COMMUNICATIONS SYSTEMS INC
Form 10-Q
August 09, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended **June 30, 2012**
OR
o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ______________________ to ________________________________

Commission File Number: 001-31588

COMMUNICATIONS SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

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

Class	**Name of Exchange On Which Registered**	**Outstanding at August 1, 2012**
Common Stock, par value $.05 per share	NASDAQ	8,521,438

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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

	June 30 2012	December 31 2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 14,465,348	$ 22,515,710
Investments	17,814,117	18,635,601
Trade accounts receivable, less allowance for doubtful accounts of $190,000 and $175,000, respectively	15,260,418	14,461,168
Inventories	31,059,932	25,986,003
Prepaid income taxes	3,579,839	3,893,003
Other current assets	649,514	999,863
Deferred income taxes	3,435,233	3,455,047
TOTAL CURRENT ASSETS	86,264,401	89,946,395
PROPERTY, PLANT AND EQUIPMENT, net	14,155,239	14,019,019
OTHER ASSETS:		
Investments	5,005,523	4,883,510
Goodwill	5,990,571	5,990,571
Prepaid pensions	1,047,753	905,552
Other assets	853,381	913,869
TOTAL OTHER ASSETS	12,897,228	12,693,502
TOTAL ASSETS	$ 113,316,868	$ 116,658,916
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	$ 442,148	$ 427,345
Accounts payable	5,222,815	4,398,848
Accrued compensation and benefits	2,737,715	5,870,000
Accrued consideration	971,681	1,002,623
Other accrued liabilities	2,055,503	2,388,867
Dividends payable	1,431,803	1,299,963
TOTAL CURRENT LIABILITIES	12,861,665	15,387,646
LONG TERM LIABILITIES:		
Long-term compensation plans	380,424	283,075
Income taxes payable	422,451	405,673
Deferred income taxes	1,525,531	1,476,969
Long term debt - mortgage payable	1,350,155	1,574,993
TOTAL LONG-TERM LIABILITIES	3,678,561	3,740,710
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; 8,518,764 and 8,466,774 shares issued and outstanding, respectively	425,938	423,339
Additional paid-in capital	36,466,644	35,533,273
Retained earnings	59,598,212	61,466,342
Accumulated other comprehensive income, net of tax	285,848	107,606
TOTAL STOCKHOLDERS EQUITY	96,776,642	97,530,560
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 113,316,868	$ 116,658,916

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

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

	Three Months Ended June 30		Six Months Ended June 30	
	2012	2011	2012	2011
Sales from operations	$ 25,561,258	$ 45,429,684	$ 49,805,179	$ 76,452,487
Costs and expenses:				
Cost of sales	14,905,375	26,974,099	29,200,669	44,668,413
Selling, general and administrative expenses	9,298,281	9,930,760	19,116,463	19,117,970
Goodwill impairment	0	1,271,986	0	1,271,986
Total costs and expenses	24,203,656	38,176,845	48,317,132	65,058,369
Operating income	1,357,602	7,252,839	1,488,047	11,394,118
Other income and (expenses):				
Investment and other income	53,870	57,440	33,172	136,862
Gain (loss) on sale of assets	68,969	2,236	89,542	(9,984)
Interest and other expense	(34,971)	(47,809)	(71,730)	(95,851)
Other income, net	87,868	11,867	50,984	31,027
Income before income taxes	1,445,470	7,264,706	1,539,031	11,425,145
Income tax expense	473,735	3,180,041	512,218	4,782,641
Net income	971,735	4,084,665	1,026,813	6,642,504
Other comprehensive income, net of tax:				
Additional minimum pension liability adjustments	(3,166)	(9,201)	132,726	(18,419)
Unrealized gains (losses) on available-for-sale securities	(6,419)	(10,088)	5,633	(25,416)
Foreign currency translation adjustment	(98,134)	44	39,883	68,101
Total other comprehensive income (loss), net of tax	(107,719)	(19,245)	178,242	24,266
Comprehensive net income	$ 864,016	$ 4,065,420	$ 1,205,055	$ 6,666,770
Basic net income per share:	$ 0.11	$ 0.48	$ 0.12	$ 0.79
Diluted net income per share:	$ 0.11	$ 0.48	$ 0.12	$ 0.78
Average Basic Shares Outstanding	8,522,307	8,442,416	8,498,040	8,433,758
Average Dilutive Shares Outstanding	8,562,148	8,519,679	8,526,048	8,489,499
Dividends per share	$ 0.16	$ 0.15	$ 0.32	$ 0.30

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

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

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
BALANCE AT DECEMBER 31, 2011	8,466,774	$ 423,339	$ 35,533,273	$ 61,466,342	$ 107,606	$ 97,530,560
Net income				1,026,813		1,026,813
Issuance of common stock under Employee Stock Purchase Plan	6,936	347	93,737			94,084
Issuance of common stock to Employee Stock Ownership Plan	36,145	1,806	506,392			508,198
Issuance of common stock under Non-Employee Stock Option Plan	12,000	600	84,983			85,583
Issuance of common stock under Executive Stock Plan	16,156	808	39,503			40,311
Tax benefit from non-qualified stock options and restricted stock			67,932			67,932
Share-based compensation			223,062			223,062
Purchase of common stock	(19,247)	(962)	(82,238)	(123,902)		(207,102)
Shareholder dividends				(2,771,041)		(2,771,041)
Other comprehensive income					178,242	178,242
BALANCE AT JUNE 30, 2012	8,518,764	$ 425,938	$ 36,466,644	$ 59,598,212	$ 285,848	$ 96,776,642

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

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

	Six Months Ended June 30 2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,026,813	$ 6,642,504
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,124,254	1,034,140
Share-based compensation	223,062	249,316
Deferred income taxes	68,375	661,389
Goodwill impairment		1,271,986
(Gain) loss on sale of assets	(89,542)	9,984
Excess tax benefit from stock based payments	(67,932)	(23,227)
Changes in assets and liabilities:		
Trade receivables	(790,154)	(14,682,075)
Inventories	(5,060,313)	(2,208,145)
Prepaid income taxes	313,120	296,586
Other assets	368,680	101,517
Accounts payable	818,696	2,521,963
Accrued compensation and benefits	(2,526,956)	(165,456)
Other accrued expenses	(323,490)	(296,517)
Income taxes payable	84,710	568,899
Net cash used in operating activities	(4,830,677)	(4,017,136)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(1,213,458)	(968,912)
Purchases of investments	(8,734,935)	(10,575,526)
Proceeds from the sale of fixed assets	97,222	2,745
Proceeds from the sale of investments	9,440,039	11,950,000
Net cash (used in) provided by investing activities	(411,132)	408,307
CASH FLOWS FROM FINANCING ACTIVITIES:		
Cash dividends paid	(2,639,201)	(2,527,555)
Mortgage principal payments	(210,035)	(196,206)
Proceeds from issuance of common stock	219,978	125,953
Excess tax benefit from stock based payments	67,932	23,227
Payment of contingent consideration related to acquisition	(43,639)	
Purchase of common stock	(207,102)	
Net cash used in financing activities	(2,812,067)	(2,574,581)
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	3,514	7,232
NET DECREASE IN CASH AND CASH EQUIVALENTS	(8,050,362)	(6,176,178)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	22,515,710	16,787,558
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 14,465,348	$ 10,611,380
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Income taxes paid	$ 54,171	$ 3,255,766
Interest paid	70,793	78,210
Dividends declared not paid	1,366,082	1,268,723

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

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COMMUNICATIONS SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Communications Systems, Inc. (herein collectively called CSI or the Company) is a Minnesota corporation organized in 1969 which operates directly and through its subsidiaries located in the United States, Costa Rica, the United Kingdom and China. CSI is principally engaged through its Suttle business unit in the manufacture and sale of modular connecting and wiring devices for voice and data communications, digital subscriber line filters, and structured wiring systems and through its Transition Networks business unit in the manufacture of media and rate conversion products for telecommunications networks. CSI also provides through its JDL Technologies (JDL) business unit IT solutions including network design, computer infrastructure installations, IT service management, change management, network security and network operations services.

Financial Statement Presentation

The condensed consolidated balance sheets and condensed consolidated statement of changes in stockholders equity as of June 30, 2012 and the related condensed consolidated statements of income and comprehensive income, and the condensed consolidated statements of cash flows for the periods ended June 30, 2012 and 2011 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 June 30, 2012 and 2011 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, 2011 Annual Report to Shareholders on Form 10-K. The results of operations for the periods ended June 30, 2012 are not necessarily indicative of operating results for the entire year.

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

Except to the extent updated or described below, the significant accounting policies set forth in Note 1 to the consolidated financial statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2011, appropriately represent, in all material respects, the current status of accounting policies, and are incorporated herein by reference.

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Cash Equivalents and Investments

For purposes of the condensed consolidated balance sheets and statements of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less at the time of purchase to be cash equivalents. As of June 30, 2012, the Company had $14.5 million in cash and cash equivalents. Of this amount, $0.6 million was invested in short-term money market funds that are not considered to be bank deposits and are not insured or guaranteed by the Federal Deposit Insurance Corporation (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 of the Company s cash and cash equivalents is deposited at banks. The FDIC insures deposits at banks up to $250,000 per account. The Company s cash and cash equivalents are held at large, well-established financial institutions and the Company believes any risk associated with uninsured balances is remote.

The Company had $22.8 million in investments, which consist of certificates of deposit, commercial paper, corporate notes and bonds, and municipal bonds that were purchased in the public markets and are classified as available-for-sale at June 30, 2012. Of the $22.8 million in investments, $17.8 million mature in 12 months or less and are classified as current assets. Available-for-sale investments are reported at fair value with unrealized gains and losses net of tax excluded from operations and reported as a separate component of stockholders equity (See Accumulated Other Comprehensive Income below).

Revenue Recognition

The Company s manufacturing operations (Suttle and Transition Networks) recognize revenue when the earnings process is complete, evidenced by persuasive evidence of an agreement, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectability is reasonably assured. Revenue is recognized for domestic and international sales at the shipping point or delivery to customers, based on the related shipping terms. Risk of loss transfers at the point of shipment or delivery to customers, and the Company has no further obligation after this time. Sales are made directly to customers and through distributors. Payment terms for distributors are consistent with the terms of the Company s direct customers. The Company records a provision for sales returns, sales incentives and warranty costs at the time of the sale based on historical experience and current trends.

JDL generally records revenue on hardware, software and related equipment sales and installation contracts when the revenue recognition criteria are met and products are installed and accepted by the customer. JDL records revenue on service contracts on a straight-line basis over the contract period, unless evidence suggests the revenue is earned in a different pattern. Each contract is individually reviewed to determine when the earnings process is complete.

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Accumulated Other Comprehensive Income

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

	June 30 2012	December 31 2011
Foreign currency translation	$ (297,714)	$ (337,597)
Unrealized gain (loss) on available-for-sale investments	3,000	(2,633)
Minimum pension liability	580,562	447,836
	$ 285,848	$ 107,606

NOTE 2 - 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 90% of the price at the end of each current quarterly plan term. The most recent term ended June 30, 2012. The ESPP is considered compensatory under current rules. At June 30, 2012, after giving effect to the shares issued as of that date, 59,477 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. Up to 1,000,000 shares of our Common Stock may be issued pursuant to awards under the 2011 Incentive Plan.

During the first quarter of 2012, stock options were awarded covering 92,223 shares to key executive employees, which options expire seven years from the date of award and vest 25% each year beginning one year after the date of award. The Company also granted deferred stock awards of 94,242 shares to key employees during the first quarter under the Company s long term incentive plan for performance over the 2012 to 2014 period. The actual number of shares of deferred stock earned by the respective employees, if any, will be determined based on achievement against cumulative performance goals for the three years ending December 31, 2014 and the number of shares earned will be paid in the first quarter of 2015 to those key employees still with the Company at that time. The Company also granted deferred stock awards of up to 9,456 shares to executive employees that could be earned under the Company s short-term incentive plan if actual revenue equaled or exceeded 150% of 2012 quarterly or annual revenue targets. The number of shares earned by the respective executive employees will be paid out no later than the first quarter of 2013.

During the second quarter of 2012, the Company granted restricted stock units totaling 25,879 units to the Company s seven non-employee directors with the restricted stock units issued to each director having a value of $40,000 based on the closing price of the Company s stock on May 22, 2012. These restricted stock units vest after one year and are issued as stock after another year.

At June 30, 2012, 765,008 shares remained available for future issuance under the 2011 Incentive Plan.

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Stock Option Plan for Directors

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

No options were granted under the Director Plan in 2011 or 2012. The Director Plan was amended as of May 19, 2011 to prohibit option grants in 2011 and future years to fulfill a commitment made by the Company in connection with seeking shareholder approval of the 2011 Incentive Plan at the 2011 Annual Meeting of Shareholders that, if shareholder approval was received, it would amend the Director Plan to prohibit any future option awards under that 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 certain limitations in the Stock Plan. When seeking approval of the 2011 Incentive Plan at the 2011 Annual Meeting of Shareholders, the Company committed to amending the Stock Plan to prohibit the issuance of future equity awards if such approval was given. Effective August 11, 2011, the amendment to prohibit future stock options or other equity awards was approved.

During 2011, prior to amending the Stock Plan to prohibit future awards, stock options were awarded covering 96,250 shares to key executive employees, which options expire seven years from the date of award and vest 25% each year beginning one year after the date of award.

In addition, during 2011, prior to amending the Stock Plan to prohibit future awards, key employees were granted deferred stock awards covering 16,092 shares tied to achievement against performance goals in 2010 under the Company s long term incentive plan. To the extent earned, the deferred stock will be paid out in the first quarter of 2014 to key employees still employed by the Company at that time. The Company also granted deferred stock awards covering 77,588 shares to key employees under the Company s long term incentive plan tied to achievement against performance over the 2011 to 2013 period. The actual number of shares of deferred stock earned by the respective employees, if any, will be determined based on achievement against cumulative performance goals for the three years ending December 31, 2013 and the number of shares earned will be paid in the first quarter of 2014 to those key employees still employed by the Company at that time. During 2011, the Company also granted deferred stock awards of up to 12,156 shares to executive employees that could be earned under the Company s short-term incentive plan if actual revenue equaled or exceeded 150% of 2011 quarterly or annual revenue targets. The number of shares earned by the respective executive employees was paid out in the first quarter of 2012.

At June 30, 2012, after reserving for stock options and deferred stock awards described in the two preceding paragraphs and adjusting for forfeitures and issuances during the year, there were 155,948 shares reserved for issuance under the Stock Plan. The Company did not award stock options or deferred stock under this plan in 2012.

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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, 2011 to June 30, 2012:

	Options	Weighted average exercise price per share	Weighted average remaining contractual term
Outstanding December 31, 2011	236,820	$ 11.35	5.18 years
Awarded	92,223	13.10	
Exercised	(12,000)	7.13	
Canceled	(5,890)	10.58	
Outstanding June 30, 2012	311,153	12.05	5.49 years
Exercisable at June 30, 2012	162,550	$ 10.71	4.75 years
Expected to vest at June 30, 2012	308,405	12.04	5.49 years

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 June 30, 2012 was $182,000. The intrinsic value of all options exercised during the six months ended June 30, 2012 was $59,000. Net cash proceeds from the exercise of all stock options were $86,000 and $73,000 for the six months ended June 30, 2012 and 2011, respectively.

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, 2011 to June 30, 2012:

	Shares	Weighted Average Grant Date Fair Value
Outstanding December 31, 2011	71,849	$ 15.14
Granted	103,698	13.53
Vested		
Canceled	(5,221)	14.41
Outstanding June 30, 2012	170,326	14.17

Compensation Expense

Share-based compensation expense recognized for the six-month period ended June 30, 2012 was $223,000 before income taxes and $145,000 after income taxes. Share-based compensation expense recognized for the six month period ended June 30, 2011 was $249,000 before income taxes and $162,000 after income taxes. Unrecognized compensation expense for the Company s plans was $1,011,000 at June 30, 2012. Excess tax benefits from the exercise of stock options and issuance of restricted stock included in financing cash flows for the six month periods ended June 30, 2012 and 2011 were $68,000 and $23,000, respectively. Share-based compensation expense is recorded as a part of selling, general and administrative expenses.

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NOTE 3 - INVENTORIES

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

	June 30 2012	December 31 2011
Finished goods	$ 18,122,027	$ 14,010,071
Raw and processed materials	12,937,905	11,975,932
Total	$ 31,059,932	$ 25,986,003

NOTE 4 ACQUISITION

On July 27, 2011, the Company acquired Patapsco Designs Limited of the UK (Patapsco). The purchase price totals $5,094,000, with cash acquired totaling $862,000. The purchase price includes initial consideration of $3,271,000, deferred consideration of $466,000 to be paid out no later than two years from the acquisition date, $656,000 in working capital adjustments, and $701,000 in contingent consideration. The Company has agreed to pay consideration up to $818,000 contingent upon the Patapsco business meeting gross margin and other non-financial targets, with the consideration to paid out no later than two years from the acquisition date. Although the maximum contingent consideration is $818,000, the Company has recognized $701,000 as the estimated fair value of the contingent consideration at the date of acquisition. This contingent consideration has been calculated based on the exchange rate at the date of acquisition and actual payments may differ based on fluctuations in the exchange rate between the dollar and the pound. At June 30, 2012, the Company had estimated liabilities of $972,000 related to outstanding consideration payments.

The assets and liabilities of Patapsco were recorded at their respective fair values in the consolidated balance sheet within the Transition Networks segment as of the acquisition date. The purchase price allocation is based on the estimated fair value of assets acquired and liabilities assumed and has been allocated as follows:

	July 27, 2011
Current assets	$ 2,052,149
Property, plant, and equipment	163,671
Intangible assets	801,488
Goodwill	2,702,340
Total assets	5,719,648
Current liabilities	$ 414,735
Long-term deferred tax liabilities	210,952
Total liabilities	625,687
Net assets acquired	$ 5,093,961

Identifiable intangible assets are definite-lived assets. These assets include customer relationships, trademarks, and technology intangible assets, and have a weighted average amortization period of 8 years, which matches the weighted average useful life of the assets. Goodwill recorded as part of the purchase price allocation is not tax deductible.

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NOTE 5 GOODWILL AND OTHER 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. A two-step process is performed to analyze whether or not goodwill has been impaired. Step one is to test for potential impairment, and 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, a second step must be performed. The second step is to measure the amount of impairment loss, if any, and requires that a hypothetical purchase price allocation be done to determine the implied fair value of goodwill. This fair value is then compared to the carrying value of goodwill. If the implied fair value is lower than the carrying value, an impairment adjustment must be recorded.

During our fiscal quarter ended June 30, 2011, based on greater than expected decline in actual and forecasted profitability of legacy products in our Suttle business unit, as well as, significant project delays that occurred related to Suttle s new technologies, we concluded that that these events and circumstances were indicators to require us to perform an interim goodwill impairment analysis of our Suttle business unit. This analysis included the determination of the reporting unit s fair value primarily using discounted cash flows modeling. Based on the step one and step two analysis, considering Suttle s reduced earnings and cash flow forecasts, the Company determined that Suttle s goodwill was fully impaired and recorded a goodwill impairment for the Suttle segment of $1,272,000.

The changes in the carrying amount of goodwill for the six months ended June 30, 2012 and 2011 by segment is as follows:

	Suttle	Transition Networks	Total
January 1, 2011	$ 1,271,986	$ 3,288,231	$ 4,560,217
Impairment loss	(1,271,986)		(1,271,986)
Acquisition		2,702,340	2,702,340
June 30, 2011	$	$ 5,990,571	$ 5,990,571
January 1, 2012	$	$ 5,990,571	$ 5,990,571
June 30, 2012	$	$ 5,990,571	$ 5,990,571
Gross goodwill	$ 1,271,986	$ 5,990,571	$ 7,262,557
Accumulated impairment loss	$ (1,271,986)		(1,271,986)
Balance at June 30, 2012	$	$ 5,990,571	$ 5,990,571

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

	June 30, 2012			
	Gross Carrying Amount	Accumulated Amortization	Foreign Currency Translation	Net
Trademarks	81,785	(10,224)	(3,711)	67,850
Customer relationships	490,707	(42,941)	(22,263)	425,503
Technology	228,996	(40,078)	(10,389)	178,529
	801,488	(93,243)	(36,363)	671,882

Amortization expense on these identifiable intangible assets was $51,000 in 2012. The amortization expense is included in selling, general and administrative expenses.

NOTE 6 WARRANTY

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

The following table presents the changes in the Company s warranty liability for the six-month periods ended June 30, 2012 and 2011, respectively, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

	2012	2011
Beginning Balance	$ 634,000	$ 616,000
Actual warranty costs paid	(145,000)	(124,000)
Amounts charged to expense	98,000	93,000
Ending balance	$ 587,000	$ 585,000

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 would materially affect the Company s financial position or results of operations.

NOTE 8 INCOME TAXES

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

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At June 30, 2012 there was $355,000 of net uncertain tax benefit positions that would reduce the effective income tax rate if recognized. The Company records interest and penalties related to income taxes as income tax expense in the Condensed Consolidated Statements of Income.

The Company is subject to U.S. federal income tax as well as income tax of multiple state and foreign jurisdictions. The tax years 2008-2010 remain open to examination by the Internal Revenue Service and the years 2007-2010 remain open to examination by various state tax departments. The tax years from 2008-2010 remain open in Costa Rica.

The Company s effective income tax rate was 33.3% for the first six months of 2012. The effective tax rate differs from the federal tax rate of 35% due to state income taxes, provisions for interest charges, the release of valuation allowance placed on foreign net operating losses, and the effect of operations conducted in lower foreign tax rate jurisdictions. The effect of the foreign operations is an overall rate decrease of approximately (3.9%) for the six months ended June 30, 2012. There were no additional uncertain tax positions identified in the second quarter of 2012. There were no additional uncertain tax positions identified in the second quarter of 2012. The Company s effective income tax rate for the six months ended June 30, 2011 was 42%, and differed from the federal tax rate due to state income taxes, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges, and goodwill impairment not deductible for U.S. income tax purposes.

NOTE 9 SEGMENT INFORMATION

Effective January 1, 2012, the Company realigned its business operations. As a result of the realignment, the Company consolidated the Austin Taylor operations within its Suttle business unit. Following this realignment, the Company classifies its businesses into three segments as follows:

- Suttle manufactures and markets copper and fiber connectivity systems, enclosure systems, xDSL filters and splitters, and active technologies for voice, data and video communications;
- Transition Networks manufactures network interface devices (NIDs), media converters, network interface cards (NICs), Ethernet switches and other connectivity products that offer the ability to affordably integrate the benefits of fiber optics into any data network; and
- JDL Technologies provides technology solutions including virtualization, managed services, wired and wireless network design and implementation services, and converged infrastructure configuration and deployment.

Our non-allocated corporate general and administrative expenses are categorized as Other in the Company s segment reporting. Management has chosen to organize the enterprise and disclose reportable segments based on our products and services. There are no material inter-segment revenues. To conform to the 2012 presentation, the Company has reclassified 2011 segment information to present the Austin Taylor operations within Suttle s business unit.

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Information concerning the Company s continuing operations in the various segments for the three and six month periods ended June 30, 2012 and 2011 is as follows:

SEGMENT INFORMATION - THREE MONTHS

	Suttle	Transition Networks	JDL Technologies	Other	Total
Three months ended June 30, 2012:					
Sales	$ 10,347,556	$ 14,029,507	$ 1,184,195	$	$ 25,561,258
Cost of sales	7,850,557	6,228,019	826,799		$ 14,905,375
Gross profit	2,496,999	7,801,488	357,396		10,655,883
Selling, general and administrative expenses	2,205,227	$ 5,569,837	529,147	994,070	$ 9,298,281
Operating income (loss)	$ 291,772	$ 2,231,651	$ (171,751)	$ (994,070)	$ 1,357,602
Depreciation and amortization	$ 239,636	$ 199,060	$ 27,836	$ 73,032	$ 539,564
Capital expenditures	$ 262,689	$ 77,194	$ 4,595	$ 187,881	$ 532,359
Assets at June 30, 2012	$ 28,333,064	$ 35,613,341	$ 2,356,158	$ 47,014,305	$ 113,316,868

	Suttle	Transition Networks	JDL Technologies	Other	Total
Three months ended June 30, 2011:					
Sales	$ 9,049,714	$ 32,377,988	$ 4,001,982	$	$ 45,429,684
Cost of sales	7,009,544	17,839,905	2,124,650		26,974,099
Gross profit	2,040,170	14,538,083	1,877,332		18,455,585
Selling, general and administrative expenses	1,922,708	5,896,959	488,125	1,622,968	9,930,760
Goodwill impairment	1,271,986				1,271,986
Operating income (loss)	$ (1,154,524)	$ 8,641,124	$ 1,389,207	$ (1,622,968)	$ 7,252,839
Depreciation and amortization	$ 256,880	$ 174,606	$ 28,818	$ 74,614	$ 534,918
Capital expenditures	$ 355,388	$ 159,554	$ 1,324	$ 9,043	$ 525,309
Assets at June 30, 2011	$ 23,207,387	$ 46,946,405	$ 3,936,889	$ 41,940,702	$ 116,031,383

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SEGMENT INFORMATION - SIX MONTHS

	Suttle	Transition Networks	JDL Technologies	Other	Total
Six months ended June 30, 2012:					
Sales	$ 20,924,860	$ 26,967,699	$ 1,912,620	$	$ 49,805,179
Cost of sales	15,526,519	12,356,855	1,317,295		$ 29,200,669
Gross profit	5,398,341	14,610,844	595,325		20,604,510
Selling, general and administrative expenses	4,573,668	11,192,074	1,114,115	2,236,606	$ 19,116,463
Operating income (loss)	$ 824,673	$ 3,418,770	$ (518,790)	$ (2,236,606)	$ 1,488,047
Depreciation and amortization	$ 483,661	$ 440,496	$ 54,927	$ 145,170	$ 1,124,254
Capital expenditures	$ 665,588	$ 159,645	$ 14,691	$ 373,534	$ 1,213,458

	Suttle	Transition Networks	JDL Technologies	Other	Total
Six months ended June 30, 2011:					
Sales	$ 19,736,896	$ 48,933,885	$ 7,781,706	$	$ 76,452,487
Cost of sales	14,972,262	25,419,133	4,277,018		$ 44,668,413
Gross profit	4,764,634	23,514,752	3,504,688		31,784,074
Selling, general and administrative expenses	4,042,899	11,229,352	1,000,945	2,844,774	$ 19,117,970
Goodwill impairment	1,271,986				1,271,986
Operating income (loss)	$ (550,251)	$ 12,285,400	$ 2,503,743	$ (2,844,774)	$ 11,394,118
Depreciation and amortization	$ 485,794	$ 341,761	$ 57,306	$ 149,279	$ 1,034,140
Capital expenditures	$ 597,389	$ 351,105	$ 11,375	$ 9,043	$ 968,912

NOTE 10 PENSIONS

The Company s U.K. based subsidiary Austin Taylor maintains defined benefit pension plans that cover seven active employees. The Company does not provide any other post-retirement benefits to its employees. Components of net periodic benefit cost of the pension plans were:

	Six months Ended June 30 2012	2011
Service cost	$ 18,000	24,000
Interest cost	121,000	134,000
Expected return on plan assets	(135,000)	(127,000)
Amortization of prior service cost	23,000	
	$ 27,000	$ 31,000

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NOTE 11 NET INCOME 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 a dilutive effect of 39,841 and 28,008 shares for the three and six month periods ended June 30, 2012. The dilutive effect of stock options for the three and six month periods ended June 30, 2011 was 77,263 shares and 55,741 shares, respectively. The Company calculates the dilutive effect of outstanding options using the treasury stock method. All options were included because the exercise price was greater than the average market price of common stock during the period and deferred stock awards totaling 148,748 shares were not included because of unmet performance conditions.

NOTE 12 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.

Financial assets and liabilities measured at fair value as of June 30, 2012 and December 31, 2011, are summarized below:

	June 30, 2012			
	Level 1	**Level 2**	**Level 3**	**Total Fair Value**
Cash equivalents:				
Money Market funds	$ 643,246	$	$	$ 643,246
Subtotal	643,246			643,246
Short-term investments:				
Certificates of deposit		15,181,788		15,181,788
Municipal Notes/Bonds		1,000,794		1,000,794
Commercial Paper		1,631,535		1,631,535
Subtotal		17,814,117		17,814,117
Long-term investments:				
Certificates of deposit		933,589		933,589
Corporate Notes/Bonds		4,071,934		4,071,934
Subtotal		5,005,523		5,005,523
Current Liabilities:				
Accrued Consideration			(971,681)	(971,681)
Subtotal			(971,681)	(971,681)
Total	$ 643,246	$ 22,819,641	$ (971,681)	$ 22,491,206

	December 31, 2011			
	Level 1	**Level 2**	**Level 3**	**Total Fair Value**
Cash equivalents:				
Money Market funds	$ 829,881	$	$	$ 829,881
Subtotal	829,881			829,881
Short-term investments:				
Certificates of deposit		18,635,601		18,635,601
Subtotal		18,635,601		18,635,601
Long-term investments:				
Certificates of deposit		4,883,510		4,883,510
Subtotal		4,883,510		4,883,510
Current Liabilities:				
Accrued Consideration			(1,002,623)	(1,002,623)
Subtotal			(1,002,623)	(1,002,623)
Total	$ 829,881	$ 23,519,111	$ (1,002,623)	$ 23,346,369

The estimated fair value of remaining contingent consideration as of June 30, 2012 was approximately $972,000, as noted above. The estimated fair value is considered a level 3 measurement because the probability weighted discounted cash flow methodology used to estimate fair value includes the use of significant unobservable inputs, primarily the contractual contingent consideration gross margin targets and assumed probabilities. There was not a significant change in either the estimated contingent consideration fair value or the fair value inputs during the first half of 2012. Any change in our estimated liability for contingent consideration will increase or decrease operating income in future periods.

There were no transfers between levels during the six months ended June 30, 2012.

NOTE 13 SUBSEQUENT EVENTS

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

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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 copper and fiber connectivity systems, enclosure systems, xDSL filters and splitters, and active technologies for voice, data and video communications;
- Transition Networks manufactures network interface devices (NIDs), media converters, network interface cards (NICs), Ethernet switches and other connectivity products that offer the ability to affordably integrate the benefits of fiber optics into any data network; and
- JDL Technologies provides technology solutions including virtualization, managed services, wired and wireless network design and implementation services, and converged infrastructure configuration and deployment.

For the three months ended June 30, 2012, the Company had revenues of $25.6 million and net income of $972,000 or $0.11 per diluted share compared to 2011 second quarter revenues of $45.4 million and net income of $4.1 million or $0.48 per diluted share. For the six months ended June 30, 2012, the Company had revenues of $49.8 million and net income of $1,027,000 or $0.12 per diluted share compared to 2011 six-month revenues of $76.5 million and net income of $6.6 million or $0.78 per diluted share.

As the Company discussed in reporting its 2011 interim and full year results, its strong 2011 financial performance was bolstered by large projects in its Transition Networks and JDL business units, making year-over-year comparisons more challenging. The significant decrease in the revenue and net income for the three and six-month periods from the 2011 periods is primarily due to a large, one-time 2011 Transition Networks project that generated $19.4 million of revenue in the 2011 second quarter. The Company continues to face a difficult 2012 economic environment, primarily related to lower government spending, which is affecting both its Transition Networks and JDL business units.

Excluding the revenues from this one-time project, Transition Networks 2012 second quarter revenues increased $916,000 or 8% over the 2011 second quarter. Transition Networks is working to increase revenue in its focus markets, including the service provider market and continues to have success with Telcos that provide business Ethernet services. The July 2011 addition of Patapsco has helped to expand its capacity to serve the mobile backhaul space. The Company expects growth in this space and continues to invest in product development to support it.

JDL s 2012 revenues decreased 70.2% as it completed a large contract for the Broward Country School District in the third quarter of 2011. JDL continues to support this school district, and is working to acquire new school districts and universities and expanding its products and services to small- and medium-sized businesses to implement new technologies such as virtualization and migration to the cloud. In the second quarter, JDL received new orders from the 4th largest school district in the U.S., the Miami-Dade County Public School District (M-DCPS) to provide the hardware to M-DCPS for wireless connectivity.

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The improving housing market, especially for multi-tenant dwelling units, and Suttle s strong position within its customer base enabled it to increase revenues from its structured wiring products and to increase by $1.3 million or 14% over the second quarter of 2011. Suttle is also having success penetrating new opportunities with copper and fiber connectivity products within its existing customer base as well as gaining new customers in Latin America, Europe and the Middle East. Suttle s Costa Rica facility is growing to support customers globally with production and has added engineering resources to support new product development. In the quarter, the Company used cash to build Suttle products to support new orders.

While the Company has reduced some general and administrative costs, it continues to invest in its business to target opportunities in its core markets as it pursues new opportunities in its global customer base and expands into new markets. The Company s ongoing implementation of its enterprise resource planning (ERP) system is proceeding well. This new system will standardize all of the Company business units on one system, bringing efficiencies to product development, manufacturing, delivering services and back office support.

Despite some near-term economic uncertainty in some areas such as government spending, the Company remains optimistic about its long-term prospects and will continue to invest in areas that will enable it to be successful in its target markets.

Forward-looking statements

In this report and, from time to time, in reports filed with the Securities and Exchange Commission, 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:

- our ability to manufacture and deliver our products to customers in the time frame these customers have specified;
- possible lower future sales to major telephone companies and other major customers;
- the introduction of competitive products and technologies;
- our ability to successfully control operating expenses in our business units;
- the general health of the telecom sector;
- the continuing worldwide financial downturn and sluggish economic conditions in certain market segments;
- our ability to successfully and profitability integrate our acquisitions, including our July 27, 2011 acquisition of Patapsco;
- delays in new product introductions;
- higher than expected expense related to new sales and marketing initiatives;
- unfavorable resolution of claims and litigation;
- availability of adequate supplies of raw materials and components;
- fuel prices;
- the dependence of our Transition Networks business unit on federal government spending;

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government funding of education technology spending; and

other factors discussed from time to time in the Company s filings with the Securities and Exchange Commission, including risk factors presented under Item 1A of the Company s most recently filed annual report on Form 10-K.

Three Months Ended June 30, 2012 Compared to
Three Months Ended June 30, 2011

Consolidated sales decreased 44% in 2012 to $25,561,000 compared to $45,430,000 in 2011. Consolidated operating income in 2012 decreased to $1,358,000 compared to $7,253,000 in the second quarter of 2011. Net income in 2012 decreased to $972,000 compared to $4,085,000 in the second quarter of 2011.

Suttle

The Company realigned its business operations effective January 1, 2012 and as a result, the Austin Taylor operations are now included within the Suttle business unit. The Company has reclassified Austin Taylor s 2011 operations to conform to this presentation. Suttle sales increased 14% in the second quarter of 2012 to $10,348,000 compared to $9,050,000 in the same period of 2011 due to increases in new multi-dwelling unit construction in the US housing market and revenue from multiple new product contracts. Sales by customer groups in the second quarter of 2012 and 2011 were:

	Suttle Sales by Customer Group	
	2012	**2011**
Major telephone companies	$ 7,735,000	$ 5,760,000
Distributors	1,391,000	1,080,000
International	1,184,000	2,178,000
Other	38,000	32,000
	$ 10,348,000	$ 9,050,000

Suttle s sales by product groups in second quarter of 2012 and 2011 were:

	Suttle Sales by Product Group	
	2012	**2011**
Modular connecting products	$ 3,242,000	$ 2,711,000
Structured cabling products	4,203,000	2,460,000
DSL products	1,707,000	2,357,000
Other products	1,196,000	1,522,000
	$ 10,348,000	$ 9,050,000

Sales to the major telephone companies increased 34% in 2012 due to an increase in new multi-dwelling unit construction within the US housing market and revenue from multiple new product contracts. Sales to these customers accounted for 75% of Suttle s sales in the second quarter of 2012 compared to 64% of sales in 2011. Sales to distributors increased 29% in 2012 due to stronger demand for structured cabling products to support the increase in multi-dwelling unit construction. This customer segment accounted for 13% and 12% of sales in the second quarters of 2012 and 2011, respectively. International sales decreased 46% and accounted for 11% of Suttle s second quarter 2012 sales, due to reduction in DSL sales to a large customer.

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Modular connecting products sales have increased 20% due to an increase in new multi-dwelling unit construction in the US housing market. Sales of structured cabling products increased 71% due to an increase in new multi-dwelling unit construction market. Sales of DSL products decreased 28% due to the maturation of the U.S. DSL market and the order cycle of major customers.

Suttle s gross margin increased 22% in the second quarter of 2012 to $2,497,000 compared to $2,040,000 in the same period of 2011. Gross margin as a percentage of sales increased to 24% in 2012 from 23% in 2011 due to product mix changes. Selling, general and administrative expenses increased $282,000 or 15% in the second quarter of 2012 compared to the same period in 2011, due to increased spending in the Company s technology development and market expansion initiatives. Suttle s operating income was $292,000 in the second quarter of 2012 compared to an operating loss of $1,155,000 in 2011 due to a goodwill impairment charge of $1,272,000 in the second quarter of 2011.

Transition Networks

Transition Networks sales decreased 57% to $14,030,000 in the second quarter of 2012 compared to $32,378,000 in 2011 due to $19,387,000 in revenue from a one-time large network upgrade project with a Fortune 500 company in the second quarter of 2011. Revenues excluding this major project increased 8% or $1,039,000 as compared to the second quarter of 2011.

Second quarter sales by region are presented in the following table:

	Transition Networks Sales by Region	
	2012	**2011**
North America	$ 10,614,000	$ 29,082,000
Europe, Middle East, Africa (EMEA)	1,328,000	1,497,000
Rest of world	2,088,000	1,799,000
	$ 14,030,000	$ 32,378,000

The following table summarizes Transition Networks 2012 and 2011 second quarter sales by its major product groups:

	Transition Networks Sales by Product Group	
	2012	**2011**
Media converters	$ 9,284,000	$ 27,797,000
Ethernet switches	1,228,000	1,238,000
Ethernet adapters	336,000	605,000
Other products	3,182,000	2,738,000
	$ 14,030,000	$ 32,378,000

Sales in North America decreased 64% or $18,468,000 due to a one-time large network upgrade project with a Fortune 500 company in the second quarter of 2011 noted above. This also caused the decrease in revenue from sales of media converters. International sales increased $120,000, or 4%, due to increased project activity in the rest of world, specifically within south-east Asia.

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Gross margin on second quarter Transition Networks sales decreased 46% to $7,801,000 in 2012 from $14,538,000 in 2011. Gross margin as a percentage of sales increased to 56% in 2012 as compared to 45% in 2011 due to volume discounts given in 2011 for the large network upgrade project with a Fortune 500 company described above. Selling, general and administrative expenses decreased 6% to $5,570,000 in 2012 compared to $5,897,000 in 2011 due to cost reduction measures during the quarter. Operating income decreased to $2,232,000 in 2012 compared to $8,641,000 in 2011.

JDL Technologies, Inc.

JDL Technologies, Inc. sales decreased 70% to $1,184,000 in the second quarter of 2012 compared to $4,002,000 in 2011.

JDL s revenues by customer group were as follows:

	JDL Revenue by Customer Group	
	2012	2011
Broward County FL schools	$ 701,000	$ 3,833,000
All other	483,000	169,000
	$ 1,184,000	$ 4,002,000

Revenues earned in Broward County, Florida decreased $3,132,000 or 82% in the second quarter 2012. In the first quarter of 2010, the Company received significant funding for federal government contract work. This contract work was of a long-term nature, and the Company completed these contracts during the quarter ended September 30, 2011. All other revenues increased $314,000 due to JDL s concentrated effort to expand its market focus.

JDL gross margin decreased 81% to $357,000 in the second quarter of 2012 compared to $1,877,000 in the same period in 2011. Gross margin as a percentage of sales decreased to 30% in 2012 from 47% in 2011 due to purchasing discounts and rebates the Company was able to take advantage of during the prior year quarter. Selling, general and administrative expenses increased in 2012 to $529,000 compared to $488,000 in 2011 due to increased sales and marketing expenses as JDL has expanded its market focus. JDL reported an operating loss of $172,000 in the second quarter of 2012 compared to operating income of $1,389,000 in the same period of 2011.

Other

The Company s income before income taxes decreased to $1,445,000 in 2012 compared to $7,265,000 in 2011. The Company s effective income tax rate was 33% in 2012 and 44% in 2011. This effective rate differs from the standard rate of 35% due to state income taxes, provisions for interest charges, the release of valuation allowance placed on foreign net operating losses, and the effect of operations conducted in lower foreign tax rate jurisdictions.

Six Months Ended June 30, 2012 Compared to
Six Months Ended June 30, 2011

Consolidated sales decreased 35% in 2012 to $49,805,000 compared to $76,452,000 in 2011. Consolidated operating income in 2012 decreased to $1,488,000 compared to $11,394,000 in the first six months of 2011. Net income in 2012 decreased to $1,027,000 compared to $6,643,000 in the first six months of 2011.

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Suttle

The Company realigned its business operations effective January 1, 2012 and as a result, the Austin Taylor operations are now included within the Suttle business unit. The Company has reclassified Austin Taylor s 2011 operations to conform to this presentation. Suttle sales increased 6% in the first six months of 2012 to $20,925,000 compared to $19,737,000 in the same period of 2011. Sales by customer groups in the first six months of 2012 and 2011 were:

	Suttle Sales by Customer Group	
	2012	**2011**
Major telephone companies	$ 15,185,000	$ 12,635,000
Distributors	2,819,000	2,228,000
International	2,695,000	4,596,000
Other	226,000	278,000
	$ 20,925,000	$ 19,737,000

Suttle s sales by product groups in first six months of 2012 and 2011 were:

	Suttle Sales by Product Group	
	2012	**2011**
Modular connecting products	$ 6,477,000	$ 6,262,000
Structured cabling products	8,243,000	5,378,000
DSL products	3,612,000	5,316,000
Other products	2,593,000	2,781,000
	$ 20,925,000	$ 19,737,000

Sales to the major telephone companies increased 20% in 2012 due to an increase in new multi-dwelling unit construction in the US housing market and contribution from new product contracts. Sales to these customers accounted for 73% of Suttle s sales in the first six months of 2012 compared to 64% of sales in the same period in 2011. Sales to distributors increased 27% in 2012 primarily due to increase in activity in the US housing market. This customer segment accounted for 13% and 11% of sales in the first six months of 2012 and 2011, respectively. International sales decreased 41% and accounted for 13% of Suttle s first six months 2012 sales due to reduction in DSL sales to a large customer.

Modular connecting products sales have increased 3% due to an increase in new multi-dwelling unit construction in the US housing market. Sales of structured cabling products increased 53% due to increased construction activity in the multi-dwelling unit space in specific regions in the U.S. Sales of DSL products decreased 32% due to the maturation of the U.S. DSL market and order cycles of major customers.

Suttle s gross margin increased 13% in the first six months of 2012 to $5,398,000 compared to $4,765,000 in the same period of 2011. Gross margin as a percentage of sales increased to 26% in 2012 from 24% in 2011 due to product mix changes. Selling, general and administrative expenses increased $531,000 or 13% in the first six months of 2012 compared to the same period in 2011, due to an increase in spending in the technology development and market expansion initiative. Suttle s operating income was $825,000 in the first six months of 2012 compared to an operating loss of $550,000 in 2011 due to a goodwill impairment charge of $1,272,000 in the second quarter of 2011.

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Transition Networks

Transition Networks sales decreased 45% to $26,968,000 in the first six months of 2012 compared to $48,934,000 in 2011 due to $19,387,000 in revenue from a one-time large network upgrade project with a Fortune 500 company in the second quarter of 2011 and a slowdown in Federal Government spending.

First six months sales by region are presented in the following table:

	Transition Networks Sales by Region	
	2012	**2011**
North America	$ 19,942,000	$ 42,300,000
Europe, Middle East, Africa (EMEA)	3,056,000	3,329,000
Rest of world	3,970,000	3,305,000
	$ 26,968,000	$ 48,934,000

The following table summarizes Transition Networks 2012 and 2011 first six months sales by its major product groups:

	Transition Networks Sales by Product Group	
	2012	**2011**
Media converters	$ 17,968,000	$ 39,426,000
Ethernet switches	2,447,000	2,274,000
Ethernet adapters	1,543,000	2,901,000
Other products	5,010,000	4,333,000
	$ 26,968,000	$ 48,934,000

Sales in North America decreased 53% or $22,538,000 due to revenue from a one-time large network upgrade project with a Fortune 500 company in the second quarter of 2011 as noted above. This also caused the decrease in revenue from sales of media converters. Other vertical markets, especially the Federal Government market in the United States, continued to record lower revenue due to the slow down in government purchases resulting in project delays. International sales increased $392,000, or 6% due to increased project activity in the rest of world, specifically within south-east Asia.

Gross margin on the first six months of Transition Networks sales decreased to $14,611,000 in 2012 from $23,515,000 in 2011. Gross margin as a percentage of sales increased to 54% in 2012, compared to 48% in the 2011 period, due to volume discounts in the prior year on an upgrade project with the Fortune 500 Company described above. Selling, general and administrative expenses remained flat at $11,192,000 in 2012 compared to $11,229,000 in 2011 due to cost reduction measures taken in the second quarter offset by additional administrative costs in our United Kingdom facility. Operating income decreased to $3,419,000 in 2012 compared to $12,285,000 in 2011.

JDL Technologies, Inc.

JDL Technologies, Inc. sales decreased 75% in the first six months of 2012 to $1,913,000 compared to $7,782,000 in 2011.

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JDL s revenues by customer group were as follows:

	JDL Revenue by Customer Group	
	2012	2011
Broward County FL schools	$ 1,182,000	$ 7,570,000
All other	731,000	212,000
	$ 1,913,000	$ 7,782,000

Revenues earned in Broward County FL decreased $6,388,000 or 84% in 2012. In the first quarter of 2010, the Company received significant funding for federal government contract work. This contract work was of a long-term nature, and the Company completed these contracts during the quarter ended September 30, 2011. All other revenues increased $519,000 due to JDL s concentrated effort to expand its market focus.

JDL gross margin decreased 83% to $595,000 in the first six months of 2012 compared to $3,505,000 in the same period in 2011. Gross margin as a percentage of sales decreased to 31% in 2012 from 45% in 2011 due to purchasing discounts and rebates the Company was able to take advantage of during the first half of the prior year. Selling, general and administrative expenses increased 11% in 2012 to $1,114,000 compared to $1,001,000 in 2011 due to increased sales and marketing expenses as JDL has expanded its market focus. JDL reported an operating loss of $519,000 in the first six months of 2012 compared to operating income of $2,504,000 in the same period of 2011.

Other

Income before income taxes decreased to $1,539,000 in 2012 compared to $11,425,000 in 2011. The Company s effective income tax rate was 33% in 2012 as compared to 42% in 2011. This effective rate was lower than the standard rate of 35% due to state income taxes, provisions for interest charges, the release of valuation allowance placed on foreign net operating losses, and the effect of operations conducted in lower foreign tax rate jurisdictions.

Liquidity and Capital Resources

As of June 30, 2012, the Company had approximately $37,285,000 in cash, cash equivalents and investments. Of this amount, $643,000 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, which are fully insured through the FDIC. The Company also had $22,820,000 in investments consisting of certificates of deposit, commercial paper, corporate notes and bonds, and municipal bonds that are traded on the open market and are classified as available-for-sale at June 30, 2012.

The Company had current assets of approximately $86,264,000 and current liabilities of $12,862,000 at June 30, 2012 compared to current assets of $89,946,000 and current liabilities of $15,388,000 at December 31, 2011.

Cash flow used in operating activities was approximately $4,831,000 in the first half of 2012 compared to $4,017,000 used by operations in the same period of 2011. Significant working capital changes from December 31, 2011 to June 30, 2012 included a decrease in accrued compensation and benefits of $2,527,000 related to the payment of the Company s annual and long term compensation during the first quarter and an increase in inventories of $5,060,000 due to high production levels related to increased orders and new product initiatives within one of our business segments.

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Net cash used in investing activities was $411,000 in the first half of 2012 compared to $408,000 in cash provided in the same period of 2011. The Company continued to make capital investments and purchases of certificates of deposit and other marketable securities.

Net cash used by financing activities was $2,812,000 in the first half of 2012 compared to $2,575,000 in the same period of 2011. Cash dividends paid on common stock increased to $2,639,000 in 2012 ($0.32 per common share) from $2,528,000 in 2011 ($0.30 per common share). Proceeds from common stock issuances, principally shares sold to the Company s Employee Stock Ownership Plan and under the Company s Employee Stock Purchase Plan, totaled approximately $220,000 in 2012 and $126,000 in 2011. The Company purchased and retired 19,247 shares in 2012 and none in 2011. At June 30, 2012, Board of Director authority to purchase approximately 462,691 additional shares remained in effect.

The Company has a $10,000,000 line of credit from Wells Fargo Bank. Interest on borrowings on the credit line is at LIBOR plus 1.1% (1.6% at June 30, 2012). There were no borrowings on the line of credit during the first six months of 2012 or 2011. The credit agreement expires October 31, 2013 and is secured by assets of the Company.

As part of the acquisition of the new Minnetonka headquarters building in July 2007, the Company assumed an outstanding mortgage of $4,380,000. The mortgage is payable in monthly installments and carries an interest rate of 6.83%. The mortgage matures on March 1, 2016. Mortgage payments on principal totaled $210,000 during 2012. The outstanding balance on the mortgage was $1,792,000 at June 30, 2012.

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 2011 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 three months ended June 30, 2012.

The Company s accounting policies have been consistently applied in all material respects and disclose such matters as allowance for doubtful accounts, sales returns, inventory valuation, warranty expense, income taxes, revenue recognition, asset and goodwill 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.

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Recently Issued Accounting Pronouncements

We do not believe there are any recently issued accounting standards that have not yet been adopted that would have a material impact on the Company s 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 June 30, 2012 our bank line of credit carried a variable interest rate based on LIBOR plus 1.1%.

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

The Company carried out an evaluation, under the supervision and with the participation of its management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in the Exchange Act Rule 13a-15(e)) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective.

There was no change 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.

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

In the three months ending June 30, 2012, the Company repurchased shares of stock as follows:

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (1)
April 2012				481,938
May 2012				481,938
June 2012	19,247	$10.76	19,247	462,691
Total	19,247	$10.76	19,247	462,691

(1) Shares represent remaining amount of a 500,000 share repurchase authorization approved by the Company s Board in October 2008 and publicly announced in November 2008.

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).

99.1 Press Release dated August 8, 2012 announcing 2012 Second Quarter Results.

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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 thereto duly authorized.

		Communications Systems, Inc.
	By	/s/ William G. Schultz William G. Schultz
Date: August 9, 2012		President and Chief Executive Officer
		/s/ David T. McGraw David T. McGraw
Date: August 9, 2012		Chief Financial Officer