

ELECTRO SENSORS INC  
Form 10-Q  
August 09, 2013  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, DC 20549

**Form 10-Q**

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

**For the quarterly period ended June 30, 2013**

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

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

**Commission File Number 0-9587**

**ELECTRO-SENSORS, INC.**

(Exact name of registrant as specified in its charter)

**Minnesota**

(State or other jurisdiction of incorporation or organization)

**41-0943459**

(IRS Employer Identification No.)

**6111 Blue Circle Drive  
Minnetonka, Minnesota 55343-9108**

(Address of principal executive offices)

**(952) 930-0100**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer o

Accelerated filer o

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

Smaller reporting company x

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

The number of shares outstanding of the registrant's common stock, \$0.10 par value, on August 8, 2013 was 3,394,707.

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**ELECTRO-SENSORS, INC.**  
**Form 10-Q**  
**For the Period Ended June 30, 2013**

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

|  | June 30,<br>2013   | December 31,<br>2012 |
|--|--------------------|----------------------|
| <b>ASSETS</b>  | <b>(unaudited)</b> |                      |
| <b>Current assets</b>  |                    |                      |
| Cash and cash equivalents  | \$ 771             | \$ 1,102             |
| Treasury bills   | 5,424              | 5,248                |
| Available-for-sale securities  | 2,705              | 3,677                |
| Trade receivables, less allowance for doubtful accounts of \$8 and \$10, respectively  | 754                | 602                  |
| Inventories  | 1,322              | 1,330                |
| Other current assets   | 110                | 75                   |
| <b>Total current assets</b>  | <b>11,086</b>      | <b>12,034</b>        |
| <b>Property and equipment, net</b>   | <b>1,262</b>       | <b>1,304</b>         |
| <b>Total assets</b>  | <b>\$ 12,348</b>   | <b>\$ 13,338</b>     |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                    |                      |
| <b>Current liabilities</b>   |                    |                      |
| Accounts payable   | \$ 90              | \$ 94                |
| Accrued expenses   | 265                | 227                  |
| Accrued income tax   | 64                 | 313                  |
| <b>Total current liabilities</b>   | <b>419</b>         | <b>634</b>           |
| <b>Deferred income tax liability</b>   | <b>1,110</b>       | <b>1,455</b>         |
| <b>Commitments and contingencies</b>   |                    |                      |
| <b>Stockholders' equity</b>  |                    |                      |
| Common stock par value \$0.10 per share; authorized 10,000,000 shares; issued and outstanding:<br>3,393,736 and 3,391,912 shares, respectively | 339                | 339                  |
| Additional paid-in capital   | 1,581              | 1,575                |
| Retained earnings  | 7,277              | 7,113                |
| Accumulated other comprehensive income (unrealized gain on available-for-sale securities, net of<br>income tax)                                | 1,622              | 2,222                |
| <b>Total stockholders' equity</b>  | <b>10,819</b>      | <b>11,249</b>        |
| <b>Total liabilities and stockholders' equity</b>  | <b>\$ 12,348</b>   | <b>\$ 13,338</b>     |

See accompanying notes to unaudited condensed consolidated financial statements

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

|  | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2013                           | 2012      | 2013                         | 2012      |
| <b>Net sales</b>   | \$ 1,571                       | \$ 1,795  | \$ 3,105                     | \$ 3,437  |
| <b>Cost of goods sold</b>  | 673                            | 787       | 1,315                        | 1,493     |
| <b>Gross profit</b>  | 898                            | 1,008     | 1,790                        | 1,944     |
| <b>Operating expenses:</b>   |                                |           |                              |           |
| Selling and marketing  | 390                            | 383       | 785                          | 793       |
| General and administrative   | 284                            | 248       | 582                          | 525       |
| Research and development   | 112                            | 101       | 230                          | 228       |
| <b>Total operating expenses</b>  | 786                            | 732       | 1,597                        | 1,546     |
| <b>Operating income</b>  | 112                            | 276       | 193                          | 398       |
| <b>Non-operating income:</b>   |                                |           |                              |           |
| Gain on sale of available-for-sale securities                                  | 298                            | 0         | 401                          | 0         |
| Interest income  | 0                              | 3         | 2                            | 4         |
| Other income   | 5                              | 3         | 8                            | 6         |
| <b>Total non-operating income</b>  | 303                            | 6         | 411                          | 10        |
| <b>Income before income taxes</b>  | 415                            | 282       | 604                          | 408       |
| <b>Income taxes</b>  | 145                            | 99        | 168                          | 147       |
| <b>Net income</b>  | \$ 270                         | \$ 183    | \$ 436                       | \$ 261    |
| <b>Other comprehensive income (loss):</b>                                      |                                |           |                              |           |
| Change in unrealized value of available-for-sale securities, net of income tax | \$ 33                          | \$ (508)  | \$ (199)                     | \$ (115)  |
| Reclassification of gains included in net income                               | (298)                          | 0         | (401)                        | 0         |
| <b>Net change in other comprehensive loss</b>                                  | (265)                          | (508)     | (600)                        | (115)     |
| <b>Total comprehensive income (loss)</b>                                       | \$ 5                           | \$ (325)  | \$ (164)                     | \$ 146    |
| <b>Net income per share data:</b>  |                                |           |                              |           |
| <b>Basic</b>   |                                |           |                              |           |
| Net income per share   | \$ 0.07                        | \$ 0.05   | \$ 0.12                      | \$ 0.07   |
| Weighted average shares  | 3,393,736                      | 3,390,785 | 3,393,696                    | 3,390,752 |
| <b>Diluted</b>   |                                |           |                              |           |
| Net income per share   | \$ 0.07                        | \$ 0.05   | \$ 0.12                      | \$ 0.07   |
| Weighted average shares  | 3,415,716                      | 3,407,765 | 3,415,676                    | 3,407,732 |
| <b>Dividends paid per share</b>  | \$ .04                         | \$ .04    | \$ .08                       | \$ .08    |

See accompanying notes to unaudited condensed consolidated financial statements



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**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)  
(unaudited)

|  | Six Months Ended<br>June 30, |          |
|--|------------------------------|----------|
|  | 2013                         | 2012     |
| <b>Cash flows from (used in) operating activities</b>                                |                              |          |
| <b>Net income</b>  | \$ 436                       | \$ 261   |
| Adjustments to reconcile net income to net cash from (used in) operating activities: |                              |          |
| Depreciation   | 54                           | 32       |
| Gain on sales of available-for-sale securities                                       | (401)                        | 0        |
| Deferred income taxes  | 23                           | (1)      |
| Interest accrued on investments  | (1)                          | 0        |
| Change in allowance for doubtful accounts  | (2)                          | (1)      |
| Change in:   |                              |          |
| Trade receivables  | (150)                        | (62)     |
| Inventories  | 8                            | 7        |
| Other current assets   | (35)                         | 17       |
| Accounts payable   | (4)                          | 79       |
| Accrued expenses   | 38                           | 76       |
| Accrued income taxes   | (249)                        | 58       |
| <b>Net cash from (used in) operating activities</b>                                  | (283)                        | 466      |
| <b>Cash flows from (used in) investing activities</b>                                |                              |          |
| Proceeds from sale of available-for-sale securities                                  | 405                          | 0        |
| Purchase of treasury bills   | (5,426)                      | 0        |
| Proceeds from the maturity of treasury bills   | 5,251                        | 0        |
| Purchase of property and equipment   | (12)                         | (42)     |
| <b>Net cash from (used in) investing activities</b>                                  | 218                          | (42)     |
| <b>Cash flows from (used in) financing activities</b>                                |                              |          |
| Proceeds from issuance of stock  | 6                            | 4        |
| Dividends paid   | (272)                        | (270)    |
| <b>Net cash used in financing activities</b>   | (266)                        | (266)    |
| <b>Net increase (decrease) in cash and cash equivalents</b>                          | (331)                        | 158      |
| Cash and cash equivalents, beginning   | 1,102                        | 5,476    |
| Cash and cash equivalents, ending  | \$ 771                       | \$ 5,634 |
| <b>Supplemental schedule of non-cash investing and financing activities</b>          |                              |          |
| Net change in unrealized loss on available-for-sale securities                       | \$ (600)                     | \$ (115) |
| <b>Supplemental cash flow information</b>  |                              |          |
| Cash paid for income taxes   | \$ 394                       | \$ 109   |

See accompanying notes to unaudited condensed consolidated financial statements



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**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE PERIOD ENDED JUNE 30, 2013**  
(unaudited)

**Note 1. Basis of Presentation**

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

This report should be read together with the Company's Annual Report on Form 10-K for the year ended December 31, 2012, including the audited financial statements and footnotes therein.

It is the opinion of management that the unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring accruals, necessary to fairly state the financial position and results of operations as of June 30, 2013 and for the three and six month periods then ended in accordance with accounting principles generally accepted in the United States of America. The results of interim periods may not be indicative of results to be expected for the year.

**Nature of Business**

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

Electro-Sensors, Inc. manufactures and markets a complete line of speed monitoring and motor control systems for industrial machinery. The Company utilizes leading-edge technology to continuously improve its products and make them easier to use with the ultimate goal of manufacturing the industry-preferred product for every market served. These products are sold through an internal sales staff, manufacturer's representatives, and distributors to a wide variety of manufacturers, original equipment manufacturers and processors who use the products to monitor process machinery operations. The Company markets its products to a number of different industries located throughout the United States, Asia, Central America, Canada, and Europe.

In addition, through its subsidiary ESI Investment Company, the Company periodically makes strategic investments in other businesses and companies, primarily when the Company believes that such investments will facilitate development of technology complementary to the Company's products. Although the Company, through ESI Investment Company, invests in other businesses or companies, the Company does not intend to become an investment company and intends to remain primarily an operating company. The Company's primary investment is 241,336 shares of Rudolph Technologies, Inc. which is accounted for using the available-for-sale method. See Note 4 for additional information regarding the Company's investments. The Company's investments in securities are subject to normal market risks.

**Revenue Recognition**

The Company recognizes revenue from the sale of its production monitoring equipment when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed and determinable and collection of the resulting receivable is reasonably assured. The Company may offer discounts to its distributors or quantity discounts that are recorded at the time of sale. The Company recognizes revenue on products sold to customers and distributors upon shipment because the contracts do not include post-shipment obligations. In addition to exchanges and warranties, customers have refund rights. The Company's standard products are used in a wide variety of industries, returns are minimal and insignificant to the consolidated financial statements and are recognized when the returned product is received by the Company. In some situations, the Company receives advance payments from its customers. Revenue associated with these advance payments is deferred until the product is shipped or services performed.

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**Available for Sale Securities**

ESI Investment Company's portfolio consists of equity securities, primarily common stocks and government debt securities. The estimated fair value of publicly traded equity securities is based on quoted market prices, and therefore subject to the inherent risk of market fluctuations. Management determines the appropriate classification of securities at the date individual investments are acquired, and evaluates the appropriateness of such classification at each balance sheet date.

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

Realized gains and losses on securities, including losses from declines in value of specific securities determined by management to be other-than-temporary, are included in the period realized. There were no temporary impairments in the six months ended June 30, 2013 and 2012.

**Fair Value Measurements**

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

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

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

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

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

The carrying value of cash and cash equivalents, treasury bills, commercial paper, money market funds, investments, trade receivables, accounts payable, and other working capital items approximate fair value at June 30, 2013 and December 31, 2012 due to the short maturity nature of these items.

**Income Taxes**

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

**Use of Estimates**

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

Table of Contents**Note 2. Stock-Based Compensation**

The Company records compensation expense for employee stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes-Merton (BSM) model. The Company uses historical data among other factors to estimate the expected price volatility, the expected option life and the expected forfeiture rate. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option. At June 30, 2013, the Company had two stock-based employee compensation plans.

At the Annual Meeting on April 24, 2013, shareholders approved the adoption of the 2013 Equity Incentive Plan.

During the six-month periods ended June 30, 2013 and 2012, there were no stock options granted or exercised.

**Note 3. Net Income Per Share**

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

**Note 4. Investments**

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

|   | Cost                | Gross<br>unrealized<br>gain | Gross<br>unrealized<br>loss | Fair<br>value       |
|---|---------------------|-----------------------------|-----------------------------|---------------------|
| <b>June 30, 2013</b>                        |                     |                             |                             |                     |
| Money Market                                | \$ 409,000          | \$ 0                        | \$ 0                        | \$ 409,000          |
| Commercial Paper                            | 101,000             | 0                           | 0                           | 101,000             |
| Treasury Bills                              | 5,426,000           | 0                           | (2,000)                     | 5,424,000           |
| Equity Securities                           | 88,000              | 2,671,000                   | (54,000)                    | 2,705,000           |
|   | 6,024,000           | 2,671,000                   | (56,000)                    | 8,639,000           |
| Less Cash and Cash Equivalents              | 510,000             | 0                           | 0                           | 510,000             |
| <b>Total Investments, June 30, 2013</b>     | <b>\$ 5,514,000</b> | <b>\$ 2,671,000</b>         | <b>\$ (56,000)</b>          | <b>\$ 8,129,000</b> |
| <b>December 31, 2012</b>                    |                     |                             |                             |                     |
| Money Market                                | \$ 804,000          | \$ 0                        | \$ 0                        | \$ 804,000          |
| Commercial Paper                            | 200,000             | 0                           | 0                           | 200,000             |
| Treasury Bills                              | 5,249,000           | 0                           | (1,000)                     | 5,248,000           |
| Equity Securities                           | 92,000              | 3,639,000                   | (54,000)                    | 3,677,000           |
|   | 6,345,000           | 3,639,000                   | (55,000)                    | 9,929,000           |
| Less Cash and Cash Equivalents              | 1,004,000           | 0                           | 0                           | 1,004,000           |
| <b>Total Investments, December 31, 2012</b> | <b>\$ 5,341,000</b> | <b>\$ 3,639,000</b>         | <b>\$ (55,000)</b>          | <b>\$ 8,925,000</b> |

At June 30, 2013 and December 31, 2012, the Company's significant investment in equity securities was 241,336 and 273,267 shares, respectively, of Rudolph Technologies, Inc. (Rudolph), which is accounted for under the available-for-sale method. As of June 30, 2013 and December 31, 2012, the aggregate value of the Company's Rudolph shares as reported on the Nasdaq Stock Exchange was approximately \$2,703,000 and \$3,673,000, respectively, with an approximate cost of \$32,000 and \$36,000, respectively. During the three and six-month periods ended June 30, 2013, the Company sold 24,431 and 31,931 shares, respectively, of Rudolph stock and reported a gain of \$297,000 and \$400,000, respectively, in non-operating income.

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**Note 5. Fair Value Measurements**

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

|                             | Carrying amount<br>in condensed<br>consolidated<br>balance sheet<br>June 30, 2013 | Fair Value<br>June 30, 2013 | Fair Value Measurement Using |         |         |
|-----------------------------|---|-----------------------------|------------------------------|---------|---------|
|                             |   |                             | Level 1                      | Level 2 | Level 3 |
| <b>Assets:</b>              |   |                             |                              |         |         |
| Cash and cash equivalents:  |   |                             |                              |         |         |
| Money Market                | \$ 409,000  | \$ 409,000                  | \$ 409,000                   | \$ 0    | \$ 0    |
| Commercial Paper            | 101,000   | 101,000                     | 101,000                      | 0       | 0       |
| Treasury Bills              | 5,424,000   | 5,424,000                   | 5,424,000                    | 0       | 0       |
| Available-for-sale:         |   |                             |                              |         |         |
| <b>Equities:</b>            |   |                             |                              |         |         |
| Small Cap Technology Sector | 2,705,000   | 2,705,000                   | 2,705,000                    | 0       | 0       |

|                             | Carrying amount<br>in condensed<br>consolidated<br>Balance Sheet<br>December 31,<br>2012 | Fair Value<br>December 31, 2012 | Fair Value Measurement Using |         |         |
|-----------------------------|--|---------------------------------|------------------------------|---------|---------|
|                             |  |                                 | Level 1                      | Level 2 | Level 3 |
| <b>Assets:</b>              |  |                                 |                              |         |         |
| Cash and cash equivalents:  |  |                                 |                              |         |         |
| Money Market                | \$ 804,000   | \$ 804,000                      | \$ 804,000                   | \$ 0    | \$ 0    |
| Commercial Paper            | 200,000  | 200,000                         | 200,000                      | 0       | 0       |
| Treasury Bills              | 5,248,000  | 5,248,000                       | 5,248,000                    | 0       | 0       |
| Available-for-sale:         |  |                                 |                              |         |         |
| <b>Equities:</b>            |  |                                 |                              |         |         |
| Small Cap Technology Sector | 3,677,000  | 3,677,000                       | 3,677,000                    | 0       | 0       |

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

Available-for-sale securities include equity securities that are traded in an active market. Closing stock prices are readily available from active markets and are used as being representative of fair value. The Company classifies these securities as level 1.

**Note 6. Inventories**

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

|                          | June 30,<br>2013    | December 31,<br>2012 |
|--------------------------|---------------------|----------------------|
| Raw Materials            | \$ 816,000          | \$ 835,000           |
| Work In Process          | 266,000             | 283,000              |
| Finished Goods           | 240,000             | 212,000              |
| <b>Total Inventories</b> | <b>\$ 1,322,000</b> | <b>\$ 1,330,000</b>  |

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On September 16, 2011, the Company sold its entire interest in its AutoData Systems Division to Auto Data Inc. (ADI). The purchase price will be paid as an earn-out based on three percent of the software, hardware, and maintenance contracts that ADI sells over the next five years (four percent while ADI continues to occupy the Company's building). As of June 30, 2013 and December 31, 2012, ADI owed the Company approximately \$8,000 and \$0, respectively, under the earn-out. The amount is included in other current assets on the consolidated balance sheet. For the three-month periods ended June 30, 2013 and 2012, the Company recognized approximately \$5,000 and \$3,000, respectively, as other income from ADI under the earn-out agreement. For the six-month periods ended June 30, 2013 and 2012, the Company recognized approximately \$8,000 and \$6,000, respectively, as other income from ADI under the earn-out agreement.

**Note 8. Segment Information**

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

The accounting policies of the segments are the same as those described in Note 1 of the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. In evaluating segment performance, management focuses on sales and income before taxes. The Company has no inter-segment sales.

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

|                                | Three Months Ended<br>June 30, |                 | Six Months Ended<br>June 30, |                 |
|--------------------------------|--------------------------------|-----------------|------------------------------|-----------------|
|                                | 2013                           | 2012            | 2013                         | 2012            |
| <b>External sales</b>          |                                |                 |                              |                 |
| Production monitoring          | \$ 1,571                       | \$ 1,795        | \$ 3,105                     | \$ 3,437        |
| <b>Total</b>                   | <b>\$ 1,571</b>                | <b>\$ 1,795</b> | <b>\$ 3,105</b>              | <b>\$ 3,437</b> |
| <b>Net income before taxes</b> |                                |                 |                              |                 |
| Production monitoring          | \$ 117                         | \$ 281          | \$ 201                       | \$ 406          |
| Investments                    | 298                            | 1               | 403                          | 2               |
| <b>Total</b>                   | <b>\$ 415</b>                  | <b>\$ 282</b>   | <b>\$ 604</b>                | <b>\$ 408</b>   |

**Note 9. Subsequent Events**

Subsequent to the end of the quarter, the Company sold 10,000 shares of Rudolph Technology stock for proceeds of approximately \$131,000, resulting in a gain on the sale of approximately \$129,000.

On July 23, 2013, the Board of Directors (the Board) accepted the resignation of Brad Slye as President, CEO, and CFO. Mr. Slye will continue with the company as Product Development and Integration Manager. The Board appointed David Klenk, an existing board member, as the new President, CEO, and CFO. At the same time, the Board granted Mr. Klenk a ten-year option to purchase 50,000 shares of the Company's common stock at an exercise price of \$4.21 per share. The options were fully vested and immediately exercisable as of the grant date.

On July 23, 2013, the Board appointed Scott Gabbard to the Board and as the audit committee chair. Mr. Gabbard will be compensated pursuant to the Company's existing director compensation plan.

Also, on July 23, 2013, the Board temporarily suspended the quarterly dividend. The Board is acutely focused on maximizing shareholder value and is suspending the dividend to best position the Company for renewed growth.

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

**CRITICAL ACCOUNTING ESTIMATES**

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make decisions based upon estimates, assumptions, and factors it considers relevant to the circumstances. Such decisions include the selection of applicable accounting principles and the use of judgment in their application, the results of which impact reported amounts and disclosures. Changes in economic conditions or other business circumstances may affect the outcomes of management's estimates and assumptions. An in-depth description of our accounting estimates can be found in the interim financial statements included in this report and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012. No new estimates exist other than those discussed in our Annual Report.

**RESULTS OF OPERATIONS**

**Net Sales**

Net sales for the three-month period ended June 30, 2013 decreased \$224,000, or 12.5%, when compared to the same period in 2012. Net sales for the six-month period ended June 30, 2013 decreased \$332,000, or 9.7%, when compared to the same period in 2012. The decrease in net sales for both periods was mainly in the agricultural storage and processing sector of our business. The first half of 2012 was very strong in this sector due to anticipation of record crop production, which did not materialize due to the severe drought last summer, and this impacted our comparative net sales during the first half of 2013. We believe business in this sector is beginning to strengthen as higher crop production is anticipated this year.

**Cost of Goods Sold**

Our cost of goods sold decreased \$114,000, or 14.5%, for the three months ended June 30, 2013 compared to the same period in 2012. For the six-month period ended June 30, 2013, our cost of goods sold decreased \$178,000, or 11.9%, compared to the same period in 2012. The decrease in both periods was primarily a direct result of decreased sales. We continue our efforts to maintain or reduce production costs by manufacturing products in the most cost effective manner.

**Gross Margin**

Gross margin for the three-month period ended June 30, 2013 was 57.2% versus 56.2% for the same period in 2012. For the six-month periods ended June 30, 2013 and 2012, gross margins were 57.6% and 56.6%, respectively. The increase in gross margin for both periods was due to a change in the mix of products sold, with a relative increase in the sale of higher margin products, and the increase for the six-month period in 2013 was favorably impacted by a price increase that went into effect in January 2013.

**Operating Expenses**

Total operating expenses increased \$54,000, or 7.4%, for the three months ended June 30, 2013 when compared to the same period in 2012. Total operating expenses increased \$51,000, or 3.3%, for the six months ended June 30, 2013 when compared to the same period in 2012.

Selling and marketing costs increased \$7,000, or 1.8%, for the three months ended June 30, 2013 when compared to the same period in 2012. For the six months ended June 30, 2013, selling and marketing costs decreased \$8,000, or 1.0%, when compared to the same period in 2012. For the three months ended June 30, 2013, the increase was due to higher wages and salaries due to additional sales personnel and increased travel expenses due to additional international sales trips, offset by a decrease in outside sales representative commissions (due to decreased sales), and a change in the mix of print advertising, on-line advertising, and tradeshow. For the six months ended June 30, 2013, the decrease was due to a decrease in outside sales representative commissions (due to decreased sales), and a change in the mix of print advertising, on-line advertising, and tradeshow, offset by an increase in wages and salaries due to the hiring of an additional sales person.

General and administrative costs increased \$36,000, or 14.5%, for the three months ended June 30, 2013 compared to the same period in 2012. For the six months ended June 30, 2013, general and administrative costs increased \$57,000, or 10.9%, when compared to the same period in 2012. For the three months ended June 30, 2013, the increase was due to an increase in depreciation expense on the upgrade of the enterprise software and related hardware, legal and professional fees related to board changes. For the six months ended June 30, 2013, the increase was due to an increase in depreciation expense on the upgrade of the enterprise software and related hardware, legal and professional fees (related to board changes and our domain name), and computer software and supplies (due to modifications to our enterprise software). The increase was offset by a decrease in our bad debts expense due to the write off of accounts in 2012, which did not occur in 2013.



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Research and development costs increased \$11,000, or 10.9%, for the three months ended June 30, 2013 compared to the same period in 2012. For the six months ended June 30, 2013, research and development costs increased \$2,000, or 0.9%, when compared to the same period in 2012. For the three months ended June 30, 2013, the increase was due to an increase in salaries and wages and lab testing fees for product testing and approval for hazardous locations. For the six months ended June 30, 2013, the increase resulted from an increase in prototypes and lab materials due to the development of new products, offset by decreases in lab testing for product testing and approval for hazardous locations.

### Non-Operating Income

Non-operating income increased by \$297,000, or 4,950.0%, for the three-month period ended June 30, 2013 compared to the same period for 2012. For the six months ended June 30, 2013, non-operating income increased \$401,000, or 4,010.0%, when compared to the same period in 2012. During the three and six months ended June 30, 2013, we sold 24,431 and 31,931 shares, respectively, of Rudolph Technology stock and recognized a gain of \$297,000 and \$400,000, respectively, on the sales. There were no sales of investments during the three and six months ended June 30, 2012.

Other income from the earn-out on the sale of the AutoData Systems Division increased \$2,000, or 66.7%, for the three months ended June 30, 2013 when compared to the same period in 2012. Other income from the sale of the AutoData Systems Division increased \$2,000, or 33.3%, for the six months ended June 30, 2013 when compared to the same period in 2012. This increase was due to an increase in the software, hardware, and maintenance contracts that Auto Data, Inc. sold during the periods.

Interest income decreased \$3,000, or 100.0%, when comparing the three months ended June 30, 2013 to the same period in 2012. For the six months ended June 30, 2013, interest income decreased \$2,000, or 50.0% when compared to the same period in 2012. These decreases were due to the interest recognized on Treasury Bills owned in 2013.

### Income Before Income Taxes

Income before income taxes was \$415,000 for the three months ended June 30, 2013, representing an increase of \$133,000, or 47.2%, when compared to the same period in 2012. Income before income taxes was \$604,000 for the six months ended June 30, 2013, representing an increase of \$196,000, or 48.0%, when compared to the same period in 2012.

The Production Monitoring Division had income before income taxes of \$117,000 for the three months ended June 30, 2013 compared to \$281,000 for the same period in 2012, a decrease of \$164,000, or 58.6%. For the six months ended June 30, 2013, the Production Monitoring Division had income before income taxes of \$201,000 compared to \$406,000 for the same period in 2012, a decrease of \$205,000, or 50.5%. These decreases in income before income taxes were mainly due to decreased sales.

ESI Investment Company had income before taxes of \$298,000 for the three-month period ended June 30, 2013 compared to \$1,000 for the same period in 2012 an increase of \$297,000, or 29,700.0%. ESI Investment Company had income before taxes of \$403,000 for the six-month period ended June 30, 2013 compared to \$2,000 for the same period in 2012, an increase of \$401,000, or 20,050.0%. These increases were a result of the gain on sales of available-for-sale securities in 2013 compared to 2012 (see Non-Operating Income ).

The net decrease in the unrealized value of available-for-sale securities was \$265,000 and \$600,000 for the three and six months, respectively, ended June 30, 2013. The net decrease is due to the sale of Rudolph Technology stock which resulted in a \$297,000 and \$400,000 gain on the sale and the decrease in Rudolph Technology stock during the three and six months, respectively, ended June 30, 2013. ESI Investment Company has approximately \$2,671,000 in unrealized gain on the Rudolph Technologies, Inc. investment that is reported in Other Comprehensive Income (see Note 4 Investments in the notes to the accompanying condensed consolidated financial statements).

### **LIQUIDITY AND CAPITAL RESOURCES**

Cash and cash equivalents were \$771,000 at June 30, 2013, and \$1,102,000 at December 31, 2012. The decrease was mainly from investing activities. As of June 30, 2013 and December 31, 2012, we owned \$5,424,000 and \$5,248,000, respectively, in Treasury Bills with a maturity of more than three months from the date of purchase. We did not own any Treasury Bills as of June 30, 2012.

Cash used in operating activity was \$283,000 for the six months ended June 30, 2013, compared to cash from operating activities of \$466,000 for the six months ended June 30, 2012. Cash used in operating activities increased \$749,000 for the six months ended June 30, 2013 when compared to the same period in 2012 mainly due to the net change in accrued income taxes and gain on sale of available-for-sale securities. The net change in income taxes was due to a decrease in the payable balance of \$249,000 at June 30, 2013 when compared to the prior year and an increase in the payable of \$58,000 at June 30, 2012 when compared to the prior year. The primary reason for the decrease is due to the payment in 2013 of the taxes owed for the year ended December 31, 2012. The gain on the sale of available-for-sale securities was \$401,000 for the six

months ended June 30, 2013 and there were no sales of available-for-sale securities in 2012.

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Cash from investing activities was \$218,000 for the six months ended June 30, 2013 and cash used in investing activities was \$42,000 for the six months ended June 30, 2012. The significant increase in cash from investing activities was the proceeds of \$405,000 on the sale of available-for-sales securities during the six months ended June 30, 2013. There were no such sales during the six months ended June 30, 2012. In addition, we purchased \$12,000 and \$42,000 of property and equipment for the six months ended June 30, 2013 and 2012, respectively. On July 23, 2013, the Board temporarily suspended the quarterly dividend. The Board is acutely focused on maximizing shareholder value and is suspending the dividend to best position the Company for renewed growth.

Cash used in financing activities was \$266,000 for each of the six months ended June 30, 2013 and 2012. During the six-month periods ended June 30, 2013 and 2012, we paid aggregate dividends of \$272,000 and \$270,000, respectively. During the six-month periods ended June 30, 2013 and 2012, we had \$6,000 and \$4,000, respectively, in stock purchases under the Employee Stock Purchase Plan for each year.

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

Our primary investment is 241,336 shares of Rudolph Technologies, Inc., listed on the Nasdaq stock market, accounted for using the available-for-sale method. The investment is subject to fluctuations in market price and could have a negative effect on our liquidity.

***Off-balance Sheet Arrangements***

As of June 30, 2013, the Company had no off-balance sheet arrangements or transactions.

**FORWARD-LOOKING STATEMENTS**

This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding our expectations, beliefs, intentions or strategies regarding the future. Forward-looking statements include, but are not limited to, statements relating to our marketing efforts or our efforts to accelerate growth; our belief that the agricultural storage and processing sector is beginning to strengthen; our efforts to maintain or reduce production costs; management's intention that we not become an investment company; our expected use of cash on hand; our cash requirements; and the sufficiency of our cash flows. Any statement that is not based solely upon historical facts, including strategies for the future and the outcome of events that have not yet occurred, is considered a forward-looking statement.

All forward-looking statements in this document are based on information available to us as of the date hereof, and we assume no obligation to update any such forward-looking statements, other than as required by law. It is important to note that our actual results could differ materially from those in such forward-looking statements. The forward-looking statements we make in this Quarterly Report are subject to certain risks and uncertainties that could cause future results to differ materially from our recent results or those projected in the forward-looking statements, including the accuracy of management's assumptions with respect to industry trends, fluctuations in industry conditions, the accuracy of management's assumptions regarding expenses and our cash needs and those listed under the heading "Cautionary Statements" under "Item 1 Business," in our Annual Report on Form 10-K for the year ended December 31, 2012.

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

Not Applicable.

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**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

Based on an evaluation under the supervision and with the participation of the Company's management, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ( Exchange Act ) were effective as of June 30, 2013 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

*Changes in Internal Control Over Financial Reporting*

There were no changes in the Company's internal control over financial reporting during the second quarter of 2013, which were identified in connection with management's evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II OTHER INFORMATION**

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

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

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

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

**Item 4. Mine Safety Disclosures Not Applicable.**

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

**Item 6. Exhibits**

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

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## **SIGNATURES**

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

**Electro-Sensors, Inc.**

August 9, 2013

/s/ David L. Klenk  
David L. Klenk  
Chief Executive Officer and Chief Financial Officer

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**EXHIBIT INDEX**

**ELECTRO-SENSORS, INC.**

**FORM 10-Q FOR QUARTER ENDED JUNE 30, 2013**

| <b>Exhibit</b> | <b>Description</b>  |
|----------------|---|
| 10.1           | Electro-Sensors, Inc. 2013 Equity Incentive Plan (incorporated by reference to Appendix C of the Registrant's Definitive Proxy Statement on Schedule 14A filed March 22, 2013).   |
| 10.2           | Form of Incentive Stock Option Agreement for use under the Electro-Sensors, Inc. 2013 Equity Incentive Plan (incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed April 29, 2013).  |
| 10.3           | Form of Nonqualified Stock Option Agreement for use under the Electro-Sensors, Inc. 2013 Equity Incentive Plan (incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K filed April 29, 2013).   |
| 31.1           | Certification of CEO and CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1           | Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101            | The following financial information from Electro-Sensors, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2013, formatted in eXtensible Business Reporting Language (XBRL): (i) Condensed Consolidated Balance Sheet as of June 30, 2013 and December 31, 2012, (ii) Condensed Consolidated Statements of Operations and Comprehensive Income for the three and six months ended June 30, 2013 and June 30, 2012, (iii) Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2013 and June 30, 2012, and (iv) Notes to Condensed Consolidated Financial Statements. |