

ELECTRO SENSORS INC  
Form 10-Q  
November 12, 2014  
Table of Contents

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, DC 20549

**Form 10-Q**

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

**For the quarterly period ended September 30, 2014**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 000-9587**

**ELECTRO-SENSORS, INC.**

(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)

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

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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 10, 2014 was 3,395,521.

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**ELECTRO-SENSORS, INC.**  
**Form 10-Q**  
**For the Quarter Ended September 30, 2014**

**TABLE OF CONTENTS**

**PART I FINANCIAL INFORMATION**

Item 1. Financial Statements (unaudited):

<u>Consolidated Balance Sheets As of September 30, 2014 and December 31, 2013</u>	3
<u>Consolidated Statements of Comprehensive Income (Loss) For the Three and Nine months ended September 30, 2014 and September 30, 2013</u>	4
<u>Consolidated Statements of Cash Flows For the Nine months ended September 30, 2014 and September 30, 2013</u>	5
<u>Notes to the Consolidated Financial Statements</u>	6

<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14
--	----

<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	17
---	----

<u>Item 4. Controls and Procedures</u>	18
--	----

**PART II OTHER INFORMATION**

<u>Item 1. Legal Proceedings</u>	18
----------------------------------	----

<u>Item 1A. Risk Factors</u>	18
------------------------------	----

<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	18
--	----

<u>Item 3. Defaults Upon Senior Securities</u>	18
--	----

<u>Item 4. Mine Safety Disclosures</u>	18
--	----

<u>Item 5. Other Information</u>	18
----------------------------------	----

<u>Item 6. Exhibits</u>	18
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<u>SIGNATURES</u>	19
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<u>EXHIBITS</u>	20
-----------------	----

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands except share and per share amounts)

	September 30, 2014	December 31, 2013
	(unaudited)	
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$ 887	\$ 1,505
Treasury bills	6,543	5,227
Available-for-sale securities	1,252	2,718
Trade receivables, less allowance for doubtful accounts of \$8	873	746
Inventories	1,265	1,060
Other current assets	180	136
<b>Total current assets</b>	<b>11,000</b>	<b>11,392</b>
<b>Intangible asset, net</b>	<b>1,564</b>	<b>0</b>
<b>Property and equipment, net</b>	<b>1,175</b>	<b>1,217</b>
<b>Total assets</b>	<b>\$ 13,739</b>	<b>\$ 12,609</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current liabilities</b>		
Current maturities of note payable	\$ 381	\$ 0
Accounts payable	216	59
Accrued expenses	445	265
Accrued income tax	51	0
<b>Total current liabilities</b>	<b>1,093</b>	<b>324</b>
<b>Long-term liabilities</b>		
Note payable long term	390	0
Contingent earn-out	472	0
Deferred income tax liability	452	1,022
<b>Total long term liabilities</b>	<b>1,314</b>	<b>1,022</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: 3,395,521 and 3,394,707 shares, respectively	340	339
Additional paid-in capital	1,800	1,746
Retained earnings	8,462	7,547
Accumulated other comprehensive income (unrealized gain on available-for-sale securities, net of income tax)	730	1,631

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<b>Total stockholders equity</b>		<b>11,332</b>		11,263
<b>Total liabilities and stockholders equity</b>		<b>\$ 13,739</b>	<b>\$</b>	12,609
	See accompanying notes to unaudited consolidated financial statements			

Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**  
(in thousands except share and per share amounts)  
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>Net sales</b>	\$ 1,917	\$ 1,708	\$ 5,379	\$ 4,813
<b>Cost of goods sold</b>	770	727	2,246	2,042
<b>Gross profit</b>	1,147	981	3,133	2,771
<b>Operating expenses:</b>				
Selling and marketing	409	378	1,197	1,163
General and administrative	327	444	971	1,026
Research and development	186	144	567	374
<b>Total operating expenses</b>	922	966	2,735	2,563
<b>Operating income</b>	225	15	398	208
<b>Non-operating income (expense):</b>				
Gain on sale of available-for-sale securities	258	129	1,008	530
Other income	3	3	11	11
Interest expense	(5)	0	(12)	0
Interest income	0	3	2	5
<b>Total non-operating income</b>	256	135	1,009	546
<b>Income before income taxes</b>	481	150	1,407	754
<b>Provision for income taxes</b>	168	46	492	214
<b>Net income</b>	\$ 313	\$ 104	\$ 915	\$ 540
<b>Other comprehensive income (loss):</b>				
Change in unrealized value of available-for-sale securities, net of income tax	\$ (67)	\$ 41	\$ (276)	\$ (310)
Reclassification of gains included in net income, net of income tax	(160)	(80)	(625)	(329)
<b>Net change in other comprehensive loss</b>	(227)	(39)	(901)	(639)
<b>Net comprehensive income (loss)</b>	\$ 86	\$ 65	\$ 14	\$ (99)
<b>Net income per share data:</b>				
<b>Basic</b>				
Net income per share	\$ 0.09	\$ 0.03	\$ 0.27	\$ 0.15
Weighted average shares	3,395,521	3,394,696	3,395,515	3,394,033
<b>Diluted</b>				
Net income per share	\$ 0.09	\$ 0.02	\$ 0.25	\$ 0.15
Weighted average shares	3,658,751	3,511,784	3,652,761	3,448,064
<b>Dividends paid per share</b>	\$ 0.00	\$ 0.00	\$ 0.00	\$ 0.08

See accompanying notes to unaudited consolidated financial statements

Table of Contents

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

(in thousands)

(unaudited)

	Nine Months Ended September 30,	
	2014	2013
<b>Cash flows from (used in) operating activities</b>		
Net income	\$ 915	\$ 540
Adjustments to reconcile net income to net cash from (used in) operating activities:		
Depreciation and amortization	120	82
Gain on sale of available-for-sale securities	(1,008)	(530)
Deferred income taxes	(17)	(21)
Interest accrued on investments	(2)	(4)
Stock-based compensation expense	51	149
Change in allowance for doubtful accounts	0	(2)
Loss on disposal of property and equipment	1	0
Change in, net of acquisition:		
Trade receivables	(127)	(126)
Inventories	(205)	70
Other current assets	1	(83)
Accounts payable	157	2
Accrued expenses	180	147
Accrued income taxes	51	(289)
<b>Net cash from (used in) operating activities</b>	<b>117</b>	<b>(65)</b>
<b>Cash flows from (used in) investing activities</b>		
Proceeds from sale of available-for-sale securities	1,020	536
Purchases of treasury bills	(9,676)	(5,426)
Proceeds from the maturity of treasury bills	8,362	5,251
Cash paid for acquisition	(400)	0
Purchase of property and equipment	(45)	(18)
<b>Net cash from (used in) investing activities</b>	<b>(739)</b>	<b>343</b>
<b>Cash flows from (used in) financing activities</b>		
Proceeds from issuances of common stock	4	8
Dividends paid	0	(272)
<b>Net cash from (used in) financing activities</b>	<b>4</b>	<b>(264)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(618)</b>	<b>14</b>
Cash and cash equivalents, beginning	1,505	1,102
Cash and cash equivalents, ending	\$ 887	\$ 1,116
<b>Supplemental cash flow information</b>		
Cash paid for income taxes	\$ 462	\$ 524
<b>Supplemental disclosure of non-cash investment and financing activities</b>		
Note payable issued to fund acquisition, net of discount	\$ 771	\$ 0
Contingent consideration recorded in connection with the acquisition	\$ 472	\$ 0





Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE PERIOD ENDED SEPTEMBER 30, 2014**  
**(in thousands except share and per share amounts)**  
(unaudited)

**Note 1. Basis of Presentation**

The accompanying unaudited 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, 2013, including the audited financial statements and footnotes therein.

It is the opinion of management that the unaudited consolidated financial statements include all adjustments, consisting of normal recurring accruals, necessary to fairly state the financial position and results of operations as of September 30, 2014 and for the three and nine-month periods then ended in accordance with accounting principles generally accepted in the United States of America. The results of interim periods may not be indicative of results to be expected for the year.

**Nature of Business**

The accompanying 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. manufactures and markets a complete line of monitoring and motor control systems for a variety of industrial machinery. The Company uses leading-edge technology to continuously improve its products and make them easier to use with the ultimate goal of manufacturing 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 and processors who use the products to monitor process machinery operations. The Company markets its products to a variety of industries located throughout the United States, Canada, Latin America, Europe, and Asia.

In addition, through its subsidiary ESI Investment Company, the Company periodically makes strategic investments in other businesses, primarily when the Company believes that these investments will facilitate development of technology complementary to the Company's products. Although the Company, through ESI Investment Company, invests in other businesses, the Company does not intend to become an investment company and intends to remain primarily an operating company. The Company's primary investment is 138,217 shares of Rudolph Technologies, Inc. (Rudolph) which the Company accounts for using the available-for-sale method. See Note 4 for additional information regarding the Company's investments. The Company's investments in securities are subject to normal market risks.

**Revenue Recognition**

The Company recognizes revenue from the sale of its production monitoring equipment when persuasive evidence of an arrangement exists, the product has been picked up by common carrier, the fee is fixed and determinable and collection of the resulting receivable is reasonably assured. The Company recognizes revenue upon shipment because the contracts do not include post-shipment obligations. The Company may offer discounts that are recorded at the time of sale. In addition to exchanges and warranty returns, customers have limited refund rights. Historically, returns have been minimal and immaterial to the consolidated financial statements and are generally recognized when the returned product is received by the Company. In some situations, the Company receives advance payments from its customers. Revenue associated with these advance payments is deferred until the product is shipped.

Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE PERIOD ENDED SEPTEMBER 30, 2014**  
**(in thousands except share and per share amounts)**  
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**Available-for-Sale Securities**

The Company's investments consist of equity securities, primarily common stocks and government debt securities. The estimated fair value of publicly traded equity securities 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 each 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 and treasury bills are classified as available-for-sale. 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 a 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, are included in the period realized. There were no other-than-temporary impairments in either of the nine-month periods ended September 30, 2014 and 2013.

**Fair Value Measurements**

The Company's policies incorporate the guidance for accounting for fair value measurements of financial assets and financial liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis. These policies also incorporate the guidance for fair value measurement related to nonfinancial items that are recognized and disclosed at fair value in the consolidated financial statements on a nonrecurring basis. The guidance establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.

Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

The carrying values of cash equivalents, treasury bills, commercial paper, money market funds, trade receivables, accounts payable, and other working capital items approximate fair value at September 30, 2014 and December 31, 2013 due to the short maturity nature of these instruments.

**Stock Based Compensation**

The Company uses the straight-line method to recognize compensation expense based on the fair value on the date of grant over the requisite service period required for each award to vest. The fair value of stock options is estimated using the Black-Sholes-Merton (BSM) option pricing model, which incorporates certain assumptions, such as risk-free interest rate, expected volatility, expected dividend yield, and expected life of options.

Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE PERIOD ENDED SEPTEMBER 30, 2014**  
**(in thousands except share and per share amounts)**  
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**Income Taxes**

Deferred income taxes are presented as assets or liabilities based on timing differences between financial reporting and tax reporting methods. The Company computes deferred income tax assets and liabilities, and reports differences that have future tax consequences using the currently enacted tax laws and rates that apply to the periods in which the Company expects these income tax assets and liabilities to affect taxable income. Income tax expense (benefit) 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 tax assets are reduced by a valuation allowance to the extent that realization of the related deferred tax asset is not assured. No valuation allowance was deemed necessary at September 30, 2014 and December 31, 2013.

**Use of Estimates**

The preparation of 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 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, the determination of fair value of acquired tangible and intangible assets, realizability of accounts receivable, valuation of deferred tax assets/liabilities, inventories, investments, contingent earn-out, and stock compensation expense. It is at least reasonably possible that these estimates may change in the near term.

**Note 2. Business Combination**

On February 18, 2014, the Company acquired Harvest Engineering, Inc.'s wireless hazard monitoring technology and Insta-Link product family, together with related technology and intellectual property rights, for a total purchase price of \$1,643.

The fair value of the consideration transferred on the acquisition date consisted of the following:

Cash consideration	\$ 400
Note payable issued to seller (Note 9)	771
Contingent earn-out liability	472
Total consideration	\$ 1,643

The transaction was recorded as a business combination and the results of operations have been included in the consolidated statement of comprehensive income (loss) since the date of acquisition. Acquisition fees of approximately \$15 incurred in connection with the transaction were recorded in operating expenses for the nine months ended September 30, 2014.

In connection with the acquisition, the Company is obligated to pay an earn-out of up to \$550 based upon the level of revenues generated from the acquired products during the four calendar years following closing. The Company currently has recorded a liability of \$472 related to this obligation. This contingent liability represents the fair value estimate of the earn-out based upon the Company's projected likelihood of meeting the revenue targets.

The following table summarizes the estimated fair values of the assets acquired at the acquisition date:

In process research and development	\$ 1,478
Not-to-compete agreement	120
Deferred service costs	45
Total assets acquired	\$ 1,643

The not-to-compete agreement is being amortized over a five-year period. The fair value of the not-to-compete agreement was estimated using a discounted cash flow model. The unobservable inputs are considered Level 3 inputs in the fair value hierarchy.

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The Company has not presented pro forma results of operations for the current acquisition because the acquisition is not material to the Company's consolidated results of operations, financial position or cash flows.

Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE PERIOD ENDED SEPTEMBER 30, 2014**  
(in thousands except share and per share amounts)  
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**Note 3. Net Income Per Share**

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common shares outstanding and common stock equivalents outstanding during the period.

**Note 4. Investments**

The cost and estimated fair value of the Company's investments are as follows:

	Cost	Gross unrealized gain	Gross unrealized loss	Fair value
<b>September 30, 2014</b>				
Money Market	\$ 353	\$ 0	\$ 0	\$ 353
Commercial Paper	345	0	0	345
Treasury Bills	6,543	0	0	6,543
Equity Securities	74	1,233	(55)	1,252
	7,315	1,233	(55)	8,493
Less Cash Equivalents	698	0	0	698
<b>Total Investments, September 30, 2014</b>	<b>\$ 6,617</b>	<b>\$ 1,233</b>	<b>\$ (55)</b>	<b>\$ 7,795</b>
<b>December 31, 2013</b>				
Money Market	\$ 540	\$ 0	\$ 0	\$ 540
Commercial Paper	601	0	0	601
Treasury Bills	5,226	1	0	5,227
Equity Securities	86	2,686	(54)	2,718
	6,453	2,687	(54)	9,086
Less Cash Equivalents	1,141	0	0	1,141
<b>Total Investments, December 31, 2013</b>	<b>\$ 5,312</b>	<b>\$ 2,687</b>	<b>\$ (54)</b>	<b>\$ 7,945</b>

At September 30, 2014 and December 31, 2013, the Company's significant investment in equity securities was 138,217 and 231,336 shares, respectively, of Rudolph, accounted for under the available-for-sale method. As of September 30, 2014 and December 31, 2013, the aggregate value of the Company's Rudolph shares as reported on the Nasdaq Stock Exchange (ticker symbol RTEC) was approximately \$1,251 and \$2,716, respectively, with an approximate cost of \$18 and \$30, respectively. During the three-month periods ended September 30, 2014 and 2013, the Company sold 25,700 and 10,000 shares, respectively, of Rudolph stock and reported gains of \$258 and \$129, respectively, in non-operating income. During the nine-month periods ended September 30, 2014 and 2013, the Company sold 93,119 and 41,931 shares, respectively, of Rudolph stock and reported gains of \$1,008 and \$529, respectively, in non-operating income.

Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE PERIOD ENDED SEPTEMBER 30, 2014**  
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**Note 5. Fair Value Measurements**

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

**September 30, 2014**

	Carrying amount in consolidated balance sheet	Fair Value	Fair Value Measurement Using		
			Level 1	Level 2	Level 3
<b>Assets:</b>					
Cash and cash equivalents					
Money Market	\$ 353	\$ 353	\$ 353	\$ 0	\$ 0
Commercial Paper	345	345	345	0	0
Treasury Bills	6,543	6,543	6,543	0	0
Available for sale:					
Equities:					
Small Cap Technology Sector	1,252	1,252	1,252	0	0
<b>Liabilities:</b>					
Contingent Earn-out	472	472	0	0	472

**December 31, 2013**

	Carrying amount in consolidated balance sheet	Fair Value	Fair Value Measurement Using		
			Level 1	Level 2	Level 3
<b>Assets:</b>					
Cash and cash equivalents					
Money Market	\$ 540	\$ 540	\$ 540	\$ 0	\$ 0
Commercial Paper	601	601	601	0	0
Treasury Bills	5,227	5,227	5,227	0	0
Available for sale:					
Equities:					
Small Cap Technology Sector	2,718	2,718	2,718	0	0

The fair value of the money market funds, commercial paper, and treasury bills is based on quoted market prices in an active market.

Available-for-sale securities include equity securities that are traded 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. Management estimated the probability of meeting the revenue targets over the measurement period to determine the fair value of the contingent payable, which is considered a level 3 input in the fair value hierarchy.

The change in level 3 liabilities at fair value on a recurring basis is summarized as follows:

Balance at December 31, 2013	\$ 0
Additions (Note 2)	472
Balance at September 30, 2014	\$ 472

Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE PERIOD ENDED SEPTEMBER 30, 2014**  
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(unaudited)

**Note 6. Inventories**

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

	September 30, 2014	December 31, 2013
Raw Materials	\$ 797	\$ 658
Work In Process	263	226
Finished Goods	205	176
<b>Total Inventories</b>	<b>\$ 1,265</b>	<b>\$ 1,060</b>

**Note 7. Property and Equipment**

The following is a summary of property and equipment:

	September 30, 2014	December 31, 2013
Equipment	\$ 266	\$ 272
Furniture & Fixtures	380	388
Building	1,365	1,365
Land	415	415
	<b>2,426</b>	<b>2,440</b>
Less Accumulated Depreciation	1,251	1,223
<b>Total Property and Equipment</b>	<b>\$ 1,175</b>	<b>\$ 1,217</b>

**Note 8. Net Intangible Assets**

Our intangible assets are comprised of a Not-to-Compete and the HazardPRO™ technology. The Not-to-Compete is being amortized over five years and the HazardPRO™ technology is being amortized over seven years, in both cases on a straight-line basis.

	September 30, 2014		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Not-to-Compete	\$ 120	\$ 16	\$ 104
Technology	1,478	18	1,460
Net Intangible Assets	\$ 1,598	\$ 34	\$ 1,564

Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE PERIOD ENDED SEPTEMBER 30, 2014**  
(in thousands except share and per share amounts)  
(unaudited)

**Note 9. Note Payable**

The note payable consists of the following at September 30, 2014:

Note Payable	\$	800
Payable in two annual installments of principal of \$400 with a maturity date of February 2016. This note is non-interest bearing and unsecured.		
Less: Discount of debt instrument listed above		(29)
Net Note Payable		771
Less: Current Maturities		381
Note Payable Long Term	\$	390

Scheduled maturities of the note payable are as follows at September 30, 2014

October 1, 2014 to September 30, 2015	\$	381
October 1, 2015 to September 30, 2016		390
Total	\$	771

**Note 10. Stock-Based Compensation**

The Company records compensation expense for stock options based on the estimated fair value of the options on the date of grant using the BSM model with the assumptions included in the table below. 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. The Company calculates expected volatility for stock options and awards using historical volatility because the Company believes the future volatility will approximate historical volatility. At September 30, 2014, the Company had one active stock-based employee compensation plan.

During the second quarter of 2014, the Company granted one director options to purchase 25,000 shares of common stock. The options were priced above fair market value and vested 20% on the grant date, with an additional 20% vesting on the first four anniversaries of the grant date. The options expire ten years from the date of grant.

During the third quarter of 2013, the Company granted to its Chief Executive Officer and three of its outside directors options to each purchase 50,000 shares of common stock and granted options to purchase 25,000 shares of common stock to the fourth outside director. The options to the Chief Executive Officer were granted at fair market value and vested immediately. The options granted to outside directors were priced above fair market value and vested 20% on the grant date, with an additional 20% vesting on the first four anniversaries of the grant date. All of the stock option grants expire ten years from the date of the grant.

The assumptions made in estimating the fair value of the options on the grant date based upon the BSM option-pricing model are as follows:

	Nine Months Ended	
	September 30	
	2014	2013
Dividend Yield	0.00%	0.00%
Expected Volatility	44.11%	44.27-45.00%
Risk Free Interest Rate	2.02%	1.33-1.92%
Expected Life	6 Years	5.5-6 Years





Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE PERIOD ENDED SEPTEMBER 30, 2014**  
(in thousands except share and per share amounts)  
(unaudited)

The Company recognized compensation expense of approximately \$51 and \$149 during the nine months ended September 30, 2014 and 2013, respectively, in connection with the issuance of the options.

There were no stock options exercised during the nine-month period ended September 30, 2014. During the nine-month period ended September 30, 2014, 14,480 stock options outstanding were forfeited.

A summary of the Company's stock option plan as of September 30, 2014 and changes during the nine months then ended is listed below:

	Number of Shares	Weighted- Average Exercise Price
Balance at January 1, 2014	246,980	\$ 4.53
Granted	25,000	4.39
Exercised	0	
Canceled/forfeited/expired	14,480	4.16
Balance at September 30, 2014	257,500	\$ 4.54
Vested and exercisable as of September 30, 2014	132,500	

The Company has two equity plans with options outstanding. This roll forward includes both plans.

As of September 30, 2014, there was approximately \$188 of unrecognized compensation expense. The Company expects to recognize this expense over the next four years. There was no intrinsic value in the options outstanding or exercisable as of September 30, 2014 as all exercise prices were greater than the current fair market value as of that date.

**Note 11. Segment Information**

The Company has two reportable operating segments: Production Monitoring and Investments. The Production Monitoring segment manufactures and markets a complete line of production monitoring equipment, in particular speed monitoring and motor control systems for industrial machinery. ESI Investment Company holds investments in marketable and non-marketable securities.

The accounting policies of the segments are described in Note 1 of the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. In evaluating segment performance, management focuses on sales and income before taxes. The Company has no inter-segment sales.

The following is financial information relating to the continuing operating segments:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>External sales</b>				
Production monitoring	\$ 1,917	\$ 1,708	\$ 5,379	\$ 4,813
<b>Total</b>	<b>\$ 1,917</b>	<b>\$ 1,708</b>	<b>\$ 5,379</b>	<b>\$ 4,813</b>
<b>Income before income taxes</b>				
Production monitoring	\$ 223	\$ 18	\$ 397	\$ 220
Investments	258	132	1,010	534
<b>Total</b>	<b>\$ 481</b>	<b>\$ 150</b>	<b>\$ 1,407</b>	<b>\$ 754</b>

13

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. These decisions include the selection of applicable accounting principles and the use of judgment in their application, the results of which affect 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, 2013. New estimates for the allocation of the purchase price for acquired tangible and intangible assets and the contingent earn-out have been added to the estimates discussed in our Annual Report.

The following table contains selected financial information, for the periods indicated, from our consolidated statements of comprehensive income (loss) expressed as a percentage of net sales.

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	40.2	42.6	41.8	42.4
Gross profit	59.8	57.4	58.2	57.6
Operating expenses:				
Selling and marketing	21.3	22.1	22.3	24.2
General and administrative	17.1	26.0	18.0	21.3
Research and development	9.7	8.4	10.5	7.8
Total operating expenses	48.1	56.5	50.8	53.3
Operating income	11.7	0.9	7.4	4.3
Non-operating income (expense):				
Interest expense	(0.3)	0.0	(0.2)	0.0
Gain on sale of available-for-sale securities	13.5	7.5	18.7	11.0
Interest income	0.0	0.2	0.0	0.1
Other income	0.2	0.2	0.2	0.2
Total non-operating income	13.4	7.9	18.7	11.3
Income before income taxes	25.1	8.8	26.1	15.6
Provision for income taxes	8.8	2.7	9.1	4.4
Net income	16.3%	6.1%	17.0%	11.2%

The following discusses the Company's performance for the three and nine months ended September 30, 2014 and 2013.

**RESULTS OF OPERATIONS****Net Sales**

Net sales for the three-month period ended September 30, 2014 increased \$209,000, or 12.2%, when compared to the same period in 2013. Net sales for the nine-month period ended September 30, 2014 increased \$566,000, or 11.8%, when compared to the same period in 2013. The increase in both periods was primarily due to strong performance in our central U.S. regions, which increased 37.3% and 20.9% in the respective three-month and nine-month periods, compared to the same 2013 periods. In the 2014 third quarter, we also experienced strong performance in the grain, feed, and milling market segments, which we believe was a result of facility expansion and plant upgrades in anticipation of large harvest volumes of corn and soybeans.

## Table of Contents

Consistent with our prior disclosures, we continue to integrate and deploy the HazardPRO™ wireless hazard monitoring technology acquired earlier in 2014 and continue to believe these products will be accretive to our quarterly earnings per share beginning in the 2015 second quarter.

### Gross Margin

Gross margin for the three-month period ended September 30, 2014 was 59.8% versus 57.4% for the same period in 2013. For the nine-month periods ended September 30, 2014 and 2013, gross margins were 58.2% and 57.6%, respectively. The increase in gross margin, for both periods, was primarily due to a change in the mix of products sold. We continue our efforts to maintain or increase gross margin by designing and manufacturing products in the most cost effective manner.

### Operating Expenses

Total operating expenses decreased \$44,000, or 4.6%, for the three months ended September 30, 2014 when compared to the same period in 2013. Operating expenses for the nine months ended September 30, 2014 increased \$172,000, or 6.7% compared to the same 2013 period. As a percentage of revenue, however, operating expenses decreased to 48.1% in the 2014 three-month period compared to 56.5% in the same period for 2013 and decreased to 50.8% in the 2014 nine-month period compared to 53.3% for the same period in 2013.

Selling and marketing costs increased \$31,000, or 8.2%, for the three months ended September 30, 2014 when compared to the same period in 2013. For the nine months ended September 30, 2014, selling and marketing costs increased \$34,000, or 2.9%, over the same period in 2013. The increase for both the three- and nine-month periods was due to both higher sales compensation due to increased sales and to higher travel expenses.

General and administrative costs decreased \$117,000, or 26.4%, for the three months ended September 30, 2014 compared to the same period in 2013. For the nine months ended September 30, 2014, general and administrative costs decreased \$55,000, or 5.4%, when compared to the same period in 2013. The decrease in the three-month period was primarily due to a decrease of approximately \$133,000 of noncash stock compensation expense related to stock options granted during the 2013 third quarter. This decrease was partially offset by increases in depreciation and amortization and expenses related to developing post-closing deliverables, which are both related to the technology purchased in February 2014. The decrease in the nine-month period was primarily due to a decrease of approximately \$98,000 of noncash stock compensation expense related to stock options granted during the 2013 third quarter. The decrease was partially offset by increases in depreciation and amortization and expenses related to developing post-closing deliverables, which are both related to the technology purchased in February 2014, and insurance expense due to a new director and officer liability insurance policy.

Research and development costs for the three months ended September 30, 2014 increased \$42,000, or 29.2%, compared to the same period in 2013. For the nine months ended September 30, 2014, research and development costs increased \$193,000, or 51.6%, when compared to the same period in 2013. For the three months ended September 30, 2014, the increase was due to development of new prototypes and an increase in wages and benefits due to changes in management responsibilities. For the nine months ended September 30, 2014, the increase resulted from an increase in wages and benefits due to changes in management responsibilities, lab testing fees for product approval for hazardous location and development of new prototypes.

### Non-Operating Income

Non-operating income increased by \$121,000, or 89.6%, for the three-month period ended September 30, 2014 compared to the same period for 2013. For the nine months ended September 30, 2014, non-operating income increased \$463,000, or 84.8%, when compared to the same period in 2013. The increase for the 2014 three- and nine-month periods is due to a higher number of shares of Rudolph Technologies, Inc. ( Rudolph ) stock sold, partially offset by an increase in interest expense. During the three months ended September 30, 2014 and 2013, we sold 25,700 and 10,000 shares, respectively, of Rudolph stock and recognized gains of \$258,000 and \$129,000, respectively, on the sales. During the nine months ended September 30, 2014 and 2013, we sold 93,119 and 41,931 shares, respectively, of Rudolph stock and recognized gains of \$1,008,000 and \$529,000, respectively, on the sales. During the three and nine months ended September 30, 2014, we recognized \$5,000 and \$12,000, respectively, of interest expense related to our 2014 technology acquisition.

## Table of Contents

### Income Before Income Taxes

Income before income taxes was \$481,000 for the three months ended September 30, 2014, representing an increase of \$331,000, or 220.7%, when compared to the same period in 2013. Income before income taxes was \$1,407,000 for the nine months ended September 30, 2014, representing an increase of \$653,000, or 86.6%, when compared to the same period in 2013.

The Production Monitoring Division had income before income taxes of \$223,000 for the three months ended September 30, 2014 compared to \$18,000 for the same period in 2013, an increase of \$205,000, or 1138.9%. For the nine months ended September 30, 2014, the Production Monitoring Division had income before income taxes of \$397,000 compared to \$220,000 for the same period in 2013, an increase of \$177,000, or 80.5%. The increase in income before income taxes for the three and nine months ended September 30, 2014 was due to the increase in sales, higher gross profits, and lower operating costs as a percentage of sales than in the 2013 periods. (See *Operating Expenses* ).

ESI Investment Company had income before income taxes of \$258,000 for the three-month period ended September 30, 2014 compared to \$132,000 for the same period in 2013, an increase of \$126,000, or 95.5%. ESI Investment Company had income before income taxes of \$1,010,000 for the nine-month period ended September 30, 2014 compared to income before income taxes of \$534,000 for the same period in 2013, an increase of \$476,000, or 89.1%. These increases were a result of the greater gain on the sales of available-for-sale securities in 2014 compared to 2013 (see *Non-Operating Income* ).

The net decrease in the unrealized value of available-for-sale securities was \$227,000 and \$901,000 for the three and nine months, respectively, ended September 30, 2014. The net decrease is due to the sale of Rudolph stock, which resulted in a \$258,000 and \$1,008,000 gain on the sales, and the decrease in the market price of Rudolph during the three and nine months, respectively, ended September 30, 2014. ESI Investment Company has approximately \$1,233,000 in unrealized gain on the Rudolph investment that is reported in Other Comprehensive Income (see Note 4 *Investments* in the notes to the accompanying consolidated financial statements).

### Provision for Income Taxes

Income taxes for the three-month periods increased from \$46,000 in 2013 to \$168,000 in 2014 and for the nine-month periods increased from \$214,000 in 2013 to \$492,000 in 2014, reflecting higher income in both 2014 periods. Income taxes increased as a percentage of sales because of significant gains on sale of available-for-sale securities.

## **LIQUIDITY AND CAPITAL RESOURCES**

Cash and cash equivalents were \$887,000 at September 30, 2014 and \$1,505,000 at December 31, 2013.

Cash from operating activities was \$117,000 for the nine months ended September 30, 2014, compared to cash used in operating activities of \$65,000 for the nine months ended September 30, 2013. Cash from operating activities increased \$182,000 for the nine months ended September 30, 2014 when compared to the same period in 2013, mainly due to the net change in accounts payable and accrued income taxes, partially offset by the net change in inventories and the decrease in net income, adjusted for the gain on sales of available-for-sale securities. The net change in accounts payable was due to the timing of inventory purchases. The net change in income taxes was due to an increase in the payable balance of \$44,000 at September 30, 2014 when compared to the prior year and a decrease in the payable of \$289,000 at September 30, 2013 when compared to the prior year. The 2014 payable increase resulted from the increase in operating income and the gain on sales of available-for-sale securities when comparing 2014 to 2013. The Company paid the 2012 tax year balance due in March 2013. The net change in inventories was due to increased 2014 sales and the purchase of HazardPRO™ components.

Cash used in investing activities was \$739,000 compared to cash generated from investing activities of \$343,000 for the nine months ended September 30, 2014 and 2013, respectively. The Company had net purchases of Treasury Bills with a maturity date of more than three months from the date of purchase of \$1,314,000 in 2014 compared to \$175,000 in 2013. In addition, the Company acquired the Harvest Engineering, Inc. wireless hazard monitoring technology and Insta-Link product family in February 2014, paying \$400,000 and financing the remaining purchase price through a seller-financed note. We received \$1,020,000 on the sales of available-for-sale securities during the nine months ended September 30, 2014 compared to \$536,000 received during the nine months ended September 30, 2013. In addition, we purchased \$45,000 and \$18,000 of property and equipment for the nine months ended September 30, 2014 and 2013, respectively.

The Company issued an \$800,000 non-interest bearing note payable to Harvest Engineering, Inc., payable in annual installments of \$400,000. In addition, the agreement includes an earn-out that is payable if specified revenue targets are met over the four calendar years following closing. The maximum amount of the earn-out is \$550,000. The estimated fair value of the earn-out is \$472,000 as of September 30, 2014.



## Table of Contents

Cash generated from financing activities was \$4,000 for the nine months ended September 30, 2014, compared to cash used in financing activities of \$264,000 for the nine months ended September 30, 2013. During the nine-month period ended September 30, 2013 we paid aggregate dividends of \$272,000. We did not pay any dividends during the nine months ended September 30, 2014. During the nine-month periods ended September 30, 2014 and 2013, the Company had \$4,000 and \$8,000, respectively, in stock purchases under the Employee Stock Purchase Plan.

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

As of September 30, 2014, our primary investment is 138,217 shares of Rudolph Technologies, Inc., listed on the Nasdaq Stock Exchange, accounted for using the available-for-sale method. The investment is subject to fluctuations in market price and could have a negative effect on our liquidity.

### *Off-balance Sheet Arrangements*

As of September 30, 2014, the Company had no off-balance sheet arrangements or transactions.

### *February 2014 Acquisition and Future Business Development Activities*

During the first quarter of 2014, the Company acquired certain assets of Harvest Engineering, Inc., which include wireless hazard monitoring technology and Insta-Link product family, together with related technology and intellectual property rights, for a total purchase price of \$1,643,000. The Company will manufacture and service this new hazard monitoring product line at its Minnetonka, Minnesota facility and market and sell the products under its new HazardPRO™ product line.

The Company continues to seek growth opportunities, both internally through the Company's existing portfolio of products, technologies and markets, as well as externally through technology partnerships or related-product acquisitions. Although the Company is continuing to explore these external opportunities, it currently has no agreements or understandings with any third parties.

## **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 our marketing efforts or our efforts to accelerate growth; our business development activities; our efforts to maintain or reduce production costs; 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, the accuracy of management's assumptions regarding expenses and our cash needs and those listed under the heading "Cautionary Statements" under Item 1 Business, in our Annual Report on Form 10-K for the year ended December 31, 2013.

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

Not Applicable.

Table of Contents

**Item 4. 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 has 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, 2014 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 2014, 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. Mine Safety Disclosures - Not Applicable.**

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

**Item 6. Exhibits**

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



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.

November 12, 2014

**Electro-Sensors, Inc.**

/s/ David L. Klenk

David L. Klenk

Chief Executive Officer and Chief Financial Officer

November 12, 2014

**Electro-Sensors, Inc.**

/s/ Gloria M. Grundhoefer

Gloria M. Grundhoefer

Controller

Table of Contents

**EXHIBIT INDEX**

**ELECTRO-SENSORS, INC.**

**FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2014**

<b>Exhibit</b>	<b>Description</b>
31.1	Certification of CEO and CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Controller 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
101	The following financial information from Electro-Sensors, Inc. s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2014, formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets as of September 30, 2014 and December 31, 2013, (ii) Consolidated Statements of Comprehensive Income (Loss) for the three and nine months ended September 30, 2014 and September 30, 2013, (iii) Consolidated Statements of Cash Flows for the nine months ended September 30, 2014 and September 30, 2013, and (iv) Notes to Consolidated Financial Statements.