ELECTRO SENSORS INC
Form 10-K
March 21, 2014
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-K

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

For the fiscal year ended December 31, 2013
or

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

Commission file number 000-09587

ELECTRO-SENSORS, INC.

(Exact name of registrant as specified in its charter)

Minnesota	**41-0943459**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

6111 Blue Circle Drive
Minnetonka, Minnesota 55343-9108
(Address of principal executive offices, including zip code)

(952) 930-0100
(Registrant s telephone number)

Securities registered under Section 12(b) of the Exchange Act:
Common Stock, $0.10 par value, registered on the NASDAQ (Capital) Market
Securities registered under Section 12(g) of the Exchange Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yes o No x

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 if disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form

10-K or any amendment to this Form 10-K. x

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). o Yes x No

The aggregate market value of the voting stock held by non-affiliates (persons other than officers, directors, or holders of more than 5% of the outstanding stock) of the registrant was approximately $5,200,000 based upon the closing price of the Common Stock as reported on The Nasdaq Stock Market® on June 30, 2013.

The number of shares outstanding of the registrant s Common Stock, $0.10 par value, on March 19, 2014 was 3,395,521.

DOCUMENTS INCORPORATED BY REFERENCE

Certain information called for by Part III of this Form 10-K is incorporated by reference from the registrant s Definitive Proxy Statement which will be filed pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

ELECTRO-SENSORS, INC.
Form 10-K for the Year Ended December 31, 2013
TABLE OF CONTENTS

Table of Contents

PART I

Item 1. Business.

Introduction

Electro-Sensors, Inc. (we , us , our , the Company or ESI) is engaged in the manufacturing and distribution of industrial production monitoring process control systems.

In addition, through our subsidiary ESI Investment Company, we periodically make strategic investments in other businesses and companies, primarily when we believe that these investments will facilitate development of technology complementary to our existing products. Although we invest in other businesses and companies through our subsidiary ESI Investment Company, we do not intend to become an investment company and intend to remain primarily an operating company. As of March 19, 2014, our primary investment is 192,157 shares of Rudolph Technologies, Inc., which is accounted for using the available-for-sale method.

Unless indicated otherwise, the terms Company and ESI when used herein, include Electro-Sensors, Inc. and its consolidated subsidiaries. As of December 31, 2013, ESI had two consolidated subsidiaries: ESI Investment Company and Senstar Corporation. Senstar Corporation does not have any business operations.

ESI was incorporated in Minnesota in July 1968. Our executive offices are located at 6111 Blue Circle Drive, Minnetonka, Minnesota, 55343-9108. Our telephone number is (952) 930-0100.

Products

We manufacture and sell several different types of monitoring systems that measure actual machine production and operation rates, as well as systems that regulate the speed of related machines in production processes.

Our original products speed monitoring systems compare machine revolutions per minute or speed against acceptable rates as determined by a customer. The monitors generally have the same relative operating principle and use a non-contacting sensing head that translates the speed of a rotating shaft into analog readouts. The systems vary in complexity, from a simple system that detects slow-downs or stoppages, to more sophisticated systems that warn of deviations from precise tolerances and that permit various subsidiary operations to be determined through monitoring the shaft speed.

The speed monitoring systems also include a line of digital products that translate sensor impulses from its production monitoring systems into digital readouts indicating production counts or rates, such as parts, gallons, or board feet. The speed monitoring systems also include alarm systems, tachometers, and other devices that translate impulses from the sensors into alarm signals, computer inputs, or digital displays that are usable by the customer.

Three production monitoring devices that do not operate by measuring shaft speeds are also in the speed monitoring systems product line. These devices are the tilt switch, vibration monitor, and slide gate position monitor. A tilt switch is designed to alert the operator when a storage bin or production system reaches a certain capacity (*e.g.,* when grain fills a silo). A vibration monitor will alert an operator when the vibration of a machine in a production system exceeds or is below a specified level. The slide gate position monitor is used in plant operations to provide feedback of the position of a slide gate. As part of our Electro-Sentry Hazard Monitoring system, we also have temperature sensors that are used to monitor bearing temperature and belt misalignment.

We have several products used in drive control systems that regulate the speed of motors on related machines in a production sequence to ensure that the performances of various operations are coordinated. The products consist of a line of digital control products for motors that require a complete closed loop PID (Proportional Integral Derivative) control. The closed loop controllers coordinate production speed among process motors and reduce waste.

We have a sales agreement with Motrona GmbH (the West German manufacturer of control and interface devices), giving us rights to distribute their products in the United States. These products interface with our products on various applications.

We believe that a wide variety of organizations can achieve significant savings in both time and materials by adding production monitoring and drive control technology to existing processes to coordinate the operation of related machines. Our products are sold into both the retro-fit market and into new manufacturing or processing systems.

3

Table of Contents

In 2008, we introduced our Electro-Sentry Hazard Monitoring System, which integrates our sensors for montioring temperature, belt misalignment, and shaft speed with a programmable logic controller and touch screen interface to create a complete system for hazard monitoring. The system enables our customers to locate which part of the material handling system is operating incorrectly, typically in less than ten seconds, by using visual diagrams on a touch screen. In 2012, we introduced the Electro-Sentry 16 hazard monitoring system and added new features to the Electro-Sentry 1 system.

In 2013, the Company added ION Frequency/Discrete-In, a product that allows users to remotely acquire shaft speed from up to 12 pulse-frequency-output shaft speed sensors, or discrete state for up to 12 switches/sensors, or any combination (up to 12) of both. This is our third ION product, completing the ION product line to support all ESI sensor products and providing the customer high-speed/accuracy signal acquisition at low cost and saved wiring costs. The Company also expanded the Series 18 shaft speed sensors to include additional housings and connection options to reach a broader range of installations. In addition, product upgrades for sensing capability and ruggedness were introduced on the Hall-effect sensors.

February 2014 Acquisition of Wireless Hazard Monitoring System

On February 18, 2014, the Company purchased the Insta-Link wireless hazard technology monitoring system and product family, together with related technology and intellectual property rights, from Harvest Engineering Inc., a privately held Illinois-based corporation, and its affiliated parties and owners (Harvest). The Company will market the wireless hazard monitoring products under its new HazardPRO™ product line and manufacture and service these products at its Minnetonka, Minnesota facility.

The Company agreed to pay $1,200,000 for the product line, of which $400,000 was paid at closing, and additional payments of $400,000 will be paid on each of the first and second anniversary of the closing. Harvest may earn up to an additional $550,000 of purchase price, depending upon the achievement of revenue measures during the four calendar years following the closing.

We expect to continue to expend resources in new product development and the marketing of new and existing products for use in a wide variety of monitoring applications.

Our customers have diverse applications for our products in the grain, feed, bio-fuels, power generation, water utilities and waste water treatment, mining, chemical, and other processing areas. We are continuing to look for new industries to expand sales and may also consider acquiring compatible businesses as part of our growth strategy. Our corporate web site provides significant information and product application knowledge to existing and prospective customers and also direct knowledge to our sales partners. Information on our website is not incorporated by reference herein and is not a part of this Form 10-K.

Marketing and Distribution

We sell our products primarily through both our internal sales team and a number of manufacturer s representatives and distributors located throughout the United States, Canada, Mexico, Bolivia, Chile, Colombia, Guatemala, Peru, Great Britain, Egypt, Saudi Arabia, Australia, China, Korea, Malaysia, Philippines, Singapore, and Taiwan. The sensing and control units are sold under the Electro-Sensors, Inc. brand as a range of products from simple sensors to complex motor speed controllers. These products are sold to businesses in wide variety of industries, including grain, feed, biofuels, food processing, chemicals, agricultural, mining, utility, forest products, steel, tire, glass and electronics. Any business that uses machinery with a rotating shaft is a potential customer.

We advertise in national industrial periodicals that cover a range of industrial products and attend several local, national and international tradeshows designated for the industry throughout the year. We also use our corporate website and other related industry websites for advertising and marketing purposes.

Competition

Competition for our monitoring products arises from a broad range of industrial and commercial businesses. Design, quality and multiplicity of application, rather than price, are the focus of competition in selling these products. We face substantial competition for our production monitoring systems. Many of these competitors are well established and larger than us in terms of total sales volume. Among our larger competitors are Danaher Controls, Red Lion Controls, Control Concepts, 4B Elevator Components Ltd., Durant Corporation, and Contrex, Inc. We believe our competitive advantages include that our products are sold as ready-to-install units and that our products have a wide range of applications. Our major disadvantages include the fact that our major competitors are much larger, have a broader variety of sensing instruments, and have larger sales forces and established names.

Table of Contents

Suppliers

We purchase parts and materials for our systems from various manufacturers and distributors. In some instances, these materials are manufactured in accordance with proprietary designs. Multiple sources of these parts and materials are generally available, and we are not dependent on any single source for these supplies and materials. We have not experienced any significant problem of short supply or delays from our suppliers.

Customers

We are not dependent upon a single or a few customers for a material (10% or more) portion of our sales.

Patents, Trademarks and Licenses

The Company relies on a combination of patent, trademark, and trade secret laws to establish proprietary right in its products.

The name Electro-Sensors is trademark registered with the U.S. Patent and Trademark Office (USPTO), as Reg. No. 1,142,310. We believe our trademark has been and will continue to be useful in developing and protecting market recognition for our products. We established the HazardPRO™ trademark in the first quarter of 2014 and will register the trademark with the USPTO during 2014.

We hold six patents relating to our production monitoring systems. The Company believes strongly in protecting its intellectual property and has a long history of obtaining patents, when available, in connection with its research and product development programs. The Company also relies upon trade secrets and proprietary know-how.

The Company seeks to protect its trade secrets and proprietary intellectual property, including know-how, in part, through confidentiality agreements with employees, consultants, and other parties. We cannot ensure, however, that these agreements will not be breached, that the Company would have adequate remedies for any breach, or that the Company s trade secrets will not otherwise become known or independently developed by competitors.

Business Development Activities

The Company continues to seek growth opportunities, both internally through the Company s existing portfolio of products, technologies and markets, as well as externally through technology partnerships or related-product acquisitions.

Governmental Approvals

We are not required to obtain governmental approval of our products.

Effect of Governmental Regulations

We do not believe that any existing or proposed governmental regulations will have a material effect on our business.

Research and Development

We invest in research and development programs to develop new products in related markets and to integrate state of the art technology into existing products. We incurred research and development expenses of $560,000 and $443,000 during 2013 and 2012, respectively. Our development projects are undertaken based upon the identified specific needs of our customer base.

Our future success is dependent in part upon our ability to develop new products in our varying segments. Difficulties or delays in our ability to develop, produce, test and market new products could have a material adverse effect on future sales growth.

Compliance with Environmental Laws

Compliance with federal, state and local environmental laws has only a nominal effect on current or anticipated capital expenditures and has had no material effect on earnings or on our competitive position.

Table of Contents

Employees

As of March 19, 2014, we had 31 employees, of whom all are full-time. We believe that our relations with our employees are good. None of our employees are members of unions.

Our ability to maintain a competitive position and to continue to develop and market new products depends, in part, on our ability to retain key employees and qualified personnel. If we are unable to retain our key employees, or recruit and train others, our product development, marketing and sales could be negatively impacted.

Fluctuations in Operating Results.

We have experienced fluctuations in our operating results in the past, and may experience fluctuations in the future, which may affect the market price of our Common Stock. Sales can fluctuate as a result of a variety of factors, many of which are beyond our control. Some of these factors are: product competition and acceptance, timing of customer orders, cancellation of orders, the mix of products sold, downturns in the market and economic disruptions. Because fluctuations can happen, we caution investors that results of our operations for preceding periods may not be indicative of how we will perform in the future. We cannot ensure that we will experience revenue or earnings growth.

Further, investments held by our subsidiary, ESI Investment Company, are subject to significant positive and negative changes in value. In particular, our significant investment in Rudolph Technologies, Inc. has experienced substantial value fluctuations, both negative and positive, which are expected to continue. Our current intention is to continue to gradually liquidate our investment securities to finance our working capital needs as required.

Expending Funds for Changes in Industry Standards, Customer Preferences or Technology.

Our business depends upon periodically introducing new and enhanced products and solutions for customer needs. Our product development requires us to commit financial resources, personnel and time, usually in advance of significant market demand for these products. In order to compete, we must anticipate both future demand and the technology available to meet that demand. We cannot ensure that our research and development efforts will lead to new products or product innovations that can be made available to or will be accepted by the market.

Table of Contents

Cautionary Statements

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements made by us or on our behalf. We have made, and may continue to make, forward-looking statements with respect to our business and financial matters, including statements contained in this document, other filings with the Securities and Exchange Commission, and reports to shareholders. Forward-looking statements generally include discussion of current expectations or forecasts of future events and can be identified by the use of terminology such as believe, estimate, expect, intend, may, could, will, and similar words or expressions. Any statement that does not relate solely to historical fact sh considered forward-looking.

Our forward-looking statements generally relate to our growth strategy, future financial results, product development and sales efforts. Forward-looking statements are made throughout this Annual Report, but primarily in this Item 1 and Item 7 -*Management s Discussion and Analysis of Financial Condition and Results of Operations*, and include statements relating to management s intentions that we not become an investment company, our expectations and intentions with respect to growth, statements relating to management s beliefs with respect to our marketing and product development, our expectations and beliefs with respect to the value of our intellectual property, our beliefs with respect to our competitive position in the marketplace, our beliefs with respect to the effect of governmental regulations on our business, our beliefs with respect to our employee relations, our intention with respect to gradually liquidating our investment securities to finance working capital needs, our expectations and beliefs with respect to the future performance of our investment securities, the adequacy of our facilities, expansion of the number of our manufacturer s representatives and exclusive distributors, our intention to develop new products, the possibility of acquiring compatible businesses as part of our growth strategy, and our expectations with respect to our cash requirements and use of cash.

Forward-looking statements cannot be guaranteed and actual results may vary materially due to the uncertainties and risks, known and unknown, associated with such statements, including our ability to successfully develop new products and manage our cash requirements. We undertake no obligations to update any forward-looking statements. We wish to caution investors that the following important factors, among others, in some cases have affected and in the future could affect our actual results of operations and cause such results to differ materially from those anticipated in forward-looking statements made in this document and elsewhere by us or on our behalf. It is not possible to foresee or identify all factors that could cause actual results to differ from expected or historical results. As such, investors should not consider any list of such factors to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions. These factors include:

- our ability to successfully develop new products;
- our ability to successfully integrate the wireless hazard technology and product line we purchased in February 2014;
- our ability to quickly and successfully adapt to changing industry technological standards;
- our ability to comply with existing and changing industry regulations;
- our ability to manage cash requirements;
- our ability to attract and retain new manufacturer s representatives and distributors;
- our ability to attract and retain key personnel, including senior management;
- our ability to adapt to changing economic conditions and manage downturns in the economy in general; and
- our ability to keep pace with competitors, some of whom are much larger and have substantially greater resources than us.

Item 1A. Risk Factors.

Not required for smaller reporting companies.

Item 2. Properties.

We own and occupy a 25,400 square foot facility at 6111 Blue Circle Drive, Minnetonka, Minnesota 55343-9108. All operations are conducted within this facility. The facility is in excellent condition and we continue to maintain and update the facility as necessary. The facility is anticipated to be adequate for our needs in 2014.

Item 3. Legal Proceedings.

We are not the subject of any legal proceedings as of the date of this filing. We are not aware of any threatened litigation.

Table of Contents

Item 4. Mine Safety Disclosures.

Not applicable.

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Our Common Stock trades on the Nasdaq Capital Market of The Nasdaq Stock Market® under the symbol ELSE . The following table sets forth the quarterly high and low reported last sales prices for our Common Stock for each period indicated as reported on the Nasdaq system.

	Period	High	Low
2013	First Quarter	$ 4.62	$ 3.67
	Second Quarter	$ 4.66	$ 4.04
	Third Quarter	$ 4.83	$ 4.00
	Fourth Quarter	$ 4.59	$ 3.85
2012	First Quarter	$ 4.37	$ 3.59
	Second Quarter	$ 4.40	$ 3.99
	Third Quarter	$ 4.20	$ 3.29
	Fourth Quarter	$ 4.11	$ 3.61

Based on data provided by our transfer agent, management was informed that as of March 19, 2014, the number of share owner accounts of record was approximately 87. The Company is aware that there are additional shareholders in which the shares are held in the street name.

The Company paid cash dividends for a number of years, paying $272,000 in 2013 and $543,000 in 2012. In July 2013, the Company s Board announced that it had temporarily suspended the Company s dividend. In February 2014, the Board formally suspended the dividend to give the Company flexibility to pursue opportunities for future growth. The Board will continue to assess its capital resources and its working capital and liquidity needs, as well as strategic opportunities. The Company will consider various options for increasing shareholder value. These options may include acquisitions, partnerships, purchasing our own shares in the open market and in privately negotiated transactions, and resuming the payment of cash dividends.

From time to time, we may be required to repurchase some of our equity securities as a result of obligations described in Note 9 to our 2013 consolidated financial statements. We did not repurchase any equity securities during the years ended December 31, 2013 and 2012.

Item 6. Selected Financial Data.

Not required for smaller reporting companies.

Table of Contents

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read in conjunction with our consolidated financial statements and related notes. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated due to various factors discussed under Forward-Looking Statements elsewhere in this Annual Report on Form 10-K.

RESULTS OF OPERATIONS

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

	Year Ended December 31, 2013	2012
Net Sales	100.0%	100.0%
Cost of Goods Sold	42.8	44.0
Gross Profit	57.2	56.0
Operating Expenses		
Selling and marketing	22.0	20.7
General and administrative	20.7	15.7
Research and development	8.6	6.8
Total Operating Expenses	51.3	43.2
Operating Income	5.9	12.8
Non-operating Income		
Gain on sale of available-for-sale securities	8.1	12.2
Interest income	.1	.1
Other income	.2	.2
Total Non-operating Income	8.4	12.5
Income before Income Taxes	14.3	25.3
Income Taxes	3.5	8.6
Net Income	10.8%	16.7%

The following paragraphs discuss the Company s performance for years ended December 31, 2013 and 2012.

Comparison of 2013 vs. 2012

Net Sales

Net sales increased $43,000 or 0.7%, to $6,541,000 in 2013 from $6,498,000 in 2012. Net sales increased steadily throughout the year reaching $3,104,000 for the six-month period ending June 30, 2013 and increasing by 10.7% to $3,438,000 in the second half of the year ending December 31, 2013. This increase was primarily driven by a 25.7% increase in system-level orders, which contain multiple pieces of monitoring equipment. We believe these larger projects were generally related to broader facility improvements, modernization programs, and capacity upgrades as companies responded to more favorable economic conditions and improved harvest yields. In addition, we experienced strong activity in the industrial and agricultural industries in the Canadian market resulting in a 32.7% year-over-year sales increase in that market.

Cost of Sales

Our cost of goods sold decreased $60,000 or 2.1%, to $2,798,000 from $2,858,000 in 2012, primarily due to a change in the mix of products, with a relative increase in the sale of higher margin products. We continue our efforts to maintain or reduce our production costs by manufacturing products in the most cost effective manner.

9

Table of Contents

Gross Profit

Gross profit for 2013 was 57.2% compared to 56.0% in 2012. The slight increase in the gross margin was primarily due to both a price increase that we put into effect in January 2013, and our focus on driving down manufacturing costs.

Operating Expenses

Total operating expenses increased by $545,000, or 19.4%, to $3,354,000 in 2013 compared to $2,809,000 in 2012. This increase was due to the following:

Selling and marketing costs increased by $98,000, or 7.3%, to $1,442,000 in 2013 compared to $1,344,000 in 2012. The increase was due to increased wages and benefit expense related to additional sales personnel and increased travel costs related to a higher number of customer visits, partially offset by decreases in marketing expenses and bonuses.

General and administrative costs increased by $330,000, or 32.3%, to $1,352,000 in 2013 compared to $1,022,000 in 2012. The increase was due primarily to noncash compensation expense on stock option grants for non-employee directors and our chief executive officer; depreciation and amortization expense related to the upgrade of our enterprise software system and related hardware; legal and professional fees related to our February 2014 acquisition of Harvest Engineering; compensation resulting from the July 2013 management transition; and a new director and officer liability insurance policy. These increases were partially offset by a decrease in bad debt expense due to 2012 write offs that did not occur in 2013. Stock-based compensation for 2013 was approximately $162,000 compared to approximately $6,000 in 2012.

Research and development costs increased $117,000, or 26.4%, to $560,000 in 2013 compared to $443,000 in 2012. The 2013 increase resulted from higher wages and benefits due to changes in management responsibilities and lab testing fees for the certification of new products for use in hazardous locations.

Operating Income

Operating income decreased by $442,000 or 53.2%, to $389,000 in 2013 from $831,000 in 2012, due primarily to the operating expense increases discussed above.

Non-Operating Income

ESI Investment Company continues to provide us with an alternative source of earnings through investments in available-for-sale securities and other investments. We intend to remain an operations-based company. Our investments in available-for-sale securities are subject to significant positive and negative changes in value. In addition to gains from the sale of investments, we also realize interest income from short-term holdings.

Non-operating income decreased by $262,000 to $549,000 in 2013 from $811,000 in 2012, primarily as a result of fewer gains on the sale of investments. The Company recognized a gain on sale of investments of $530,000 and $794,000 in 2013 and 2012, respectively, primarily from sales of shares of Rudolph Technologies, Inc.. The Company is in the process of slowly liquidating that investment.

Available-for-sale securities are stated at fair value, and unrealized holding gains and losses, net of the related deferred tax effect, are reported as a separate component of stockholders equity. Dividends on marketable equity securities are recognized on the ex-dividend date.

Realized gains and losses, including losses from declines in value of specific securities determined by management to be other-than-temporary, are included in the statement of comprehensive income. Realized gains and losses are determined on the basis of the specific securities sold.

Net Income After Tax

We reported 2013 net income of $706,000 as compared to net income of $1,086,000 in 2012, a decrease of $380,000, or 35.0%. Basic and diluted earnings per share were $0.20 in 2013, compared to basic and diluted earnings per share of $0.32 and $0.31, respectively, in 2012.

Table of Contents

OFF-BALANCE SHEET ARRANGEMENTS

We are not a party to any off-balance sheet transactions, arrangements or obligations that have, or are reasonably likely to have, a material effect on our financial condition, changes in the financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were $1,505,000 and $1,102,000 at December 31, 2013 and 2012, respectively. The increase was mainly due to net cash from investing activities, as described below. Working capital was $11,068,000 at 2013 year end compared to $11,400,000 at 2012 year end.

Cash generated from 2013 operating activities was $127,000, compared to $732,000 generated in 2012, a decrease of $605,000. The decrease was primarily a result of a decrease in our net income adjusted for the gain on the sale of investments and noncash stock compensation expense, an increase in trade receivable, and a decrease in income tax accruals, partially offset by the change in inventories. The net change in trade receivables was primarily due to an increase of $142,000 in the balance at December 31, 2013 compared to the prior year and a decrease of $57,000 in the balance at December 31, 2012 when compared to the prior year. The increase is due to increased sales in the fourth quarter of 2013. The net change in income taxes was due to an increase in the receivable balance of $314,000 at December 31, 2013 compared to the prior year and an increase in the payable balance of $330,000 at December 31, 2012 when compared to the prior year. The increase in the net receivable was due to the timing of tax payments to meet IRS safe harbor rules. In 2013, the Company made estimated tax payments based on income. The Company made tax payments in 2012 based on the 2011 tax liability and paid the 2012 balance in March 2013. Those changes were partially offset by the $270,000 inventory decrease in the balance at December 31, 2013 compared to the prior year and an increase of $102,000 in the balance at December 31, 2012 when compared to the prior year. The decrease as of December 31, 2013 was due to increased sales in the fourth quarter of 2013.

Cash generated from 2013 investing activities was $539,000, compared to $4,571,000 of cash used in 2012 investing activities. We received $536,000 on the sale of investments during 2013 compared to $874,000 during 2012. During 2012, the Company implemented a significant increase in the purchase of Treasury Bills with maturity dates of more than three months. During 2013, the Company s proceeds from and purchases of Treasury Bills were roughly equivalent and the Company generated 2013 net proceeds of $26,000. We purchased $23,000 and $196,000 of property and equipment in the years ended December 31, 2013 and 2012, respectively.

Cash used in financing activities was $263,000 and $535,000 for 2013 and 2012, respectively. During 2013 and 2012, we paid aggregate dividends of $272,000 and $543,000, respectively. During 2013 and 2012, we had $9,000 and $8,000, respectively, in stock purchases under our 1996 Employee Stock Purchase Plan.

We intend that our ongoing cash requirements will be primarily used for capital expenditures, potential acquisitions, 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 231,336 and 273,267 shares of Rudolph Technologies, Inc. (Rudolph), as of December 31, 2013 and 2012, respectively, listed on the Nasdaq stock market. We account for the Rudolph investment using the available-for-sale method. The fair value of the Rudolph investment totaled $2,716,000 and $3,673,000 as of December 31, 2013 and 2012, respectively. Our Rudolph shares are subject to fluctuations in price and could have a negative effect on our liquidity. Liquid securities are periodically sold as deemed appropriate by management. The market value of the Rudolph stock as of March 18, 2014 was approximately $2,169,000.

Table of Contents

CRITICAL ACCOUNTING ESTIMATES

The preparation of our consolidated 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.

Significant estimates, including the underlying assumptions, consist of the economic lives of property and equipment, realizability of accounts receivable, and valuation of deferred tax assets/liabilities, inventory, investments, and stock compensation expense. It is at least reasonably possible that these estimates may change in the near term.

Economic lives of property and equipment
We estimate the economic useful life of property and equipment used in the business. Expected asset lives may be shortened or an impairment would be recorded based on a change in the expected use of the asset.

Realizability of accounts receivable
We estimate our allowance for doubtful accounts based on prior history and the aging of our accounts receivable. We are unable to predict which, if any, of our customers will be unable to pay their open invoices at a future date.

Valuation of deferred tax assets/liabilities
We estimate our deferred tax assets and liabilities based on current tax laws and rates. The tax laws and rates could change in the future to either disallow the deductions or increase/decrease the tax rates.

Valuation of inventory
We purchase inventory based on estimated demand of products. It is possible that the inventory we have purchased will not be used in the products that our customers need or meet future technological requirements.

Valuation of investments
Our investments in equity securities are valued at market prices in an open market. The prices are subject to the normal fluctuations that could be either negative or positive.

Valuation of Stock-based Compensation Expense
We estimate the expected life and forfeiture rates of stock options granted when calculating the value of options using the Black-Sholes-Merton model. The actual life and forfeiture rate could be different from what we estimated.
Additional information regarding our significant accounting policies is provided below in Part II, Item 8, *Financial Statements and Supplementary Data Notes to Consolidated Financial Statements, Note 1, Nature of Business and Significant Accounting Policies*.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.
Not applicable.

Table of Contents

Item 8. Financial Statements and Supplementary Data.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors
Electro-Sensors, Inc. and Subsidiaries
Minnetonka, Minnesota

We have audited the accompanying consolidated balance sheets of Electro-Sensors, Inc. and Subsidiaries (the Company) as of December 31, 2013, and 2012, and the related consolidated statements of comprehensive income, changes in stockholders equity, and cash flows for each of the years in the two-year period ended December 31, 2013. Electro-Sensors, Inc. and Subsidiaries management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Electro-Sensors, Inc. and Subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America.

/s/ Boulay PLLP
Certified Public Accountants

Minneapolis, Minnesota
March 21, 2014

Table of Contents

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

	December 31 2013	December 31 2012
ASSETS		
Current assets		
Cash and cash equivalents	**$ 1,505**	$ 1,102
Treasury bills	**5,227**	5,248
Available-for-sale securities	**2,718**	3,677
Trade receivables, less allowance for doubtful accounts of $8 and $10, respectively	**746**	602
Inventories	**1,060**	1,330
Income tax receivable	**1**	0
Other current assets	**135**	75
Total current assets	**11,392**	12,034
Property and equipment, net	**1,217**	1,304
Total assets	**$ 12,609**	$ 13,338
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	**$ 59**	$ 94
Accrued expenses	**265**	227
Income tax payable	**0**	313
Total current liabilities	**324**	634
Deferred income tax liability	**1,022**	1,455
Commitments and contingencies		
Stockholders equity		
Common stock par value $0.10 per share; authorized 10,000,000 shares; issued and outstanding: 3,394,707 and 3,391,912 shares, respectively	**339**	339
Additional paid-in capital	**1,746**	1,575
Retained earnings	**7,547**	7,113
Accumulated other comprehensive income (unrealized gain on available-for-sale securities, net of income tax)	**1,631**	2,222
Total stockholders equity	**11,263**	11,249
Total liabilities and stockholders equity		