other businesses or companies, ESI does not intend to become an investment company and intends to remain primarily an operating company. The Company's primary investments are 343,267 shares of Rudolph Technologies, Inc. ( Rudolph ) and 551,759 shares of PPT Vision Inc ( PPT ). The Rudolph investment is accounted for using the available-for-sale method. The PPT investment is accounted for under the equity method of accounting. See Note 6 for additional information regarding its investments. The Company's investments in securities are subject to normal market risks.

### **Note 3. Stock-Based Compensation**

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes-Merton ( BSM ) model. The Company uses historical data among other factors to estimate the expected price volatility, the expected option life and the expected forfeiture rate. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option. At September 30, 2009, the Company had one stock-based employee compensation plan. During the nine months ended September 30, 2009, one employee exercised 1,500 options. There were no option grants in the nine months ended September 30, 2009.

### **Note 4. Net Income Per Share**

All common share equivalents relating to stock options and warrants are included in the diluted weighted average common shares.

7

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### Table of Contents

### **Note 5. Treasury Bills**

During February 2009, the Company purchased \$4,972,000 in six month Treasury Bills. The Treasury Bills matured on August 6, 2009. With the proceeds, the Company purchased \$4,977,000 in six month Treasury Bills. The Treasury Bills are due on January 10, 2010. It is the intention of management to hold the Treasury Bills until maturity.

### **Note 6. Investments**

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The cost and estimated fair value of the investments (other than an investment accounted for under the equity method of accounting) are as follows:

|  | Cost               | Gross<br>unrealized<br>gain | Gross<br>unrealized<br>loss | Fair<br>value      |
|--|--------------------|-----------------------------|-----------------------------|--------------------|
| <b>December 31, 2008</b>                     |                    |                             |                             |                    |
| Treasury Bills                               | \$5,180,000        | \$0                         | \$0                         | \$5,180,000        |
| Money Market Funds                           | 169,000            | 0                           | 0                           | 169,000            |
| Equity Securities                            | 101,000            | 1,169,000                   | (55,000 )                   | 1,215,000          |
|  | 5,450,000          | 1,169,000                   | (55,000 )                   | 6,564,000          |
| Less Cash Equivalents                        | 5,349,000          | 0                           | 0                           | 5,349,000          |
| <b>Total Investments, December 31, 2008</b>  | <b>\$101,000</b>   | <b>\$1,169,000</b>          | <b>\$(55,000 )</b>          | <b>\$1,215,000</b> |
| <br>   |                    |                             |                             |                    |
| <b>September 30, 2009</b>                    |                    |                             |                             |                    |
| Treasury Bills                               | \$4,979,000        | \$0                         | \$0                         | \$4,979,000        |
| Money Market Funds                           | 385,000            | 0                           | 0                           | 385,000            |
| Equity Securities                            | 101,000            | 2,498,000                   | (54,000 )                   | 2,545,000          |
|  | 5,465,000          | 2,498,000                   | (54,000 )                   | 7,909,000          |
| Less Cash Equivalents                        | 385,000            | 0                           | 0                           | 385,000            |
| <b>Total Investments, September 30, 2009</b> | <b>\$5,080,000</b> | <b>\$2,498,000</b>          | <b>\$(54,000 )</b>          | <b>\$7,524,000</b> |

At September 30, 2009, the Company's significant investment in equity securities is 343,267 shares of Rudolph Technologies, Inc. ( Rudolph ), accounted for under the available-for-sale method. As of September 30, 2009, the aggregate value of the Company's Rudolph shares as reported on the Nasdaq Stock Exchange was approximately \$2,540,000 with an approximate cost of \$45,000.

### Investment Reported on Equity Method

At September 30, 2009, the Company owned 551,759 shares of PPT Vision, Inc. ( PPT ), which is 1.5% of PPT's outstanding common stock. The fair value of its holdings based on the quoted market price at September 30, 2009 was approximately \$31,000 with an approximate cost of \$2,434,000.

Since the Company owns approximately 1.5% of PPT's outstanding stock and the Company's Secretary owns a controlling interest, it has been determined that the Company has significant influence over the operations of PPT, and as a result its ownership interest should be reported using the equity method of accounting for investments.

Under the equity method of accounting, the Company's proportionate share of PPT's net loss would ordinarily be directly reflected on the Company's income statement, along with a corresponding reduction in the PPT investment account on the Company's balance sheet. However, where net losses exceed the value of the initial investment, these losses are no longer recognized in the financial statements, but rather are suspended and applied against the investor's proportionate share in any future net earnings for the investee. Accordingly, since the Company's proportionate share of PPT's previous net losses have already reduced the PPT investment account on its balance sheet to \$0, the Company's proportionate share of PPT's net loss through September 30, 2009 has not been recognized on its current financial statements. At September 30, 2009, the Company had approximately \$1,513,000 in suspended losses from its investment in PPT that will be used to offset future recognition of equity method earnings from the investment.

Table of Contents**Note 7. Fair Value Measurements**

Effective January 1, 2008, the Company adopted Fair Value Measurements accounting standards as they relate to our financial instruments. The standard for fair value measurements defines fair value, outlines a framework for measuring fair value, and details the required disclosures about fair value measurements. Fair value standards permit companies to irrevocably choose to measure certain financial instruments and other items at fair value. The standards also establish presentation and disclosure requirements designed to facilitate comparison between entities that choose different measurement attributes for similar types of assets and liabilities.

Under the fair value standards, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or most advantageous market. The fair value standards establish a hierarchy in determining the fair value of an asset or liability. The fair value hierarchy has three levels of inputs, both observable and unobservable. Fair value standards require the utilization of the lowest possible level of input to determine fair value. Level 1 inputs include quoted market prices in an active market for identical assets or liabilities. Level 2 inputs are market data, other than Level 1, that are observable either directly or indirectly. Level 2 inputs include quoted market prices for similar assets or liabilities, quoted market prices in an inactive market, and other observable information that can be corroborated by market data. Level 3 inputs are unobservable and corroborated by little or no market data.

Except for those assets and liabilities which are required by authoritative accounting guidance to be recorded at fair value in our condensed consolidated balance sheets, we have elected not to record any other assets or liabilities at fair value, as permitted by the fair value standards. No events occurred during the third quarter 2009 which would require adjustment to the recognized balances of assets or liabilities which are recorded at fair value on a nonrecurring basis.

The following table provides information on those assets and liabilities measured at fair value on a recurring basis.

|                     | <b>Carrying amount<br/>in condensed<br/>consolidated<br/>balance sheet<br/>September 30, 2009</b> | <b>Fair Value<br/>September 30, 2009</b> | <b>Fair Value Measurement Using</b> |                |                |
|---------------------|---|--|-------------------------------------|----------------|----------------|
|                     |   |  | <b>Level 1</b>                      | <b>Level 2</b> | <b>Level 3</b> |
| Assets:             |   |  |                                     |                |                |
| Money Market Funds  | \$ 385,000  | \$ 385,000                               | \$385,000                           | \$             | \$             |
| Treasury Bills      | \$ 4,979,000  | \$ 4,979,000                             | \$4,979,000                         | \$             | \$             |
| Available-for-sale: |   |  |                                     |                |                |
| Equity Securities   | \$ 2,545,000  | \$ 2,545,000                             | \$2,545,000                         | \$             | \$             |

The fair value of the money market funds, treasury bills, and equity securities are based on quoted market prices in an active market. Closing stock prices are readily available from active markets and are used as being representative of fair value. The Company classifies these securities as level 1.

**Note 8. Inventories**

Inventories used in the determination of cost of goods sold are as follows:

|                          | <b>September 30,<br/>2009</b> | <b>December 31,<br/>2008</b> |
|--------------------------|-------------------------------|------------------------------|
| Raw Materials            | <b>\$ 683,000</b>             | \$ 840,000                   |
| Work In Process          | <b>179,000</b>                | 195,000                      |
| Finished Goods           | <b>148,000</b>                | 204,000                      |
| <b>Total Inventories</b> | <b>\$ 1,010,000</b>           | <b>\$ 1,239,000</b>          |

9

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Table of Contents

**Note 9. Segment Information**

The Company has three reportable operating segments based on the nature of its product lines: Production Monitoring, AutoData Systems, and Investments. The Production Monitoring Division manufactures and markets a complete line of production monitoring equipment, in particular speed monitoring and motor control systems for industrial machinery. The AutoData Systems Division designs and markets desktop software-based systems that read hand printed characters, checkmarks, and bar code information from scanned or faxed forms, in addition to collecting and reporting data from web forms. Sales of this system include software and can include hardware. ESI Investment Company holds investments in marketable and non-marketable securities.

The accounting policies of the segments are the same as those described in Note 1 of the Company's annual report on Form 10-K for the year ended December 31, 2008. In evaluating segment performance, management focuses on sales and income before taxes. The Company has no inter-segment sales.

The net income (loss) before taxes reported below has excluded an inter-segment allocation of expenses. The net income (loss) before taxes reported in the annual report on Form 10-K included inter-segment allocation of expenses.

The following is financial information relating to the continuing operating segments (in thousands):

|                                  | <b>Three Months Ended</b>     |             | <b>Nine Months Ended</b>      |             |
|----------------------------------|-------------------------------|-------------|-------------------------------|-------------|
|                                  | <b>September 30,<br/>2009</b> | <b>2008</b> | <b>September 30,<br/>2009</b> | <b>2008</b> |
| <b>External sales</b>            |                               |             |                               |             |
| Production monitoring (products) | <b>\$ 1,604</b>               | \$ 1,684    | <b>\$ 3,960</b>               | \$ 4,959    |

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|   |                |                |                |                |
|---|----------------|----------------|----------------|----------------|
| Character recognition (software and related hardware) | 107            | 147            | 292            | 418            |
| Investments   | 0              | 0              | 0              | 0              |
| <b>Total</b>  | <b>\$1,711</b> | <b>\$1,831</b> | <b>\$4,252</b> | <b>\$5,377</b> |
| <b>Net Income/(Loss) before taxes</b>                 |                |                |                |                |
| Production monitoring                                 | \$263          | \$336          | \$239          | \$869          |
| Character recognition                                 | (4)            | 34             | (46)           | 35             |
| Investments   | 7              | 25             | 13             | 37             |
| <b>Total</b>  | <b>\$266</b>   | <b>\$395</b>   | <b>\$206</b>   | <b>\$941</b>   |

10

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### Table of Contents

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

### **CRITICAL ACCOUNTING ESTIMATES**

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make decisions based upon estimates, assumptions, and factors it considers relevant to the circumstances. Such decisions include the selection of applicable accounting principles and the use of judgment in their application, the results of which impact reported amounts and disclosures. Changes in economic conditions or other business circumstances may affect the outcomes of management's estimates and assumptions. An in-depth description of our accounting estimates can be found in the interim financial statements included in this report and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008. No new estimates exist other than those discussed in our Annual Report.

### **RESULTS OF OPERATIONS**

#### Net Sales

Net sales for the three-month period ended September 30, 2009 decreased \$120,000, or 6.6%, when compared to net sales for the same period in 2008. Net sales for the nine-month period ended September 30, 2009 decreased \$1,125,000, or 20.9%, when compared to net sales for the same period in 2008.

For the three months ended September 30, 2009 compared to the same period in 2008, the Production Monitoring Division had a decrease in net sales of \$80,000, or 4.8%, and the AutoData Systems Division had a decrease in net sales of \$40,000, or 27.2%.

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For the nine months ended September 30, 2009 compared to the same period in 2008, the Production Monitoring Division had a decrease in net sales of \$999,000, or 20.1%, and the AutoData Systems Division had a decrease in net sales of \$126,000, or 30.1%.

The Production Monitoring Division decrease was due in large part to the delay in our customers' plant construction and expansion plans. The slowing of capital spending on plant construction and expansion projects that started in the last half of 2008 has continued through the third quarter of 2009. This slowdown in sales has been across all of our major markets, and has had a particularly significant effect on original equipment manufacturers (OEM) equipment builders. While customers have shown an interest in the new Electro-Sentry product, the aforementioned slowing of capital spending has negatively impacted sales of the product. However, during the third quarter, we installed several Electro-Sentry systems that were sold during the second quarter and have experienced an approximate 26% increase in sales as compared to the first and second quarter of fiscal year 2009. We are actively marketing and bidding on projects for the Electro-Sentry systems. We are also seeing a significant increase in the sales of our new speed and temperature sensors to end user customers and system integrators, who use them in their applications.

The bulk of our sales volume has historically been derived from the Speed Monitoring product lines to the grain, feed, biofuels, power generation, and mining industries, as well as other key industrial markets and equipment builders. Products sold into these markets include shaft speed sensors and switches, ratemeters and counters, motor controllers, vibration switches, and position monitors. Energy production applications in fossil fuel and other power generation applications continue to show growth in the application of our products.

The AutoData Systems Division decrease in net sales for the third quarter of 2009 was due to the continuation of the economic downturn. New potential customers are delaying the purchase of new systems. Current customers, who had hoped to expand their automated data collection capabilities, have put the expansion temporarily on hold. After the bidding process has been completed, the turnaround time for receipt of purchase orders has increased due to longer approval cycles. With many non-profits and governmental entities at the beginning of their new fiscal year, we are cautiously optimistic that funding may begin to become available to some of our potential customer during our fourth quarter for the purchase of data collection and reporting software.

### **Cost of Goods Sold**

Our cost of goods sold decreased \$6,000, or .8%, for the three months ended September 30, 2009 compared to the same period in 2008. For the nine-month period ended September 30, 2009, the cost of goods sold decreased \$255,000, or 12.8%, compared to the same period in 2008. This decrease was primarily a result of decreased sales.

### **Gross Profit**

Gross margin for the three-month period ended September 30, 2009 was 59.0% versus 61.3% for the same period in 2008. For the nine-month periods ended September 30, 2009 and 2008, gross margins were 59.0% and 62.8%, respectively. The decrease in gross margin was due to an increase in relative sales volume of lower margin, higher-priced items within the Production Monitoring Division.

Operating Expenses

Total operating expenses decreased \$10,000, or 1.3%, for the three months ended September 30, 2009 when compared to the same period of 2008. Of this decrease, the Production Monitoring Division had a decrease of \$14,000, or 2.1%, offset by an increase in the AutoData Systems Division of \$4,000, or 4.1%.

For the nine months ended September 30, 2009 when compared to the same period of 2008, operating expenses decreased \$177,000, or 7.1%. Of this decrease, the Production Monitoring Division had a decrease of \$149,000, or 6.9%, and the AutoData Systems Division had a decrease of \$28,000, or 8.4%.

Selling and marketing costs decreased \$15,000, or 4.2%, for the three months ended September 30, 2009 when compared to the same period in 2008. For the nine months ended September 30, 2009, selling and marketing costs decreased \$154,000, or 13.4%, when compared to the same period in 2008. Of the decrease for the three months ended September 30, 2009, the AutoData Systems Division had a decrease of \$2,000, or 5.4%, and the Production Monitoring Division had a decrease of \$13,000, or 4.0%. Of the decrease for the nine months ended September 30, 2009, the Production Monitoring Division had a decrease of \$123,000, or 12.1%, and the AutoData Systems Division had a decrease of \$31,000, or 23.7%. For the three months ended September 30, 2009, the decrease in the AutoData Systems Division expenses was due to a decrease in sales commissions and advertising. The decrease in the Production Monitoring Division was due to a decrease in advertising, travel expenses, and sales representative commissions, offset by an increase in contractor personnel. For the nine months ended September 30, 2009, decreases in sales representative commissions, advertising, travel, and tradeshow, offset by an increase in contract personnel expenses, are the predominant expenses that decreased in the Production Monitoring Division based on discretionary cost reductions and a decline in sales. Marketing efforts are continuing to be directed to our core industries and to industries that are receiving funds in connection with the federal economic stimulus package. The decrease in selling and marketing costs in the AutoData Systems Division was due to decreased wages due to a reduction in staff, sales commissions, and advertising.

General and administrative costs increased \$5,000, or 1.9%, for the three months ended September 30, 2009 compared to the same period in 2008. For the nine months ended September 30, 2009, general and administrative costs decreased \$28,000, or 3.2%, when compared to the same period in 2008. Of the increase for the three months ended September 30, 2009, the Production Monitoring Division contributed an increase of \$3,000, or 1.2%, and the AutoData Systems Division had an increase of \$2,000, or 13.3%. The decrease for the nine months ended September 30, 2009 was due to a decrease in costs of \$29,000, or 3.5%, from the Production Monitoring Division, offset by an increase in the AutoData Systems Division of \$1,000, or 1.8%. For the three months ended September 30, 2009, the increase in general and administrative expenses from the Production Monitoring Division was due to increases in employee benefits, doubtful account write-offs, stock handling fees, and legal and professional fees (due to IRS mandatory employee benefit plan document restatements), offset by a decrease in computer supplies and maintenance. The increase in stock handling fees was due to such fees now being allocated evenly over each quarter in 2009, whereas all such fees had been expensed in the first quarter of 2008. The increase in the AutoData Systems Division was due to such an increase in stock handling fees. For the nine months ended September 30, 2009, the decrease in general and administrative expenses from the Production Monitoring Division was due to decreases in computer supplies and maintenance, charitable contributions, and stock handling fees, offset by increases in employee benefits, doubtful account writeoffs, and legal and professional fees. The increase in the AutoData Systems Division was due to last year's adjustment for the decline in the allowance for doubtful accounts, offset by a decrease in computer supplies and maintenance.

Research and development costs for the three months ended September 30, 2009 remained unchanged as compared to the amount for the same period in 2008. For the nine months ended September 30, 2009, research and development costs increased \$5,000, or 1.1%, when compared to the same period in 2008. For the three months ended September 30, 2009, the Production Monitoring Division had a decrease of \$4,000, or 4.0%, offset by an increase in the AutoData Systems Division of \$4,000, or 8.9%. Of the increase for the nine months ended September 30, 2009, the Production Monitoring Division contributed an increase of \$3,000, or .9%, and the AutoData System Division had an increase of \$2,000, or 1.4%. For the three months ended September 30, 2009, the decrease in the Production Monitoring Division was due to prototypes and legal fees related to trademark/patents. The increase in the AutoData Systems Division was due to an increase in salary and wages. For the nine months ended September 30, 2009, the increase in the Production Monitoring Division was due to lab testing for product certification, offset by a decrease in prototypes. During 2008, the development of the Electro-Sentry system substantially increased prototype expenses. We do not expect the prototype expenses to increase significantly during the remainder of 2009, although that is dependent on the products developed. The increase in the AutoData Systems Division was due to an increase in salaries and wages, offset by a decrease in contract personnel.



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**Table of Contents****Non-Operating Income**

Non-operating income decreased by \$25,000, or 73.5%, for the three-month period ended September 30, 2009 compared to the same period for 2008. For the nine months ended September 30, 2009, non-operating income decreased \$42,000, or 66.7%, when compared to the same period in 2008. The decrease for the three-month period ended September 30, 2009 is driven by a decrease in interest income. The decrease for the nine-month period ended September 30, 2009 was due to a decrease in interest income, offset by the recognition of gains on investments as compared to the prior year's losses. During the nine months ended September 30, 2008, ESI Investment Company recognized a loss of \$35,000 on its investment in Minn Shares, Inc. (MSHS); there was no loss recognition during the same period in 2009.

Interest income decreased \$26,000, or 89.7%, when comparing the three months ended September 30, 2009 to the same period in 2008. For the nine months ended September 30, 2009, interest income decreased \$78,000, or 88.6%, when compared to the same period in 2008. These decreases were due to the decreased interest rate on Treasury Bills, which was .152% at September 30, 2009, compared to 1.774% at September 30, 2008.

**Income Before Income Taxes**

Income before income taxes decreased \$129,000, or 32.7%, to an income before tax of \$266,000 for the three-month period ended September 30, 2009 compared to the same period in 2008. For the nine-month period ended September 30, 2009 income before income tax decreased \$735,000, or 78.1%, when compared to the same period in 2008.

The Production Monitoring Division had income before income taxes of \$263,000 for the three months ended September 30, 2009 compared to \$336,000 for the same period in 2008, a decrease of \$73,000, or 21.7%. For the nine months ended September 30, 2009, the Production Monitoring Division had income before income taxes of \$239,000 compared to \$869,000 for the same period in 2008, a decrease of \$630,000, or 72.5%. The decrease in income before income taxes for the three months ended September 30, 2009 was mainly due to a decrease in net sales, a decrease in the gross margin (primarily due to the increase of relative sales volume of lower margin, higher-priced items), and a decrease in interest income (due to the decrease in interest rates on Treasury Bills). The decrease in net income before income taxes for the nine months ended September 30, 2009 was primarily due to a decrease in the gross margin, an increase in the percentage of operating expenses to net sales (from 43.7% of net sales in 2008 to 50.9% of net sales in 2009) and a decrease in interest income.

The AutoData Systems Division had a loss before income taxes of \$4,000 for the three months ended September 30, 2009 compared to an income before income taxes of \$34,000 for same period in 2008, a decrease of \$38,000, or 111.8%. This decrease in income before income taxes was due primarily to a decrease in sales and an increase in the percentage of operating expenses to net sales (from 66.0% of net sales in 2008 to 94.4% of net sales in 2009). For the nine months ended September 30, 2009, the AutoData Systems Division had a loss before income taxes of \$46,000 compared to an income before income taxes of \$35,000 for the same period in 2008, a decrease of \$81,000, or 231.4%. This decrease in income before income taxes was due primarily to a decrease in sales and an increase in the percentage of operating expenses to net sales (from 79.9% of net sales in 2008 to 104.8% of net sales in 2009).

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ESI Investment Company had income before taxes of \$7,000 for the three-month period ended September 30, 2009 compared to \$25,000 for the same period in 2008, a decrease of \$18,000, or 72.0%. ESI Investment Company had income before taxes of \$13,000 for the nine-month period ended September 30, 2009 compared to income before income taxes of \$37,000 for the same period in 2008, a decrease of \$24,000, or 64.9%. The decrease for the three-month period ended September 30, 2009 was due to a decrease in interest income from Treasury Bills. The decrease for the nine-month period ended September 30, 2009 was due to a decrease in interest income on Treasury Bills, offset by a decrease in recognized losses of investments (See Non-Operating Income ).

### LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were \$677,000 at September 30, 2009, \$5,529,000 at December 31, 2008, and \$5,617,000 at September 30, 2008. The decrease in cash and cash equivalents is due to the purchase of six month Treasury Bills, which are reported as an investment in Treasury Bills. In prior years, we purchased three month Treasury Bills, which we included in cash equivalents.

Cash provided by operating activities was \$508,000 and \$231,000 for the nine months ended September 30, 2009 and 2008, respectively. The increase was primarily a result of our net operating income adjusted for accounts receivable, inventories, income taxes receivable, accrued income tax activity, and realized loss on an investment.

Cash used for investing activities was \$4,966,000 for the nine-month period ended September 30, 2009 and cash provided by investing activities was \$5,000 for the same period in 2008. The significant increase in cash used for investing activities was due to purchases of six month Treasury Bills of \$9,949,000 in 2009, offset by a sale of Treasury Bills of \$4,980,000. There were no such purchases or sales during 2008.

13

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### Table of Contents

Cash used for financing activities was \$394,000 and \$398,000 for the nine months ended September 30, 2009 and 2008, respectively. During the nine-month periods ended September 30, 2009 and 2008, the Company paid aggregate dividends of \$404,000 each year. In 2009, one employee exercised a stock option which provided cash of \$2,000. There were no such exercises of stock options in 2008. During the nine-month periods ended September 30, 2009 and 2008, the Company had \$8,000 and \$6,000, respectively, in stock purchases under the Employee Stock Purchase Plan.

Our ongoing cash requirements will be primarily for capital expenditures, possible acquisitions of companies that have related product lines or technologies, research and development in both the Production Monitoring and AutoData Systems divisions, and working capital. Management believes that cash on hand and any cash provided by operations will be sufficient to meet our cash requirements through at least the next 12 months.

Our primary investments are 343,267 shares of Rudolph Technologies, Inc. ( Rudolph ), listed on the Nasdaq stock market, and 551,759 shares of PPT Vision, Inc. ( PPT ), listed on the Pink Sheets. The Rudolph investment is accounted for using the available for sale method. The PPT investment is accounted for under the equity method of accounting. These stocks are subject to fluctuations in market price and could have a negative effect on our liquidity.

*Off-balance Sheet Arrangements*

As of September 30, 2009, the Company had no off-balance sheet arrangements or transactions.

**FORWARD-LOOKING STATEMENTS**

This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding our expectations, beliefs, intentions or strategies regarding the future. Forward-looking statements include, but are not limited to, statements relating to management's beliefs with respect to the spending slowdown in our market segments; our expectations with respect to purchase order approval cycles; our expectations regarding funding availability for non-profit or governmental entities; our marketing efforts; our intention to hold our Treasury Bills until maturity; our expectations with respect to prototype expenses; management's intention that we not become an investment company; our expected use of cash on hand; our cash requirements; and the sufficiency of our cash flows. Any statement that is not based solely upon historical facts, including strategies for the future and the outcome of events that have not yet occurred, is considered a forward-looking statement.

All forward-looking statements in this document are based on information available to us as of the date hereof, and we assume no obligation to update any such forward-looking statements, other than as required by law. It is important to note that our actual results could differ materially from those in such forward-looking statements. The forward-looking statements we make in this Quarterly Report are subject to certain risks and uncertainties that could cause future results to differ materially from our recent results or those projected in the forward-looking statements, including the accuracy of management's assumptions with respect to industry trends, fluctuations in industry conditions, a prolonged slowdown in plant construction and expansion projects, the impact of any prolonged recessionary conditions or worsening of the global economy, the impact of stimulus packages, the accuracy of management's assumptions regarding expenses and our cash needs and those listed in the Cautionary Statements of the MD&A in our Annual Report on Form 10-K for the year ended December 31, 2008.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not Applicable.

14

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Table of Contents

**Item 4(T). Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

Based on an evaluation under the supervision and with the participation of the Company's management, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ( Exchange Act ) were effective as of September 30, 2009 to ensure that

information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

***Changes in Internal Control Over Financial Reporting***

There were no changes in the Company's internal control over financial reporting during the third quarter of 2009, which were identified in connection with management's evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings - None.**

**Item 1A. Risk Factors - Not Applicable.**

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds - None.**

**Item 3. Defaults Upon Senior Securities - None.**

**Item 4. Submission of Matters to a Vote of Security Holders - None.**

**Item 5. Other Information - None.**

**Item 6. Exhibits**

- (a) Exhibits - See Exhibit Index following signature page.

15

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Table of Contents

**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, thereunto duly authorized.

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**Electro-Sensors, Inc.**

November 12, 2009

/s/ Bradley D. Slye  
Bradley D. Slye  
Chief Executive Officer and Chief Financial Officer

16

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Table of Contents

**EXHIBIT INDEX**

**ELECTRO-SENSORS, INC.**

**FORM 10-Q FOR QUARTER ENDED SEPTEMBER 30, 2009**

| <b>Exhibit</b> | <b>Description</b>   |
|----------------|--|
| 31.1           | Certification of CEO and CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1           | Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

17

