COMMUNICATIONS SYSTEMS INC
Form 10-Q
November 13, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **September 30, 2017**

OR

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

For the transition period from _____ to _____

Commission File Number: 001-31588

COMMUNICATIONS SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES 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 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 a check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or emerging growth company (as defined by Rule 12b-2 of the Exchange Act).

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer Smaller Reporting Company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Class	**Name of Exchange On Which Registered**	**Outstanding at November 1, 2017**
Common Stock, par value $.05 per share	NASDAQ	8,969,037

1

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

INDEX

		Page No.
Part I.	Financial Information	
	Item 1. Financial Statements (Unaudited)	
	Condensed Consolidated Balance Sheets	3
	Condensed Consolidated Statements of Loss and Comprehensive Loss	4
	Condensed Consolidated Statement of Changes in Stockholders' Equity	5
	Condensed Consolidated Statements of Cash Flows	6
	Notes to Condensed Consolidated Financial Statements	7
	Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	23
	Item 3. Quantitative and Qualitative Disclosures about Market Risk	33
	Item 4. Controls and Procedures	33
Part II.	Other Information	36

SIGNATURES
CERTIFICATIONS

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

	September 30 2017	**December 31 2016**
CURRENT ASSETS:		
Cash and cash equivalents	$17,066,485	$10,443,274
Investments	725,112	5,805,276
Trade accounts receivable, less allowance for doubtful accounts of $117,000 and $77,000, respectively	13,807,564	14,552,191
Inventories	15,017,656	22,204,902
Prepaid income taxes	612,676	1,400,118
Other current assets	1,047,320	967,332
TOTAL CURRENT ASSETS	48,276,813	55,373,093
PROPERTY, PLANT AND EQUIPMENT, net	12,963,718	15,719,403
OTHER ASSETS:		
Goodwill	—	1,462,503
Other assets, net	19,803	622,017
TOTAL OTHER ASSETS	19,803	2,084,520
TOTAL ASSETS	$61,260,334	$73,177,016
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$5,391,519	$6,953,710
Accrued compensation and benefits	2,618,752	2,149,973
Other accrued liabilities	1,711,065	1,851,938
Dividends payable	398,210	412,542
TOTAL CURRENT LIABILITIES	10,119,546	11,368,163
LONG TERM LIABILITIES:		
Long-term compensation plans	34,287	16,299
Uncertain tax positions	3,649	106,864
Deferred income taxes	—	52,998
TOTAL LONG-TERM LIABILITIES	37,936	176,161
COMMITMENTS AND CONTINGENCIES (Footnote 7)		
STOCKHOLDERS' EQUITY		
Preferred stock, par value $1.00 per share; 3,000,000 shares authorized; none issued		
Common stock, par value $.05 per share; 30,000,000 shares authorized; 8,963,516 and 8,877,379 shares issued and outstanding, respectively	448,176	443,869
Additional paid-in capital	41,894,426	41,279,281
Retained earnings	9,386,374	20,596,203
Accumulated other comprehensive loss	(626,124)	(686,661)
TOTAL STOCKHOLDERS' EQUITY	51,102,852	61,632,692
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$61,260,334	$73,177,016

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

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

	Three Months Ended September 30		Nine Months Ended September 30	
	2017	2016	2017	2016
Sales	$20,412,439	$25,616,640	$63,280,980	$76,594,526
Cost of sales	17,108,532	18,926,042	48,001,368	55,759,167
Gross profit	3,303,907	6,690,598	15,279,612	20,835,359
Operating expenses:				
Selling, general and administrative expenses	7,161,323	7,866,009	21,516,625	27,550,271
Pension liability adjustment gains	—	—	—	(4,147,836)
Impairment loss	—	—	1,617,389	—
Restructuring expense	796,231	—	2,325,861	—
Total operating expenses	7,957,554	7,866,009	25,459,875	23,402,435
Operating loss	(4,653,647)	(1,175,411)	(10,180,263)	(2,567,076)
Other income (expenses):				
Investment and other income	38,869	19,259	78,888	119,395
Gain (Loss) on sale of assets	26,222	(60,088)	(32,024)	748,234
Interest and other expense	(42,799)	(44,228)	(61,839)	(94,375)
Foreign currency translation loss	—	—	—	(4,238,497)
Other income (expense), net	22,292	(85,057)	(14,975)	(3,465,243)
Loss from operations before income taxes	(4,631,355)	(1,260,468)	(10,195,238)	(6,032,319)
Income tax (benefit) expense	(109,340)	3,301	(67,014)	242,617
Net loss	(4,522,015)	(1,263,769)	(10,128,224)	(6,274,936)
Other comprehensive income, net of tax:				
Additional minimum pension liability adjustments	—	—	—	(4,147,836)
Unrealized (loss) gain on available-for-sale securities	(240)	(2,729)	(3,187)	35,575
Foreign currency translation adjustment	31,508	15,465	63,724	4,168,590
Total other comprehensive income	31,268	12,736	60,537	56,329
Comprehensive loss	$(4,490,747)	$(1,251,033)	$(10,067,687)	$(6,218,607)
Basic net loss per share:	$(0.50)	$(0.14)	$(1.13)	$(0.71)
Diluted net loss per share:	$(0.50)	$(0.14)	$(1.13)	$(0.71)
Weighted Average Basic Shares Outstanding	8,960,606	8,849,236	8,934,235	8,816,042
Weighted Average Dilutive Shares Outstanding	8,960,606	8,849,236	8,934,235	8,816,042
Dividends declared per share	$0.04	$0.04	$0.12	$0.36

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

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

	Common Stock		Additional Paid-in	Retained	Accumulated Other Comprehensive	
	Shares	Amount	Capital	Earnings	Loss	Total
BALANCE AT DECEMBER 31, 2016	8,877,379	$443,869	$41,279,281	$20,596,203	$ (686,661)	$61,632,692
Net loss				(10,128,224)		(10,128,224)
Issuance of common stock under Employee Stock Purchase Plan	18,139	907	79,857			80,764
Issuance of common stock to Employee Stock Ownership Plan	47,248	2,362	216,396			218,758
Issuance of common stock under Executive Stock Plan	22,555	1,128	0			1,128
Share based compensation			327,261			327,261
Other share retirements	(1,805)	(90)	(8,369)	789		(7,670)
Shareholder dividends				(1,082,394)		(1,082,394)
Other comprehensive income					60,537	60,537
BALANCE AT SEPTEMBER 30, 2017	8,963,516	$448,176	$41,894,426	$9,386,374	$ (626,124)	$51,102,852

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

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

	Nine Months Ended September 30	
	2017	**2016**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(10,128,224)	$(6,274,936)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,489,661	2,754,189
Share based compensation	327,261	505,306
Deferred taxes	(52,998)	(11,083)
Impairment loss	1,617,389	—
Change in fair value of acquisition-related contingent consideration	—	(135,316)
Loss (gain) on sale of assets	537,470	(748,234)
Excess tax benefit from share-based payments	—	63,304
Changes in assets and liabilities:		
Trade accounts receivable	765,055	1,443,908
Inventories	7,232,732	352,653
Prepaid income taxes	789,209	(141,566)
Other assets, net	358,160	(148,010)
Accounts payable	(1,648,259)	(1,188,066)
Accrued compensation and benefits	701,546	224,713
Other accrued liabilities	(157,422)	352,789
Income taxes payable	(103,215)	(49,657)
Other	—	58,001
Net cash provided by (used in) operating activities	2,728,365	(2,942,005)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(389,616)	(1,889,283)
Proceeds from the sale of property, plant and equipment	220,366	972,595
Proceeds from the sale of investments	5,076,978	2,014,023
Net cash provided by investing activities	4,907,728	1,097,335
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings on line of credit	—	4,894,046
Payments against line of credit	—	(4,894,046)
Cash dividends paid	(1,096,726)	(4,269,451)
Mortgage principal payments	—	(103,603)
Proceeds from issuance of common stock, net of shares withheld	74,222	92,191
Excess tax expense benefit from share-based payments	—	(63,304)
Payment of deferred consideration related to acquisition	—	(300,000)
Net cash used in financing activities	(1,022,504)	(4,644,167)
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	9,622	(90,510)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	6,623,211	(6,579,347)

CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	10,443,274	9,812,737
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$17,066,485	$3,233,390
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Income taxes (refunded) paid	$(646,660)	$443,106
Interest paid	29,297	43,630
Dividends declared not paid	398,210	413,966
Capital expenditures in accounts payable	75,525	57,181
Acquisition costs in accrued consideration	—	6,918

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

COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Communications Systems, Inc. (herein collectively called “CSI” or the “Company”) is a Minnesota corporation organized in 1969 that operates primarily as a holding company conducting its business through four business units having operations in the United States and the United Kingdom. CSI is principally engaged through its Suttle business unit in the manufacture and sale of connectivity infrastructure products for broadband and voice communications and through its Transition Networks business unit in the manufacture of core media conversion products, Ethernet switches, and other connectivity and data transmission products. Through its JDL Technologies business unit the Company provides technology solutions including virtualization, managed services, wired and wireless network design and implementation, HIPAA-compliant IT services, and converged infrastructure configuration and deployment. Through its Net2Edge business unit, the Company enables telecommunications carriers to connect legacy networks to high-speed services.

The Company classifies its businesses into four segments corresponding to the Suttle, Transition Networks, JDL Technologies and Net2Edge business units. Non-allocated general and administrative expenses are separately accounted for as “Other” in the Company’s segment reporting. Intersegment revenues are eliminated upon consolidation.

Financial Statement Presentation

The condensed consolidated balance sheets and condensed consolidated statement of changes in stockholders’ equity as of September 30, 2017 and the related condensed consolidated statements of loss and comprehensive loss, and the condensed consolidated statements of cash flows for the periods ended September 30, 2017 and 2016 have been prepared by Company management. In the opinion of management, all adjustments (which include only normal recurring adjustments, except where noted) necessary to present fairly the financial position, results of operations, and cash flows at September 30, 2017 and 2016 and for the periods then ended have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted. We recommend these condensed consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Company's December 31, 2016 Annual Report to Shareholders on Form 10-K. The results of operations for the period ended September 30, 2017 are not necessarily indicative of operating results for the entire year.

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

Except to the extent updated or described below, the significant accounting policies set forth in Note 1 to the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, appropriately represent, in all material respects, the current status of accounting policies, and are incorporated herein by reference.

Accumulated Other Comprehensive Loss

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

	Foreign Currency Translation	Unrealized (loss)/gain on securities	Accumulated Other Comprehensive Loss
December 31, 2016	$ (704,000)	$ 17,000	$ (687,000)
Net current period change	64,000	(3,000)	61,000
September 30, 2017	$ (640,000)	$ 14,000	$ (626,000)

The Company recognized $4,238,000 in foreign currency translation losses within the statement of loss and comprehensive loss during the first quarter of 2016 due to the substantial liquidation of our Austin Taylor facility in the U.K. Refer to Note 11 for further information regarding the pension liability adjustment recognized in income in the first quarter of 2016.

NOTE 2 – CASH EQUIVALENTS AND INVESTMENTS

The following tables show the Company's cash equivalents and available-for-sale securities' amortized cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category recorded as cash and cash equivalents or short and long term investments as of September 30, 2017 and December 31, 2016:

September 30, 2017

			Fair Value

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses		Cash Equivalents	Short-Term Investments	Long-Term Investments
Cash equivalents:							
Money Market funds	$8,986,000	$ —	$ —	$8,986,000	$8,986,000	$ —	$ —
Subtotal	8,986,000	—	—	8,986,000	8,986,000	—	—
Investments:							
Certificates of deposit	725,000	—	—	725,000	—	725,000	—
Subtotal	725,000	—	—	725,000	—	725,000	—
Total	$9,711,000	$ —	$ —	$9,711,000	$8,986,000	$ 725,000	$ —

December 31, 2016

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash Equivalents	Short-Term Investments	Long-Term Investments
Cash equivalents:							
Money Market funds	$3,851,000	$ —	$ —	$3,851,000	$3,851,000	$—	$ —
Subtotal	3,851,000	—	—	3,851,000	3,851,000	—	—
Investments:							
Certificates of deposit	4,291,000	4,000	(1,000)	4,294,000	—	4,294,000	—
Corporate Notes/Bonds	1,511,000	—	—	1,511,000	—	1,511,000	—
Subtotal	5,802,000	4,000	(1,000)	5,805,000	—	5,805,000	—
Total	$9,653,000	$ 4,000	$ (1,000)	$9,656,000	$3,851,000	$5,805,000	$ —

The following table summarizes the estimated fair value of our investments, designated as available-for-sale and classified by the contractual maturity date of the securities as of September 30, 2017:

	Amortized Cost	**Estimated Market Value**
Due within one year	$ 725,000	$ 725,000

The Company did not recognize any gross realized gains or losses during the three and nine month periods ending September 30, 2017 and 2016, respectively. If the Company had realized gains or losses, they would be included within investment and other income in the accompanying condensed consolidated statement of loss and comprehensive loss.

NOTE 3 - STOCK-BASED COMPENSATION

Employee Stock Purchase Plan

Under the Company's Employee Stock Purchase Plan ("ESPP"), employees are able to acquire shares of common stock at 85% of the price at the end of each current quarterly plan term. The most recent term ended September 30, 2017. The ESPP is considered compensatory under current Internal Revenue Service rules. At September 30, 2017, after giving effect to the shares issued as of that date, 58,726 shares remain available for purchase under the ESPP.

2011 Executive Incentive Compensation Plan

On March 28, 2011 the Board adopted and on May 19, 2011 the Company's shareholders approved the Company's 2011 Executive Incentive Compensation Plan ("2011 Incentive Plan"). The 2011 Incentive Plan authorizes incentive awards to officers, key employees and non-employee directors in the form of options (incentive and non-qualified), stock appreciation rights, restricted stock, restricted stock units, performance stock units ("deferred stock"), performance cash units, and other awards in stock, cash, or a combination of stock and cash. The 2011 Incentive Plan, as amended, allows the issuance of up to 2,000,000 shares of common stock.

During 2017, stock options covering 259,686 shares have been awarded to key executive employees and directors. These options expire seven years from the date of award and generally vest 25% each year beginning one year after the date of award. The Company also granted deferred stock awards of 100,239 shares to key employees during the first quarter of 2017 under the Company's long-term incentive plan for performance over the 2017 to 2019 period. The actual number of shares of deferred stock, if any, that are ultimately earned by the respective employees will be determined based on achievement against performance goals at the end of the three-year period ending December 31, 2019 and any shares earned will be issued in the first quarter of 2020 to those key employees still with the Company at that time.

At September 30, 2017, 160,138 shares have been issued under the 2011 Incentive Plan, 1,292,968 shares are subject to currently outstanding options, deferred stock awards, and unvested restricted stock units, and 546,894 shares are eligible for grant under future awards.

Stock Option Plan for Directors

Shares of common stock are reserved for issuance to non-employee directors under options granted by the Company prior to 2011 under its Stock Option Plan for Non-Employee Directors (the "Director Plan"). Under the Director Plan nonqualified stock options to acquire shares of common stock were automatically granted to each non-employee director concurrent with annual meetings of shareholders in 2010 and earlier years, with the exercise price of options granted being the fair market value of the common stock on the date of the respective shareholder meetings. Options granted under the Director Plan expire 10 years from date of grant. No options have been granted under the Director Plan since 2011 when the Company amended the Director Plan to prohibit future option grants. As of September 30, 2017, there were 51,000 shares subject to outstanding options under the Director Plan.

1992 Stock Plan

Under the Company's 1992 Stock Plan ("the Stock Plan"), shares of common stock may be issued pursuant to stock options, restricted stock or deferred stock grants to officers and key employees. Exercise prices of stock options under the Stock Plan cannot be less than fair market value of the stock on the date of grant. Rules and conditions governing awards of stock options, restricted stock and deferred stock are determined by the Compensation Committee of the Board of Directors, subject to limitations in the Stock Plan. The Company amended the Stock Plan in 2011 to prohibit future equity awards. At September 30, 2017, after reserving for stock options and deferred stock awards granted in prior years and adjusting for forfeitures and issuances during the year, there were 10,230 shares reserved for issuance under the Stock Plan.

10

Changes in Stock Options Outstanding

The following table summarizes changes in the number of outstanding stock options under the 2011 Incentive Plan, the Director Plan and Stock Plan over the period December 31, 2016 to September 30, 2017:

	Options	Weighted average exercise price per share	Weighted average remaining contractual term
Outstanding – December 31, 2016	922,930	$ 10.10	4.90
Awarded	259,686	4.42	
Exercised	—	—	
Forfeited	(37,199)	11.57	
Outstanding – September 30, 2017	1,145,417	8.76	4.74
Exercisable at September 30, 2017	669,186	$ 10.50	3.97
Expected to vest September 30, 2017	1,145,417	8.76	4.74

The aggregate intrinsic value of all options (the amount by which the market price of the stock on the last day of the period exceeded the market price of the stock on the date of grant) outstanding at September 30, 2017 was $0. The intrinsic value of all options exercised during the nine months ended September 30, 2017 was $0. Net cash proceeds from the exercise of all stock options were $0 in each of the nine month periods ended September 30, 2017 and 2016.

Changes in Deferred Stock Outstanding

The following table summarizes the changes in the number of deferred stock shares under the Stock Plan and 2011 Incentive Plan over the period December 31, 2016 to September 30, 2017:

	Shares	Weighted Average Grant Date Fair Value
Outstanding – December 31, 2016	149,260	$ 9.55
Granted	100,239	4.42

Vested	(9,214)	12.29
Forfeited	(44,845)	10.28
Outstanding – September 30, 2017	195,440	6.62

Changes in Restricted Stock Units Outstanding

The following table summarizes the changes in the number of restricted stock units under the 2011 Incentive Plan over the period December 31, 2016 to September 30, 2017:

	Shares	**Weighted Average Grant Date Fair Value**
Outstanding – December 31, 2016	27,134	$ 8.65
Granted	—	—
Issued	(13,341)	11.05
Forfeited	—	—
Outstanding – September 30, 2017	13,793	6.33

Compensation Expense

Share-based compensation expense recognized for the nine month period ended September 30, 2017 was $327,000 before income taxes and $213,000 after income taxes. Share-based compensation expense recognized for the nine month period ended September 30, 2016 was $505,000 before income taxes and $328,000 after income taxes. Unrecognized compensation expense for the Company's plans was $378,000 at September 30, 2017 and is expected to be recognized over a weighted-average period of 2.1 years. Excess tax benefits from the exercise of stock options and issuance of stock included in financing cash flows for the nine month periods ended September 30, 2017 and 2016 were $ 0 and $ (63,000), respectively. Share-based compensation expense is recorded as a part of selling, general and administrative expenses.

NOTE 4 - INVENTORIES

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

	September 30 2017	**December 31 2016**
Finished goods	$8,406,000	$12,083,000
Raw and processed materials	6,612,000	10,122,000
	$15,018,000	$22,205,000

The Company's reserve for obsolete inventory increased by $3,131,000 during the nine months ended September 30, 2017, or $0.35 per basic and diluted share.

NOTE 5 –GOODWILL AND INTANGIBLE ASSETS

Goodwill is required to be evaluated for impairment on an annual basis and between annual tests upon the occurrence of certain events or circumstances. In January 2017, the FASB issued new accounting guidance regarding the simplification of the test for goodwill impairment. The new standard eliminates the quantitative goodwill impairment analysis requirement to determine the fair value of individual assets and liabilities of a reporting unit to determine the amount of any goodwill impairment and instead permits an entity to recognize goodwill impairment loss as the excess of a reporting unit's carrying value over the estimated fair value of the reporting unit, to the extent this amount does not exceed the carrying amount of goodwill. The Company chose to adopt this standard early for the annual impairment analysis in 2017. The Company performed the first step of the previous two-step process, which requires

that the fair value of the reporting unit be compared to its book value including goodwill. If the fair value is higher than the book value, no impairment is recognized. If the fair value is lower than the book value, an impairment adjustment must be recorded.

The Company performs its annual impairment analysis as of April 1 each year. The Company analyzed the reporting unit that had the goodwill and also analyzed the company as a whole, including the Company's four separate reporting units. Although JDL Technologies had been profitable for the prior eight quarters, the cyclical and unpredictable nature of revenues from its education sector raised issues in forecasting cash flows in future quarters used to estimate the reporting unit's fair value. Based on this analysis of comparing the fair value of each reporting unit to the book value, and comparing the Company's overall book value with its market capitalization, the Company determined that the book value exceeded the overall fair value of the reporting units as well as the Company's overall market value. As a result, the Company recorded a goodwill impairment charge totaling $1,463,000 during the second quarter of 2017.

The changes in the carrying amount of goodwill in the JDL Technologies segment for the nine months ended September 30, 2017 are as follows:

	JDL Technologies
January 1, 2017	$ 1,463,000
Impairment loss	(1,463,000)
September 30, 2017	$ —
Gross goodwill	1,463,000
Accumulated impairment loss	(1,463,000)
Balance at September 30, 2017	$ —

As part of the overall annual impairment analysis noted above, the Company also reviewed other intangible assets for potential impairment. Based on this analysis, the Company deemed the intangible assets related to customer relationships to be impaired and recorded a $154,000 impairment loss during the second quarter of 2017.

The Company's identifiable intangible assets with finite lives, included in other assets, net on the condensed consolidated balance sheets, are being amortized over their estimated useful lives and were as follows:

	September 30, 2017				
	Gross Carrying Amount	Accumulated Amortization	Impairment loss	Foreign Currency Translation	Net
Trademarks	$98,000	$ (63,000)	$ —	$ (16,000)	$19,000
Customer relationships	491,000	(230,000)	(154,000)	(107,000)	—
Technology	229,000	(187,000)	—	(42,000)	—
	$818,000	$ (480,000)	$ (154,000)	$ (165,000)	$19,000

	December 31, 2016				
	Gross Carrying Amount	Accumulated Amortization	Impairment loss	Foreign Currency Translation	Net
Trademarks	$91,000	$ (50,000)	$ —	$ (20,000)	$21,000
Customer relationships	491,000	(200,000)	—	(122,000)	169,000
Technology	229,000	(172,000)	—	(57,000)	—
	$811,000	$ (422,000)	$ —	$ (199,000)	$190,000

13

Amortization expense on these identifiable intangible assets was $27,000 and $63,000 2017 and 2016, respectively. The amortization expense is included in selling, general and administrative expenses. At September 30, 2017, the estimated future amortization expense for definite-lived intangible assets for the remainder of 2017 and all of the following four fiscal years is as follows:

Year Ending December 31:	
2017	$3,000
2018	7,000
2019	2,000
2020	2,000
2021	2,000
Thereafter	2,000

NOTE 6 – WARRANTY

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

The following table presents the changes in the Company’s warranty liability for the nine month periods ended September 30, 2017 and 2016, respectively, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

	2017	**2016**
Beginning balance	$600,000	$554,000
Amounts charged to expense	43,000	119,000
Actual warranty costs paid	(57,000)	(75,000)
Ending balance	$586,000	$598,000

NOTE 7 – CONTINGENCIES

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

NOTE 8 – DEBT

Long-term Debt

The mortgage on the Company's headquarters building was payable in monthly installments and carried an interest rate of 6.83%. The mortgage matured on March 1, 2016 and the Company paid $104,000 in the first quarter of 2016 to fully settle the liability.

Line of Credit

The Company has a $15,000,000 line of credit from Wells Fargo Bank. The Company had no outstanding borrowings against the line of credit at September 30, 2017 and December 31, 2016. Due to the revolving nature of loans under our credit facility, additional borrowings and periodic repayments and re-borrowings may be made until the maturity date. The total amount available for borrowings under our credit facility at September 30, 2017 was $11,200,000, based on the borrowing base calculation. Interest on borrowings on the credit line is at LIBOR plus 2.0% (3.2% at September 30, 2017). The credit agreement expires August 12, 2021 and is secured by assets of the Company. Our credit agreement contains financial covenants including a minimum liquidity balance of $10,000,000. Liquidity is calculated as the sum of unrestricted cash, marketable securities and the availability on the line of credit. The Company was in compliance with its financial covenants at September 30, 2017.

NOTE 9 – INCOME TAXES

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

At September 30, 2017 there was $44,000 of net uncertain tax benefit positions that would reduce the effective income tax rate if recognized. The Company records interest and penalties related to income taxes as income tax expense in the condensed consolidated statements of loss and comprehensive loss.

The Company is subject to U.S. federal income tax as well as income tax of multiple state and foreign jurisdictions. The tax years 2014-2016 remain open to examination by the Internal Revenue Service and the years 2012-2016 remain open to examination by various state tax departments. The tax years from 2013-2016 remain open in Costa Rica. In April 2016, we received notification from the Internal Revenue Service that they would be performing an examination of our 2012 and 2013 federal consolidated income tax returns. As of September 30, 2017, the examination was complete. The settlement and payment that resulted from the examination did not have a material effect on our results of operations.

The Company’s effective income tax rate was 0.7% for the first nine months of 2017. The effective tax rate differs from the federal tax rate of 35% due to state income taxes, foreign tax rate differences, foreign losses not deductible

for U.S. income tax purposes, provisions for interest charges for uncertain income tax positions, stock compensation shortfalls and changes in valuation allowances related to deferred tax assets. The foreign operating losses may ultimately be deductible in the countries in which they occurred; however the Company has not recorded a deferred tax asset for these losses due to uncertainty regarding the eventual realization of the benefit. The effect of the foreign operations was an overall rate decrease of approximately (14.0%) for the nine months ended September 30, 2017. There were no additional uncertain tax positions identified in the first nine months of 2017. The Company's effective income tax rate for the nine months ended September 30, 2016 was (4.0%), and differed from the federal tax rate due to state income taxes, foreign tax rate differences, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges for uncertain income tax positions, and changes in valuation allowances related to deferred tax assets.

NOTE 10 – SEGMENT INFORMATION

The Company classifies its businesses into the following four segments:

Suttle manufactures and markets connectivity infrastructure products for broadband and voice communications;

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

JDL Technologies provides technology solutions that address prevalent IT challenges, including virtualization and cloud solutions, managed services, wired and wireless network design and implementation, and converged infrastructure configuration and deployment; and

Net2Edge develops, manufactures and sells products that enable telecommunications carriers to connect legacy networks to high-speed services.

Management has chosen to organize the enterprise and disclose reportable segments based on our products and services. Intersegment revenues are eliminated upon consolidation.

Information concerning the Company's continuing operations in the various segments for the three and nine month periods ended September 30, 2017 and 2016 is as follows:

	Suttle	Transition Networks	JDL Technologies	Net2Edge	Other	Intersegment Eliminations	Total
Three Months Ended September 30, 2017							
Sales	$7,536,000	$9,327,000	$3,613,000	$182,000	$—	$(245,000)	$20,413,000
Cost of sales	8,967,000	5,342,000	2,730,000	122,000	—	(52,000)	17,109,000
Gross profit	(1,431,000)	3,985,000	883,000	60,000	—	(193,000)	3,304,000
Selling, general and administrative expenses	2,239,000	3,809,000	471,000	836,000	—	(193,000)	7,162,000
Impairment loss	—	—	—	—	—	—	—
Restructuring expense	796,000	—	—	—	—	—	796,000
Operating (loss) income	$(4,466,000)	$176,000	$412,000	$(776,000)	$—	$—	$(4,654,000)
Depreciation and amortization	$525,000	$158,000	$76,000	$9,000	$—	$—	$768,000
Capital expenditures	$52,000	$174,000	$—	$3,000	$23,000	$—	$252,000

Assets	$21,389,000	$12,593,000	$4,809,000	$1,258,000	$21,239,000	$(27,000)	$61,261,000

	Suttle	Transition Networks	JDL Technologies	Net2Edge	Other	Intersegment Eliminations	Total
Three Months Ended September 30, 2016							
Sales	$10,420,000	$11,789,000	$3,397,000	$275,000	$—	$(264,000)	$25,617,000
Cost of sales	10,080,000	6,350,000	2,384,000	128,000	—	(16,000)	18,926,000
Gross profit	340,000	5,439,000	1,013,000	147,000	—	(248,000)	6,691,000
Selling, general and administrative expenses	2,891,000	3,824,000	563,000	836,000	—	(248,000)	7,866,000
Operating (loss) income	$(2,551,000)	$1,615,000	$450,000	$(689,000)	$—	$—	$(1,175,000)
Depreciation and amortization	$627,000	$205,000	$65,000	$23,000	$—	$—	$920,000
Capital expenditures	$593,000	$26,000	$44,000	$16,000	$(4,000)	$—	$675,000
Assets	$36,830,000	$17,758,000	$3,729,000	$1,488,000	$16,692,000	$(26,000)	$76,471,000

	Suttle	Transition Networks	JDL Technologies	Net2Edge	Other	Intersegment Eliminations	Total
Nine Months Ended September 30, 2017							
Sales	$24,888,000	$27,831,000	$10,504,000	$719,000	$—	$(661,000)	$63,281,000
Cost of sales	24,447,000	15,667,000	7,699,000	262,000	—	(74,000)	48,001,000
Gross profit	441,000	12,164,000	2,805,000	457,000	—	(587,000)	15,280,000
Selling, general and administrative expenses	6,775,000	11,481,000	1,604,000	2,244,000	—	(587,000)	21,517,000
Impairment loss	—	—	1,463,000	154,000	—	—	1,617,000
Restructuring expense	2,326,000	—	—	—	—	—	2,326,000
Operating (loss) income	$(8,660,000)	$683,000	$(262,000)	$(1,941,000)	$—	$—	$(10,180,000)
Depreciation and amortization	$1,695,000	$518,000	$230,000	$47,000	$—	$—	$2,490,000
Capital expenditures	$100,000	$199,000	$5,000	$63,000	$23,000	$—	$390,000

	Suttle	Transition Networks	JDL Technologies	Net2Edge	Other	Intersegment Eliminations	Total
Nine Months Ended September 30, 2016							
Sales	$33,424,000	$30,294,000	$12,360,000	$1,434,000	$—	$(918,000)	$76,594,000
Cost of sales	29,939,000	17,270,000	8,025,000	682,000	—	(157,000)	55,759,000
Gross profit	3,485,000	13,024,000	4,335,000	752,000	—	(761,000)	20,835,000
Selling, general and administrative expenses	10,038,000	13,224,000	2,531,000	2,499,000	—	(742,000)	27,550,000
Pension liability adjustment gains	—	—	—	—	(4,148,000)	—	(4,148,000)
Operating (loss) income	$(6,553,000)	$(200,000)	$1,804,000	$(1,747,000)	$4,148,000	$(19,000)	$(2,567,000)

Depreciation and amortization	$1,819,000	$658,000	$189,000	$88,000	$—	$—	$2,754,000
Capital expenditures	$1,414,000	$185,000	$128,000	$18,000	$220,000	$(19,000)	$1,946,000

NOTE 11 – PENSIONS

The Company's U.K. based subsidiary Austin Taylor maintained a defined benefit pension plan for its employees through March 31, 2016. The Company does not provide any other post-retirement benefits to its employees. Components of net periodic benefit of the pension plans for the three and nine months ended September 30, 2017 and 2016 were:

	Three Months Ended September 30		**Nine Months Ended September 30**	
	2017	**2016**	**2017**	**2016**
Service cost	$ —	$ —	$—	$—
Interest cost	—	—	—	26,000
Expected return on assets	—	—	—	(24,000)
Settlement benefit	—	—	—	(43,000)
Net periodic pension benefit	$ —	$ —	$—	$(41,000)

The Company settled all its obligations under this pension plan in the first quarter of 2016. The Company had contributed $650,000 toward the settlement of the pension into annuities in 2015, which resulted in the recognition of $1,222,000 of pension settlement costs in the income statement in the fourth quarter of 2015. The Company contributed an additional $68,000 toward the settlement in the first quarter of 2016, which resulted in a benefit of $43,000 recorded within operating expenses. As a result of the final settlement of all of its pension obligations, in the first quarter of 2016, the Company recorded $4,148,000 in pension liability adjustment gains previously recorded in accumulated other comprehensive income within operating expenses in the consolidated statement of income.

NOTE 12 – NET LOSS PER SHARE

Basic net income per common share is based on the weighted average number of common shares outstanding during each year. Diluted net income per common share takes into effect the dilutive effect of potential common shares outstanding. The Company's only potential common shares outstanding are stock options and shares associated with the long-term incentive compensation plans, which resulted in no dilutive effect for the three and nine month periods ended September 30, 2017 and 2016. The Company calculates the dilutive effect of outstanding options using the treasury stock method. Due to the net losses in the first three and nine months of 2017 and 2016, there was no dilutive impact from stock options or unvested shares. Options totaling 1,145,417 were excluded from the calculation of diluted earnings per share for the three months and nine ended September 30, 2017 because the exercise price was greater than the average market price of common stock during the period and deferred stock awards totaling 181,224 shares would not have been included for the three and nine months ended September 30, 2017 because of unmet performance conditions. Options totaling 964,563 and 846,584 were excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2016 because the exercise price was greater than the average market price of common stock during the period and deferred stock awards totaling 159,689 shares would not have been included for the three and nine months ended September 30, 2016 because of unmet performance conditions.

NOTE 13 – FAIR VALUE MEASUREMENTS

The accounting guidance establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

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

Level 2 – Observable inputs such as quoted prices for similar instruments and quoted prices in markets that are not active, and inputs that are directly observable or can be corroborated by observable market data. The types of assets and liabilities included in Level 2 are typically either comparable to actively traded securities or contracts, such as treasury securities with pricing interpolated from recent trades of similar securities, or priced with models using highly observable inputs, such as commodity options priced using observable forward prices and volatilities.

Level 3 – Significant inputs to pricing that have little or no observability as of the reporting date. The types of assets and liabilities included in Level 3 are those with inputs requiring significant management judgment or estimation, such as the complex and subjective models and forecasts used to determine the fair value of financial instruments.

As discussed in Note 5, we tested our goodwill for impairment as of April 1, 2017. As part of this impairment testing, the Company determined the fair value of the net assets of the JDL Technologies reporting unit, based primarily on discounted cash flows and forecasted future operating results, which represent Level 3 inputs. As a result of our analysis, the Company recorded a non-cash impairment charge of $1,463,000 to fully impair goodwill. A reconciliation of the beginning and ending balances of goodwill are included in Note 5.

Financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2017 and December 31, 2016, are summarized below:

September 30, 2017

	Level 1	Level 2	Level 3	Total Fair Value
Cash equivalents:				
Money Market funds	$8,986,000	$—	$ —	$8,986,000
Subtotal	8,986,000	—	—	8,986,000
Short-term investments:				
Certificates of deposit	—	725,000	—	725,000
Subtotal	—	725,000	—	725,000
Total	$8,986,000	$725,000	$ —	$9,711,000

December 31, 2016

	Level 1	Level 2	Level 3	Total Fair Value
Cash equivalents:				
Money Market funds	$3,851,000	$—	$ —	$3,851,000
Subtotal	3,851,000	—	—	3,851,000
Short-term investments:				
Certificates of deposit	—	4,294,000	—	4,294,000
Corporate Notes/Bonds	—	1,511,000	—	1,511,000
Subtotal	—	5,805,000	—	5,805,000
Total	$3,851,000	$5,805,000	$ —	$9,656,000

We record transfers between levels of the fair value hierarchy, if necessary, at the end of the reporting period. There were no transfers between levels during the nine months ended September 30, 2017.

19

NOTE 14 – RESTRUCTURING

During the nine months ended September 30, 2017, the Company recorded $2,326,000 in restructuring expense. This consisted of severance and related benefits costs due to the restructuring within the Suttle business segment, including ongoing costs related to the closure of the Costa Rica facility. We transferred substantially all of the production from Costa Rica to Minnesota by the end of the second quarter of 2017 completed the closure in the third quarter of 2017. In the third quarter of 2017, we identified $505,000 of equipment, net of accumulated depreciation, that we determined we would no longer use as a result of consolidating our operations in the Minnesota location. We were not able to make this determination until we observed and assessed the condition of the equipment once it arrived in Minnesota. We included the loss on the disposal of this equipment has been included in restructuring expense on the consolidated statement of loss and comprehensive loss. The Company paid $1,821,000 in restructuring charges during the first nine months of 2017 and had $0 in restructuring accruals recorded in accrued compensation and benefits at September 30, 2017. We do not expect any material restructuring costs in the fourth quarter of 2017.

NOTE 15 – RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board (FASB) issued a new accounting standard update on revenue recognition from contracts with customers. The new guidance will replace all current U.S. GAAP guidance on this topic and eliminate all industry-specific guidance. According to the new guidance, revenue is recognized when promised goods or services are transferred to customers in an amount that reflects the consideration the Company expects to receive in exchange for those goods or services. As a result of the FASB's July 2015 deferral of the standard's required implementation date, the guidance is effective for interim and annual reporting periods beginning after December 15, 2017. The Company will adopt the accounting standard using the modified retrospective transition approach. The modified retrospective transition approach will recognize any changes from the beginning of the year of initial application through retained earnings with no restatement of comparative periods.

We have established an implementation team and engaged a third-party consultant to assist with our assessment of the impact of the new revenue guidance on our operations, consolidated financial statements and related disclosures. To date, this assessment has included (1) utilizing questionnaires to identify our revenue streams, (2) performing detailed contract analyses for each material revenue stream identified, and (3) assessing the noted differences in recognition and measurement that may result from adopting this new standard. Based on the preliminary results of the evaluation, which we expect to complete during the fourth quarter of 2017, we believe the most significant potential changes relate to variable consideration, the timing of recognition for certain promises included within service contracts, and net recognition of third-party maintenance and support services, although our technical analysis of these potential impacts is still on-going. We also anticipate changes to the consolidated balance sheet related to accounts receivable, contract assets, and contract liabilities.

We expect to adopt certain practical expedients and make certain policy elections related to the accounting for significant finance components, sales taxes, shipping and handling, right to invoice, costs to obtain a contract and immaterial promised goods or services, which will mitigate certain impacts of adopting this new standard. We are also currently reviewing the tax impact, if any, that the new standard will have on our financial statements. We are in the process of evaluating and designing the necessary changes to our business processes, policies, systems and controls to support recognition and disclosure under the new standard. Further, we are continuing to assess what incremental disaggregated revenue disclosures will be required in our consolidated financial statements.

In July 2015, the FASB issued an accounting standard on inventory, which simplifies the subsequent measurement of inventory by requiring entities to measure inventory at the lower of cost or net realizable value, except for inventory measured using the last-in, first-out (LIFO) or the retail inventory methods. This standard requires entities to compare the cost of inventory to one measure – net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The standard is effective for the annual period beginning after December 15, 2016 and interim periods within those annual periods, with early adoption permitted, and is to be applied prospectively. The Company adopted this standard in the first quarter of 2017 with no material impact on its consolidated financial statements.

In November 2015, the FASB issued an accounting standard on deferred taxes, which removes the requirement to present deferred tax assets and liabilities as current and noncurrent on the balance sheet based on the classification of the related asset or liability, and instead requires classification of all deferred tax assets and liabilities as noncurrent. This guidance will be effective for interim and annual reporting periods beginning after December 15, 2016, and early adoption is permitted. The Company adopted this guidance in the first quarter of 2017 and other than the prescribed classification of all deferred tax assets and liabilities as noncurrent, there was no material impact on its consolidated financial statements.

In February 2016, the FASB issued new accounting requirements regarding accounting for leases, which requires an entity to recognize both assets and liabilities arising from financing and operating leases, along with additional qualitative and quantitative disclosures. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within that reporting period, and early adoption is permitted. We have not yet determined the potential effects on our financial condition or results of operations.

In March 2016, the FASB issued a new accounting standard that changed certain aspects of accounting for share-based payments to employees, including the accounting for income taxes, forfeitures and statutory withholding requirements, as well as classification in the statement of cash flows. The new standard is effective for annual and interim periods beginning after December 15, 2016. The Company adopted this standard during the first quarter of 2017 with no material impact on our financial condition or results of operations.

In August 2016, the FASB issued new accounting guidance regarding the classification of cash receipts and payments in the Statement of Cash Flows. This guidance is intended to reduce diversity in practice in how certain cash receipts and cash payments are presented and classified in the Consolidated Statement of Cash Flows by providing guidance on eight specific cash flow issues. The new standard is effective retrospectively on January 1, 2018, with early adoption permitted. We are still evaluating the impact of this standard, but do not believe it will have a material impact on our Consolidated Statement of Cash Flows.

In January 2017, the FASB issued new accounting guidance regarding the simplification of the test for goodwill impairment. The new standard eliminates the quantitative goodwill impairment analysis requirement to determine the fair value of individual assets and liabilities of a reporting unit to determine the amount of any goodwill impairment and instead permits an entity to recognize goodwill impairment loss as the excess of a reporting unit's carrying value over the estimated fair value of the reporting unit, to the extent this amount does not exceed the carrying amount of goodwill. The new guidance continues to allow an entity to perform a qualitative assessment over goodwill impairment indicators in lieu of a quantitative assessment in certain situations. The standard will be effective for annual and interim periods beginning January 1, 2020, with early adoption permitted. The Company adopted this standard during 2017. As noted above in Note 5, the Company analyzed the reporting unit that had the goodwill and also analyzed the Company as a whole, including the Company's four separate reporting units. Based on this analysis of comparing the fair value of each reporting unit to the book value and comparing the Company's overall book value with its market capitalization, the Company determined that the book value exceeds the overall fair value of the reporting units as well as the Company's overall market value. As a result, the Company recorded a goodwill impairment charge totaling $1,463,000 during the second quarter of 2017.

NOTE 16 – SUBSEQUENT EVENTS

The Company has evaluated subsequent events through the date of this filing. We do not believe there are any material subsequent events that would require further disclosure.

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

Overview

Communications Systems, Inc. provides physical connectivity infrastructure and services for global deployments of broadband networks through the following business units:

Suttle manufactures and markets connectivity infrastructure products for broadband and voice communications;

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

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

Net2Edge enables telecommunications carriers to connect legacy networks to high-speed services.

Third Quarter 2017 Summary

Consolidated sales of $20.4 million compared to $25.6 million in Q3 2016, resulting primarily from lower sales at Suttle.

The Company incurred an operating loss of $4.7 million compared to an operating loss of $1.2 million in the third quarter of 2016. The 2017 operating loss was primarily due to a $4.5 million operating loss at Suttle. The Suttle loss included $0.8 million of restructuring costs associated with the final closure of its Costa Rica facility as it moved these operations to Minnesota, $0.4 million write-off of prepaid royalties under a product development agreement, and $2.6 million in excess and obsolete inventory write offs and adjustments primarily related to Suttle's legacy products. In the third quarter of 2016, the Company had no restructuring costs and Suttle's excess and obsolete inventory adjustment was $353,000.

Net loss was $4.5 million, or ($0.50) per diluted share, compared to a net loss of $1.3 million, or ($0.14) per diluted share, in Q3 2016.

Forward-looking statements

In this report and, from time to time, in reports filed with the Securities and Exchange Commission ("SEC"), in press releases, and in other communications to shareholders or the investing public, the Company may make "forward looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 concerning possible or anticipated future financial performance, business activities, plans, pending claims, investigations or litigation, which are typically preceded by the words "believes," "expects," "anticipates," "intends" or similar expressions. For these forward-looking statements, the Company claims the protection of the safe harbor for forward-looking statements contained in federal securities laws. Shareholders and the investing public should understand that these forward-looking statements are subject to risks and uncertainties that could cause actual performance, activities, anticipated results, outcomes or plans to differ significantly from those indicated in the forward-looking statements. These risks and uncertainties include, but are not limited to:

General Risks and Uncertainties:

The ability of the Company's four operating units to each function in an efficient and cost-effective manner, under the oversight of the CSI parent;

The ability of our four business units to operate profitably; and

The impact of changing government expenditures in our markets.

Suttle Risks and Uncertainties:

Suttle's dependence upon its sales to a small number of major communication service providers and their continued investment and deployment into building out their networks;

Volatility in purchases of Suttle's products by major communication service providers as well as continuing pressure on our margins;

Suttle's ability to continue to introduce and sell new enterprise copper and fiber products, such as the MediaMax and FutureLink product lines, to replace declining sales and lower or fluctuating gross margins in its legacy products; and

Suttle's ability to effectively and efficiently consolidate manufacturing operations from its Costa Rica facility into its Hector, Minnesota facility.

Transition Networks Risks and Uncertainties:

The ability of Transition Networks to develop and sell new products for new and existing markets at a level adequate to counter the decline in sales of its traditional products;

Transition Networks' ability to profitably sell its products in international markets; and

Transition Networks' reliance on contract manufacturers and OEMs to supply it with components and products in a timely manner as Transition Networks develops and introduces new products.

JDL Technologies Risks and Uncertainties:

JDL's ability to continue to obtain business from its traditional South Florida school district customer;

JDL's ability to profitably increase its business serving small and medium-sized commercial businesses; and

JDL's ability to establish and maintain a productive and efficient workforce given revenues that have historically fluctuated significantly from period to period, in part due to the uncertainty and timing of federal government funding of school initiatives, including the E-Rate program.

Net2Edge's Risks and Uncertainties:

Net2Edge's ability to develop, field test and sell new products in sufficient quantities to achieve profitability.

The Company discusses these and other risk factors from time to time in its filings with the SEC, including risk factors presented under Item 1A of the Company's most recently filed Annual Report on Form 10-K and Quarterly Reports on Form 10-Q.

Company Results

Three Months Ended September 30, 2017 Compared to
Three Months Ended September 30, 2016

Consolidated sales declined 20% in the third quarter of 2017 to $20,413,000 compared to $25,617,000 in the same period of 2016. Consolidated operating loss in the third quarter of 2017 was $4,654,000 compared to an operating loss of $1,175,000 in the third quarter of 2016. The Company incurred $796,000 in restructuring expense in the third quarter of 2017 related to the closure of its Costa Rica facility in 2017. Net loss in the third quarter of 2017 was $4,522,000 or $ (0.50) per share compared to net loss of $1,264,000 or $ (0.14) per share in the third quarter of 2016.

Suttle Results

Suttle sales decreased 28% in the third quarter of 2017 to $7,536,000 compared to $10,420,000 in the same period of 2016 due to continuing pricing pressures from major telecommunications customers, volume declines in legacy products, and a continuing shift in purchasing decisions from Tier 1 telecom suppliers to contractors and installers.

Sales by customer groups in the third quarters of 2017 and 2016 were:

Suttle Sales by Customer Group	
2017	**2016**

Communication service providers	$6,912,000	$9,441,000
International	173,000	368,000
Distributors	451,000	611,000
	$7,536,000	$10,420,000

Suttle's sales by product groups in third quarter of 2017 and 2016 were:

	Suttle Sales by Product Group	
	2017	**2016**
Structured cabling and connecting system products	$7,230,000	$9,649,000
DSL and other products	306,000	771,000
	$7,536,000	$10,420,000

Sales to the major communication service providers decreased 27% in 2017 due to continuing pricing pressures and volume declines in legacy products. Sales to major communication service providers accounted for 92% of Suttle's sales in the third quarter of 2017 compared to 91% of sales in 2016. Sales to distributors decreased 26% in 2017 due to the continued decline in DSL products and the impact from the discontinuation of certain legacy products, and accounted for 6% and 6% of sales in the third quarters of 2017 and 2016, respectively. International sales decreased 53% in 2017 and accounted for 2% of Suttle's third quarter 2017 sales.

Sales of structured cabling and connecting system products decreased 25% due to volume declines as a result of project delays from major telecommunications customers.

Suttle's gross margin decreased 521% in the third quarter of 2017 to $ (1,431,000) compared to $340,000 in the same period of 2016. Gross margin as a percentage of sales decreased to -19.0% from 3.3% in the same period of 2016 due to the $417,000 write off of prepaid royalties under a product development agreement and excess and obsolete inventory adjustments. The margin impact of excess and obsolete inventory adjustments was $2,637,000 in the third quarter of 2017 (35.1% of sales) compared to $353,000 (3.4% of sales) in the same period of last year. Selling, general and administrative expenses decreased 23% to $2,239,000, or 29.7% of sales, in the third quarter of 2017 compared to $2,891,000, or 27.7% of sales, in the same period in 2016 due to reduced research and development expenditures and ongoing expense control measures. Suttle incurred $112,000 and $592,000 in research and development expenses in the respective 2017 and 2016 third quarters. Suttle incurred $796,000 in restructuring expense in the third quarter of 2017 related to the closure of its Costa Rica facility in 2017.

Suttle incurred an operating loss of $4,466,000 in the third quarter of 2017 compared to an operating loss of $2,551,000 in 2016.

Transition Networks Results

Transition Networks sales decreased 21% to $9,327,000 in the third quarter of 2017 compared to $11,789,000 in 2016. Transition Networks organizes its sales force by vertical markets and segments its customers geographically. Third quarter sales by region are presented in the following table:

	Transition Networks Sales by Region	
	2017	**2016**
North America	$7,404,000	$9,469,000
Rest of World	1,301,000	1,512,000
Europe, Middle East, Africa ("EMEA")	622,000	808,000
	$9,327,000	$11,789,000

The following table summarizes Transition Networks' 2017 and 2016 third quarter sales by its major product groups:

	Transition Networks Sales by Product Group	
	2017	**2016**
Media converters	$4,950,000	$6,703,000
Ethernet switches and adapters	2,263,000	3,045,000
Other products	2,114,000	2,041,000
	$9,327,000	$11,789,000

Sales in North America decreased $2,065,000, or 22%, due to a delay in federal government spending and disruptions in our supply chain. International sales decreased $397,000, or 17%, primarily due to generally slow global markets. Media converter sales decreased 26% or $1,753,000 due to delays in the federal sector and product availability. Sales of ethernet switches and adapters decreased 26% or $782,000 due to federal government spending delays. All other product sales increased 4% or $73,000 due to strong accessory sales.

Gross margin on third quarter sales decreased to $3,985,000 in 2017 as compared to $5,439,000 in 2016. Gross margin as a percentage of sales decreased to 42.7% in 2017 from 46.1% in 2016. The margin impact of excess and obsolete inventory adjustments was $344,000 in third quarter 2017 (3.7% of sales) compared to $88,000 (0.7% of sales) the same period last year. Selling, general and administrative expenses remained fairly flat at $3,809,000, or 40.8% of sales, in 2017 compared to $3,824,000, or 32.4% of sales, in 2016.

Transition Networks had operating income of $176,000 in 2017 compared to income of $1,615,000 in 2016, with the decrease primarily due to lower sales and gross margins.

JDL Technologies Results

JDL Technologies sales increased 6% to $3,613,000 compared to $3,397,000 in 2016.

JDL’s revenues by customer group were as follows:

	JDL Revenue by Customer Group	
	2017	**2016**
Education	$2,870,000	$2,383,000
Healthcare and commercial clients	743,000	1,014,000
	$3,613,000	$3,397,000

Revenues from the education sector increased $487,000 or 20% in the third quarter of 2017 as compared to the 2016 third quarter due to the addition un-forecasted projects by our primary education customer. Revenue from sales to small and medium-sized commercial businesses (“SMBs”), which are primarily healthcare and commercial clients, decreased $271,000, or 27% due to a decrease in the number of infrastructure and professional services projects completed in the third quarter, due, in part, to JDL’s continued focus on building managed services revenue rather than incident-based or project-based opportunities, and fewer bids for, and therefore, contracts for infrastructure refresh

projects.

Gross margin decreased 13% to $883,000 in the third quarter of 2017 compared to $1,013,000 in the same period in 2016. Gross margin as a percentage of sales decreased to 24.4% in 2017 compared to 29.8% in 2016 due to a change in revenue mix. Selling, general and administrative expenses decreased 16% in 2017 to $471,000, or 13.0% of sales, compared to $563,000, or 16.6% of sales, in 2016 due to cost saving measures taken over the past year.

JDL Technologies reported operating income of $412,000 in the third quarter of 2017 compared to income of $450,000 in the same period of 2016.

Net2Edge Results

Net2Edge's sales decreased 34% to $182,000 in the third quarter of 2017 compared to $275,000 in 2016 due to delays in the release of new products. Gross margin decreased 59% to $60,000 in the third quarter of 2017 compared to $147,000 in the same period of 2016. Gross margin as a percentage of sales decreased to 33.0% in 2017 from 53.5% in 2016 due to an increase in the excess and obsolete inventory reserve during the quarter. Selling, general and administrative expenses remained flat year over year. Net2Edge reported an operating loss of $776,000 in the third quarter of 2017 compared to an operating loss of $689,000 in the same period of 2016.

Income Taxes

The Company's loss before income taxes decreased to $4,631,000 in 2017 compared to $1,260,000 in 2016. The Company's effective income tax rate was 2.4% in 2017 and (0.3%) in 2016.

Nine Months Ended September 30, 2017 Compared to
Nine Months Ended September 30, 2016

Consolidated sales decreased 17% in 2017 to $63,281,000 compared to $76,594,000 in 2016. Consolidated operating loss in 2017 was $10,180,000 compared to a loss of $2,567,000 in the first nine months of 2016, which included $4,148,000 in pension liability adjustment gains recognized in operating income in the first quarter of 2016 from the settlement of the pension plan. The Company incurred $2,326,000 in restructuring expense in the first nine months of 2017 related to the closure of its Costa Rica facility in 2017 and $1,617,000 in asset impairment losses related to goodwill at JDL and intangible assets at Net2Edge. Net loss in 2017 was $10,128,000 or $ (1.13) per share compared to net loss of $6,275,000 or $ (0.71) per share in the first nine months of 2016.

Suttle Results

Suttle sales decreased 26% in the first nine months of 2017 to $24,888,000 compared to $33,424,000 in the same period of 2016 due to continuing pricing pressures from major telecommunications customers, volume declines in legacy products, and a shift in purchasing decisions from Tier 1 telecom suppliers to installers. Sales by customer groups in the first nine months of 2017 and 2016 were:

	Suttle Sales by Customer Group	
	2017	2016
Communication service providers	$22,468,000	$30,252,000
International	545,000	1,147,000
Distributors	1,875,000	2,025,000
	$24,888,000	$33,424,000

Suttle's sales by product groups in first nine months of 2017 and 2016 were:

	Suttle Sales by Product Group	
	2017	2016
Structured cabling and connecting system products	$22,798,000	$30,332,000
DSL and other products	2,090,000	3,092,000
	$24,888,000	$33,424,000

Sales to the major communication service providers decreased 26% in 2017 due to continuing pricing pressures and volume declines in legacy products. Sales to major communication service providers accounted for 90% of Suttle's sales in the first nine months of 2017 compared to 91% of sales in 2016. Sales to distributors decreased 7% in 2017 due to the continued decline in DSL product sales and the impact from the discontinuation of certain legacy products, and accounted for 8% and 6% of sales in the first nine months of 2017 and 2016, respectively. International sales decreased 52% in 2017 and accounted for 2% of Suttle's first nine month 2017 sales, due to reduced volume from legacy products in major telecommunications customers.

Sales of structured cabling and connecting system products decreased 25% due to volume declines as a result of project delays from major telecommunications customers.

Suttle's gross margin decreased 87% in the first nine months of 2017 to $441,000 compared to $3,485,000 in the same period of 2016. Gross margin as a percentage of sales decreased to 1.8% from 10.4% in the same period in 2016 primarily due to due to the $417,000 write off of prepaid royalties under a product development agreement and increases to the inventory reserves, driven by Suttle's decision to discontinue certain legacy products. The margin impact of excess and obsolete inventory adjustments was $3,752,000 in the first nine months of 2017 (15.1% of sales) compared to $589,000 (1.8% of sales) the same period last year. Selling, general and administrative expenses decreased 33% to $6,775,000, or 27.2% of sales, in the first nine months of 2017 compared to $10,038,000, or 30.0% of sales, in the same period in 2016 due to reduced research and development expenditures and ongoing expense control measures. Suttle incurred $495,000 and $2,137,000 in research and development expenses in the respective 2017 and 2016 first nine months. Suttle incurred $2,326,000 in restructuring expense in the first nine months of 2017 related to the planned closure of its Costa Rica facility in 2017.

Suttle incurred an operating loss of $8,660,000 in the first nine months of 2017 compared to an operating loss of $6,553,000 in 2016.

Transition Networks Results

Transition Networks sales decreased 8% to $27,831,000 in the first nine months of 2017 compared to $30,294,000 in 2016. Transition Networks organizes its sales force by vertical markets and segments its customers geographically. First nine month sales by region are presented in the following table:

Transition Networks Sales by Region		
2017	**2016**	

North America	$22,560,000	$24,296,000
Rest of World	3,751,000	3,888,000
Europe, Middle East, Africa (“EMEA”)	1,520,000	2,110,000
	$27,831,000	$30,294,000

The following table summarizes Transition Networks' 2017 and 2016 first nine months sales by its major product groups:

	Transition Networks Sales by Product Group	
	2017	**2016**
Media converters	$16,004,000	$18,817,000
Ethernet switches and adapters	5,750,000	6,083,000
Other products	6,077,000	5,394,000
	$27,831,000	$30,294,000

Sales in North America decreased $1,736,000, or 7%, due to delays in federal projects and disruptions in our supply chain. International sales decreased $727,000, or 12%, due to continued weakness in the EMEA region and project timing. Media converter sales decreased 15% or $2,813,000 due to delays in federal spending. Sales of ethernet switches and adapters decreased 5% or $333,000 due to delays in federal projects. All other products increased 13% or $683,000 due to strong accessory sales.

Gross margin on first nine month sales decreased 7% to $12,164,000 in 2017 as compared to $13,024,000 in 2016. Gross margin as a percentage of sales increased to 43.7% in 2017 from 43.0% in 2016 due to favorable product mix and efficiencies in manufacturing operations. Selling, general and administrative expenses decreased 13% to $11,481,000, or 41.3% of sales, in 2017 compared to $13,224,000, or 43.7% of sales, in 2016 due to actions taken in 2016 to reduce selling and administrative expenses.

Transition Networks had operating income of $683,000 in 2017 compared to an operating loss of $200,000 in 2016.

JDL Technologies Results

JDL Technologies sales decreased 15% to $10,504,000 in the first nine months of 2017 compared to $12,360,000 in 2016.

JDL's revenues by customer group were as follows:

	JDL Revenue by Customer Group	
	2017	**2016**
Education	$8,085,000	$9,154,000
Healthcare and commercial clients	2,419,000	3,206,000
	$10,504,000	$12,360,000

Revenues from the education sector decreased $1,069,000 or 12% in the first nine months of 2017 as compared to the 2016 first nine months due to the timing of the current network refresh cycle. Revenue from sales to small and medium-sized commercial businesses (SMBs), which are primarily healthcare and commercial clients, decreased $787,000, or 25% due to a decrease in the number of infrastructure and professional services projects completed in the first nine months, due, in part, to JDL's continued focus on building managed services revenue rather than incident-based or project-based opportunities, and fewer bids for, and therefore, contracts for infrastructure refresh projects.

Gross margin decreased 35% to $2,805,000 in the first nine months of 2017 compared to $4,335,000 in the same period in 2016. Gross margin as a percentage of sales decreased to 26.7% in 2017 compared to 35.1% in 2016 due to a lower margin project in our education sector during the second quarter of 2017. Selling, general and administrative expenses decreased 37% in 2017 to $1,604,000, or 15.3% of sales, compared to $2,531,000, or 20.5% of sales, in 2016 due to cost saving measures taken over the past year.

JDL Technologies reported an operating loss of $262,000 in the first nine months of 2017 compared to operating income of $1,804,000 in the same period of 2016, due to a $1,463,000 goodwill impairment loss recognized in the second quarter of 2017.

Net2Edge Results

Net2Edge's sales decreased 50% to $719,000 in the first nine months of 2017 compared to $1,434,000 in 2016 due to a large legacy customer project in the second quarter of 2016. Gross margin decreased 39% to $457,000 in the first nine months of 2017 compared to $752,000 in the same period of 2016. Gross margin as a percentage of sales increased to 63.6% in 2017 from 52.4% in 2016 due to lower margins realized on the large customer project in 2016. Selling, general and administrative expenses decreased 10% in 2017 to $2,244,000 compared to $2,499,000 in 2016 due primarily to the decrease in the exchange rate. Net2Edge reported an operating loss of $1,941,000 in the first nine months of 2017 compared to a loss of $1,747,000 in the same period of 2016, due to a $154,000 impairment loss related to intangible assets during the second quarter of 2017.

Income Taxes

The Company's loss before income taxes increased to $10,195,000 in 2017 compared to $6,032,000 in 2016. The Company's effective income tax rate was 0.7% in 2017 and (4.0%) in 2016. This effective tax rate for 2017 differs from the federal tax rate of 35% due to state income taxes, foreign tax rate differences, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges for uncertain income tax positions, stock compensation shortfalls and changes in valuation allowances related to deferred tax assets.

Liquidity and Capital Resources

As of September 30, 2017, the Company had approximately $17,792,000 in cash, cash equivalents and investments. Of this amount, $8,986,000 was invested in short-term money market funds that are not considered to be bank deposits and are not insured or guaranteed by the FDIC or other government agency. These money market funds seek to preserve the value of the investment at $1.00 per share; however, it is possible to lose money investing in these funds. The remainder in cash and cash equivalents is operating cash and certificates of deposit that are insured through the FDIC. The Company also had $725,000 in investments consisting of certificates of deposit that are traded on the open market and are classified as available-for-sale at September 30, 2017.

The Company had working capital of $38,157,000 at September 30, 2017, consisting of current assets of approximately $48,277,000 and current liabilities of $10,120,000 compared to working capital of $44,005,000 at December 31, 2016 consisting of current assets of $55,373,000 and current liabilities of $11,368,000.

Cash flow provided by operating activities was approximately $2,728,000 in 2017 compared to $2,942,000 used in the same period of 2016. Significant working capital changes from December 31, 2016 to September 30, 2017 included a decrease in inventory of $7,232,000, offset by a decrease in accounts payable of $1,648,000. Additionally, the Company had a $1,617,000 non-cash impairment charge.

Net cash provided by investing activities was $4,908,000 in 2017 and $1,097,000 in 2016, due to proceeds from the sale of investments.

Net cash used in financing activities was $1,023,000 in 2017 compared to $4,644,000 used in financing activities in 2016. Cash dividends paid on common stock decreased to $1,097,000 in 2017 ($0.12 per common share) from $4,269,000 in 2016 ($0.36 per common share). Proceeds from common stock issuances, principally shares sold to the Company's Employee Stock Ownership Plan and issued under the Company's Employee Stock Purchase Plan, totaled approximately $82,000 in 2017 and $118,000 in 2016. The Company did not repurchase any shares in 2017 or 2016 under the Board-authorized program. At September 30, 2017, Board of Director authority to purchase approximately 411,910 additional shares remained in effect. The Company acquired $8,000 and $26,000 in 2017 and 2016, respectively, of Company stock from employees to satisfy withholding tax obligations related to share-based compensation, pursuant to terms of Board and shareholder-approved compensation plans.

The Company has a $15,000,000 line of credit from Wells Fargo Bank. Interest on borrowings on the credit line is at LIBOR plus 2.0% (3.2% at September 30, 2017). The Company had no outstanding borrowings against the line of credit at September 30, 2017. The credit agreement expires August 12, 2021 and is secured by assets of the Company.

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

Critical Accounting Policies

Our critical accounting policies, including the assumptions and judgments underlying them, are discussed in our 2016 Form 10-K in Note 1 Summary of Significant Accounting Policies included in our Consolidated Financial Statements. There were no significant changes to our critical accounting policies during the nine months ended September 30, 2017.

The Company's accounting policies have been consistently applied in all material respects and disclose matters such as allowance for doubtful accounts, sales returns, inventory valuation, warranty expense, income taxes, revenue recognition, asset impairment recognition and foreign currency translation. On an ongoing basis, we evaluate our estimates based on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the result of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Results may differ from these estimates due to actual outcomes being different from those on which we based our assumptions. Management reviews these estimates and judgments on an ongoing basis.

Recently Issued Accounting Pronouncements

Recently issued accounting standards and their estimated effect on the Company's condensed consolidated financial statements are also described in Note 15, Recent Accounting Pronouncements, to the Condensed Consolidated Financial Statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

The Company has no freestanding or embedded derivatives. The Company's policy is to not use freestanding derivatives and to not enter into contracts with terms that cannot be designated as normal purchases or sales.

The vast majority of our transactions are denominated in U.S. dollars; as such, fluctuations in foreign currency exchange rates have historically not been material to the Company. At September 30, 2017 our bank line of credit carried a variable interest rate based on LIBOR plus 2.0%. As noted above, we had no outstanding borrowings at September 30, 2017.

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

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) that are designed 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 SEC 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.

Management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of the disclosure controls and procedures, as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as of the end of the period covered by this report. Based on that evaluation, as detailed below, management concluded that the Company's disclosure controls and procedures are effective.

(b) Changes in Internal Controls

There have been no changes in internal control over financial reporting that occurred during the third quarter of 2017 that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting, except for the successful implementation of the remediation plan in this section. As disclosed in our Annual Report on Form 10-K for the year ended December 31, 2016, we concluded that our internal control over financial reporting was not effective. As detailed below, management concluded that the Company' internal control over financial reporting was effective at September 30, 2017.

Financial Management/Enterprise Resource Planning Systems.

Based on management's testing and evaluation, we identified a material weakness in our internal controls at December 31, 2016 surrounding segregation of duty conflicts in our financial management/enterprise resource planning ("ERP") systems. We did not design and maintain processes (i) to restrict access to appropriate users or (ii) to evaluate whether appropriate segregation of duties was maintained throughout the year. Several individuals had access to programs and data, or had approval authority, beyond what they needed to perform their individual job responsibilities, and the Company did not maintain adequate independent monitoring of these individuals. In addition, we did not track or verify changes made to our vendor master file data were appropriate. These failures would have allowed individual users to override other internal controls by setting up a vendor and approving payments to that vendor.

We have performed incremental procedures and concluded that the segregation of duty conflicts did not result in misstatements within the Company's consolidated financial statements. We concluded, however, that there was a reasonable possibility that a material misstatement in the Company's consolidated financial statements may not have been prevented or detected on a timely basis.

In order to remediate the material weakness related to segregation of duty conflicts within our ERP systems, we completed a thorough assessment of system access and have modified access accordingly to either reduce or eliminate conflicts wherever possible and have designed, implemented and tested compensating controls for design and operating effectiveness in those instances where complete duty segregation could not be achieved without substantial negative impact on our business operations.

As a result of these management actions and the remediation actions completed during the first, second and third quarters of 2017, and the related controls validation testing performed, management has concluded that the material weakness related to segregation of duty conflicts within our financial management/enterprise resource planning systems was remediated as of September 30, 2017.

Goodwill Impairment Testing. Based on management's testing and evaluation, we determined that we did not design and maintain effective internal control over our step one goodwill impairment testing that we performed in accordance with ASC 350, *Intangibles – Goodwill and Other* as of December 31, 2016 and April 1, 2017. Specifically, the Company's review control did not operate at a sufficient level of precision to identify the improper assumptions used in our step one goodwill impairment test for our JDL reporting unit. We concluded that this lack of detailed analysis was a material weakness in our internal controls.

In January 2017, the FASB issued new accounting guidance regarding the simplification of the test for goodwill impairment. The new standard eliminates the quantitative goodwill impairment analysis requirement to determine the fair value of individual assets and liabilities of a reporting unit to determine the amount of any goodwill impairment and instead permits an entity to recognize goodwill impairment loss as the excess of a reporting unit's carrying value over the estimated fair value of the reporting unit, the extent this amount does not exceed the carrying amount of goodwill. The Company chose to adopt this standard early for the annual impairment analysis in 2017.

In the second quarter of 2017, the Company performed the first step of the previous two-step process, which requires that the fair value of the reporting unit be compared to its book value, including goodwill. If the fair value is higher than the book value, no impairment is recognized. If the fair value is lower than the book value, an impairment adjustment must be recorded. The Company analyzed the reporting unit that had the goodwill and initially concluded that the fair value of that reporting unit was greater than its book value, and the Company was not required to impair the goodwill. Upon further review and after analyzing the Company as a whole, the Company determined that some assumptions it used in the determination of the fair value of the reporting unit required revision, resulting in a determination that the fair value of the reporting unit was less than the book value of the reporting unit. The Company

also analyzed the Company as a whole, including the Company's four separate reporting units. Based on this analysis of comparing the fair value of each reporting unit to the book value and comparing the Company's overall book value with its market capitalization, the Company determined that the book value exceeded the overall fair value of the reporting units as well as the Company's overall market value. As a result, the Company recorded an adjustment to record a goodwill impairment charge totaling $1,463,000 during the second quarter of 2017, which reduced our balance sheet amount for goodwill to $0.

(a) Inherent Limitations on Control Systems

Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, will be or have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

(b) Changes in Internal Control

Except as noted above, there were no other changes in the Company's internal control over financial reporting that occurred during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Not Applicable.

Item 1A. Risk Factors

Not Applicable.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not Applicable.

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

Not Applicable.

Item 6. Exhibits.

The following exhibits are included herein:

31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rules 13a-14 and 15d-14 of the Exchange Act).
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rules 13a-14 and 15d-14 of the Exchange Act).
32.	Certifications pursuant Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350).
101	The following financial information from Communications Systems, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2017, formatted in eXtensible Business Reporting Language XBRL: (i) Condensed Consolidated Balance Sheets as of September 30, 2017 and December 31, 2016; (ii) Condensed Consolidated Statements of Loss and Comprehensive Loss for the three and nine months ended September 30, 2017 and September 30, 2016; (iii) Condensed Consolidated Statement of Changes in Stockholders' Equity for the nine months ended September 30, 2017; (iv) Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2017 and September 30, 2016, and (v) Notes to Financial Statements.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereto duly authorized.

Communications Systems, Inc.

By /s/ Roger H.D. Lacey
Roger H.D. Lacey
Date: November 13, 2017 Chief Executive Officer

/s/ Mark Fandrich
Mark Fandrich
Date: November 13, 2017 Chief Financial Officer