

ELECTRO SENSORS INC
Form 10-Q
November 10, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

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

For the quarterly period ended September 30, 2016

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

For the transition period from _____ to _____

Commission File Number 000-9587

ELECTRO-SENSORS, INC.

(Exact name of registrant as specified in its charter)

Michigan 481459

(State

or

other

jurisdiction

of (IRS Employer Identification No.)

incorporation

or

organization)

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

(952) 930-0100
(Registrant's telephone number,
including area code)

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

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

The number of shares outstanding of the registrant's common stock, \$0.10 par value, on November 9, 2016 was 3,395,521.

ELECTRO-SENSORS, INC.

Form 10-Q

For the Periods Ended September 30, 2016

TABLE OF CONTENTS

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited):

| | |
|--|---|
| <u>Consolidated Balance Sheets – As of September 30, 2016 and December 31, 2015</u> | 3 |
| <u>Consolidated Statements of Comprehensive Income – For the Three and Nine Months ended September 30, 2016 and September 30, 2015</u> | 4 |
| <u>Consolidated Statements of Cash Flows – For the Nine Months ended September 30, 2016 and September 30, 2015</u> | 5 |
| <u>Notes to Consolidated Financial Statements</u> | 6 |

| | |
|--|----|
| <u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> | 11 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 13 |
| <u>Item 4. Controls and Procedures</u> | 14 |

PART II – OTHER INFORMATION

| | |
|--|----|
| <u>Item 1. Legal Proceedings</u> | 14 |
| <u>Item 1A. Risk Factors</u> | 14 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 14 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 14 |
| <u>Item 4. Mine Safety Disclosures</u> | 14 |
| <u>Item 5. Other Information</u> | 14 |
| <u>Item 6. Exhibits</u> | 14 |

| | |
|--------------------------|----|
| <u>SIGNATURES</u> | 15 |
|--------------------------|----|

| | |
|------------------------|----|
| <u>EXHIBITS</u> | 16 |
|------------------------|----|

PART I. FINANCIAL INFORMATION**Item 1. Financial Statements****ELECTRO-SENSORS, INC.****CONSOLIDATED BALANCE SHEETS**

(in thousands except share and per share amounts)

| | September 30, 2016 (unaudited) | December 31, 2015 |
|--|---|-------------------------|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$ 792 | \$ 569 |
| Treasury bills | 7,432 | 7,872 |
| Trade receivables, less allowance for doubtful accounts of \$8 | 838 | 689 |
| Inventories | 1,517 | 1,564 |
| Other current assets | 187 | 170 |
| Income tax receivable | 17 | 0 |
| Deferred income tax asset | 0 | 14 |
| Total current assets | 10,783 | 10,878 |
| Deferred income tax asset | 215 | 170 |
| Intangible assets, net | 1,094 | 1,270 |
| Property and equipment, net | 1,046 | 1,103 |
| Total assets | \$ 13,138 | \$ 13,421 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities | | |
| Current maturities of note payable | \$ 0 | \$ 390 |
| Accounts payable | 157 | 136 |
| Accrued expenses | 407 | 396 |
| Accrued income tax | 0 | 4 |

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| | | |
|--|-----------|-----------|
| Deferred income tax liability | 5 | 0 |
| Total current liabilities | 569 | 926 |
| Long-term liabilities | | |
| Contingent earn-out | 383 | 455 |
| Total long-term liabilities | 383 | 455 |
| Commitments and contingencies | | |
| Stockholders' equity | | |
| Common stock par value \$0.10 per share; authorized 10,000,000 shares; 3,395,521 shares issued and outstanding | 339 | 339 |
| Additional paid-in capital | 1,945 | 1,879 |
| Retained earnings | 9,929 | 9,855 |
| Accumulated other comprehensive loss (unrealized loss on available-for-sale securities, net of income tax benefit) | (27) | (33) |
| Total stockholders' equity | 12,186 | 12,040 |
| Total liabilities and stockholders' equity | \$ 13,138 | \$ 13,421 |

See accompanying notes to unaudited consolidated financial statements

ELECTRO-SENSORS, INC.**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(in thousands except share and per share amounts)

(unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|---------|------------------------------------|---------|
| | 2016 | 2015 | 2016 | 2015 |
| Net sales | \$1,837 | \$2,132 | \$5,562 | \$6,065 |
| Cost of goods sold | 835 | 920 | 2,452 | 2,665 |
| Gross profit | 1,002 | 1,212 | 3,110 | 3,400 |
| Operating expenses | | | | |
| Selling and marketing | 387 | 368 | 1,262 | 1,186 |
| General and administrative | 386 | 389 | 1,199 | 1,194 |
| Research and development | 200 | 161 | 561 | 566 |
| Total operating expenses | 973 | 918 | 3,022 | 2,946 |
| Operating income | 29 | 294 | 88 | 454 |
| Non-operating income (expense) | | | | |
| Interest expense | 0 | (3) | (1) | (9) |
| Gain on sale of available-for-sale securities | 0 | 0 | 0 | 1,449 |
| Interest income | 3 | 4 | 18 | 6 |
| Other income | 3 | 4 | 12 | 11 |
| Total non-operating income, net | 6 | 5 | 29 | 1,457 |
| Income before income taxes | 35 | 299 | 117 | 1,911 |
| Income taxes | 12 | 104 | 43 | 667 |
| Net income | \$23 | \$195 | \$74 | \$1,244 |
| Other comprehensive income (loss) | | | | |
| Change in unrealized value of available-for-sale securities, net of income tax | 2 | 0 | 6 | 132 |
| Reclassification of gains included in net income, net of income tax | 0 | 0 | 0 | (899) |

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| | | | | |
|-----------------------------------|------|-------|------|--------|
| Other comprehensive income (loss) | 2 | 0 | 6 | (767) |
| Net comprehensive income | \$25 | \$195 | \$80 | \$477 |

Net income per share data:

| | | | | |
|-------------------------|-----------|-----------|-----------|-----------|
| Basic | | | | |
| Net income per share | \$0.01 | \$0.06 | \$0.02 | \$0.37 |
| Weighted average shares | 3,395,521 | 3,395,521 | 3,395,521 | 3,395,521 |

Diluted

| | | | | |
|-------------------------|-----------|-----------|-----------|-----------|
| Net income per share | \$0.01 | \$0.05 | \$0.02 | \$0.34 |
| Weighted average shares | 3,703,021 | 3,653,021 | 3,695,722 | 3,653,021 |

See accompanying notes to unaudited consolidated financial statements

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

(in thousands)

(unaudited)

| | Nine Months Ended September 30, | |
|--|---------------------------------------|---------|
| | 2016 | 2015 |
| Cash flows from (used in) operating activities | | |
| Net income | \$74 | \$1,244 |
| Adjustments to reconcile net income to net cash from (used in) operating activities: | | |
| Depreciation and amortization | 235 | 264 |
| Realized gain on sale of available-for-sale securities | 0 | (1,449) |
| Deferred income taxes | (26) | (34) |
| Stock-based compensation expense | 66 | 47 |
| Change in contingent earn-out fair value | (72) | (17) |
| Other | (18) | (7) |
| Change in: | | |
| Trade receivables | (149) | (176) |
| Inventories | 47 | (334) |
| Other current assets | (17) | (12) |
| Accounts payable | 21 | 50 |
| Accrued expenses | 11 | 85 |
| Accrued income taxes/income tax receivable | (21) | 110 |
| Net cash from (used in) operating activities | 151 | (229) |
| Cash flows from (used in) investing activities | | |
| Proceeds from sale of available-for-sale securities | 0 | 1,467 |
| Purchases of treasury bills | (7,425) | (8,636) |
| Proceeds from the maturity of treasury bills | 7,889 | 9,043 |
| Purchase of property and equipment | (2) | (19) |
| Net cash from investing activities | 462 | 1,855 |
| Cash flows used in financing activities | | |

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| | | |
|---|--------|---------|
| Payments on long-term debt | (390) | (381) |
| Net cash used in financing activities | (390) | (381) |
| Net increase in cash and cash equivalents | 223 | 1,245 |
| Cash and cash equivalents, beginning | 569 | 1,190 |
| Cash and cash equivalents, ending | \$792 | \$2,435 |
| Supplemental cash flow information | | |
| Cash paid for income taxes | \$90 | \$592 |
| Cash paid for interest | \$10 | \$19 |

See accompanying notes to unaudited consolidated financial statements

ELECTRO-SENSORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED SEPTEMBER 30, 2016

(in thousands except share and per share amounts)

(unaudited)

Note 1. Basis of Presentation

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

This report should be read together with the Company's Annual Report on Form 10-K for the year ended December 31, 2015, including the audited consolidated financial statements and footnotes therein.

Management believes that the unaudited financial statements include all adjustments, consisting of normal recurring accruals, necessary to fairly state the financial position and results of operations as of September 30, 2016 and for the three and nine-month periods then ended in accordance with accounting principles generally accepted in the United States of America. The results of interim periods may not be indicative of results to be expected for the year.

Nature of Business

Electro-Sensors, Inc. manufactures and markets a complete line of monitoring and control systems for a variety of industrial machinery. The Company uses leading-edge technology to continuously improve its products and make them easier to use, with the ultimate goal of manufacturing the industry-preferred product for every market served. The Company sells these products through an internal sales staff, manufacturers' representatives, and distributors to a wide variety of industries that use the products in a variety of applications to monitor process machinery operations. The Company markets its products to customers located throughout the United States, Canada, Latin America, Europe, and Asia.

Fair Value Measurements

The carrying value of cash equivalents, treasury bills, trade receivables, accounts payable, and other financial working capital items approximates fair value at September 30, 2016 and December 31, 2015, due to the short maturity nature of these instruments.

Stock-Based Compensation

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

Use of Estimates

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

ELECTRO-SENSORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED SEPTEMBER 30, 2016**(in thousands except share and per share amounts)**

(unaudited)

Note 2. Investments

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

| | Cost | Gross unrealized gain | Gross unrealized loss | Fair value |
|---------------------------------------|---------|-----------------------------|-----------------------------|---------------|
| September 30, 2016 | | | | |
| Money Market | \$240 | \$ 0 | \$ 0 | \$240 |
| Commercial Paper | 263 | 0 | 0 | 263 |
| Treasury Bills | 7,426 | 6 | 0 | 7,432 |
| Equity Securities | 54 | 0 | (54) | 0 |
| | 7,983 | 6 | (54) | 7,935 |
| Less Cash Equivalents | 503 | 0 | 0 | 503 |
| Total Investments, September 30, 2016 | \$7,480 | \$ 6 | \$ (54) | \$7,432 |
| December 31, 2015 | | | | |
| Money Market | \$246 | \$ 0 | \$ 0 | \$246 |
| Commercial Paper | 247 | 0 | 0 | 247 |
| Treasury Bills | 7,876 | 0 | (4) | 7,872 |
| Equity Securities | 54 | 0 | (54) | 0 |
| | 8,423 | 0 | (58) | 8,365 |
| Less Cash Equivalents | 493 | 0 | 0 | 493 |
| Total Investments, December 31, 2015 | \$7,930 | \$ 0 | \$ (58) | \$7,872 |

During the nine-month period ended September 30, 2015, the Company sold 122,649 shares of Rudolph Technologies, Inc. (ticker symbol RTEC) stock and reported gains of \$1,447 in non-operating income. As of September 30, 2016, the Company held no shares of RTEC stock.

ELECTRO-SENSORS, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE PERIOD ENDED SEPTEMBER 30, 2016****(in thousands except share and per share amounts)**

(unaudited)

Note 3. Fair Value Measurements

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

September 30, 2016

| | Carrying amount in consolidated balance sheet | Fair Value | Fair Value Measurement Using | | |
|---------------------|--|-----------------------|---|--------------------|--------------------|
| | | | Level 1 | Level 2 | Level 3 |
| Assets: | | | | | |
| Cash equivalents | | | | | |
| Money market funds | \$ 240 | \$240 | \$240 | \$ 0 | \$0 |
| Commercial paper | 263 | 263 | 263 | 0 | 0 |
| Treasury bills | 7,432 | 7,432 | 7,432 | 0 | 0 |
| Equity securities | 0 | 0 | 0 | 0 | 0 |
| Liabilities: | | | | | |
| Contingent earn-out | 383 | 383 | 0 | 0 | 383 |

December 31, 2015

| | Carrying amount in consolidated balance sheet | Fair Value Measurement Using | | |
|--|--|---|--|--|
| | | | | |
| | | | | |

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| | | Fair Value | Level 1 | Level 2 | Level 3 |
|---------------------|--------|---------------|------------|------------|------------|
| Assets: | | | | | |
| Cash equivalents | | | | | |
| Money market funds | \$ 246 | \$246 | \$246 | \$ 0 | \$0 |
| Commercial paper | 247 | 247 | 247 | 0 | 0 |
| Treasury bills | 7,872 | 7,872 | 7,872 | 0 | 0 |
| Equity securities | 0 | 0 | 0 | 0 | 0 |
| Liabilities: | | | | | |
| Contingent earn-out | 455 | 455 | 0 | 0 | 455 |

The fair value of the money market funds, commercial paper and treasury bills is based on quoted market prices in an active market. The available-for-sale equity security is a limited-marketable company. There is an insignificant market for the limited-marketable company and the Company has determined its value based on financial and other factors, which are considered level 3 inputs in the fair value hierarchy. Management estimated the probability of meeting the revenue targets over the measurement period to determine the fair value of the contingent earn-out, which is considered a level 3 input in the fair value hierarchy.

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

| | Period Ended September 30, 2016 2015 | |
|--------------------|--|-------|
| Beginning Balance | \$455 | \$472 |
| Credit to earnings | (72) | (17) |
| Ending Balance | \$383 | \$455 |

The decrease in the contingent liability reflects the Company's expectation of moderately lower future contingent payments throughout the four year earn-out period.

ELECTRO-SENSORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED SEPTEMBER 30, 2016

(in thousands except share and per share amounts)

(unaudited)

Note 4. Note Payable

The note payable consists of the following:

| | |
|---|----------------------|
| | December 31, 2015 |
| Note payable to seller | \$ 400 |
| Payable in annual installments of principal of \$400. The note was paid off in February 2016. This note was non-interest bearing and unsecured. | |
| Less: Discount of note payable listed above | (10) |
| Net note payable | 390 |
| Less: Current maturities | 390 |
| Note Payable – Long Term | \$ 0 |

Note 5. Stock-Based Compensation

During the first quarter of 2016, the Company granted its Chief Executive Officer options to purchase 50,000 shares of common stock. The options were priced at fair market value and vested 20% on the grant date, with an additional 20% vesting on the first four anniversaries of the grant date. The options expire ten years from the date of grant.

The assumptions made in estimating the fair value of the options on the grant date based upon the BSM option-pricing model for the nine months ended September 30, 2016 are as follows:

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| | |
|-------------------------|---------|
| Dividend yield | 0.00% |
| Expected volatility | 36.17% |
| Risk free interest rate | 1.31% |
| Expected life | 6 years |

As of September 30, 2016, there was approximately \$105 of unrecognized compensation expense. The Company expects to recognize this expense over the next four years.

ELECTRO-SENSORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FOR THE PERIOD ENDED SEPTEMBER 30, 2016**(in thousands except share and per share amounts)**

(unaudited)

Note 6. Segment Information

As of January 1, 2016, the Company has one reportable operating segment: Production Monitoring. During 2015, the Company had two reportable operating segments: Production Monitoring and Investments. The Production Monitoring Division manufactures and markets a complete line of production monitoring equipment. ESI Investment Company held investments in marketable and non-marketable securities.

The accounting policies of the segments are the same as those described in Note 1 of the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. In evaluating segment performance, management focuses on sales and income before income taxes. The Company had no inter-segment sales.

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

| | Three Months Ended September 30, 2016 | | Nine Months Ended September 30, 2015 | |
|--------------------------------|--|---------|---|---------|
| | 2016 | 2015 | 2016 | 2015 |
| External sales | | | | |
| Production monitoring | \$1,837 | \$2,132 | \$5,562 | \$6,065 |
| Total | \$1,837 | \$2,132 | \$5,562 | \$6,065 |
| Net income before income taxes | | | | |
| Production monitoring | \$35 | \$295 | \$117 | \$456 |
| Investments | N/A | 4 | N/A | 1,455 |
| Total | \$35 | \$299 | \$117 | \$1,911 |

N/A Not applicable

10

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

FORWARD-LOOKING STATEMENTS

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

All forward-looking statements in this document are based on information available to us as of the date of this Form 10Q, and we assume no obligation to update any of these forward-looking statements, other than as required by law. Our actual results could differ materially from those in projected or indicated in these forward-looking statements. These forward-looking statements are subject to certain risks and uncertainties that could cause future results to differ materially from our recent results or those projected in the forward-looking statements, including the accuracy of management’s assumptions with respect to industry trends, fluctuations in industry conditions, the accuracy of management’s assumptions regarding expenses and our cash needs and those listed under the heading “Cautionary Statements” under “Item 1—Business,” in our Annual Report on Form 10-K for the year ended December 31, 2015.

CRITICAL ACCOUNTING ESTIMATES

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make decisions based upon estimates, assumptions, and factors it considers relevant to the circumstances. These decisions include the selection of applicable accounting principles and the use of judgment in their application, and affect reported amounts and disclosures. Changes in economic conditions or other business circumstances may affect the outcomes of management’s estimates and assumptions. An in-depth description of our accounting estimates can be found in the interim financial statements included in this report and in our Annual Report on Form 10-K for the year ended December 31, 2015. We have not developed new estimates subsequent to those discussed in our Annual Report.

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

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|---|--|-------------|---|-------------|
| | 2016 | 2015 | 2016 | 2015 |
| Net sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of goods sold | 45.5 | 43.2 | 44.1 | 43.9 |
| Gross profit | 54.5 | 56.8 | 55.9 | 56.1 |
| Operating expenses | | | | |
| Selling and marketing | 21.1 | 17.3 | 22.7 | 19.6 |
| General and administrative | 21.0 | 18.2 | 21.5 | 19.7 |
| Research and development | 10.9 | 7.6 | 10.1 | 9.3 |
| Total operating expenses | 53.0 | 43.1 | 54.3 | 48.6 |
| Operating income | 1.5 | 13.7 | 1.6 | 7.5 |
| Non-operating income (expense) | | | | |
| Interest expense | 0.0 | (0.1) | 0.0 | (0.1) |
| Gain on sale of available-for-sale securities | 0.0 | 0.0 | 0.0 | 23.9 |
| Interest income | 0.2 | 0.2 | 0.3 | 0.1 |
| Other income | 0.2 | 0.2 | 0.2 | 0.1 |
| Total non-operating income, net | 0.4 | 0.3 | 0.5 | 24.0 |
| Income before income taxes | 1.9 | 14.0 | 2.1 | 31.5 |
| Income taxes | 0.7 | 4.9 | 0.8 | 11.0 |
| Net income | 1.2 | % 9.1 | % 1.3 | % 20.5 % |

The following discusses the Company's performance for the three and nine months ended September 30, 2016 and 2015.

RESULTS OF OPERATIONS (in thousands)

Net Sales

Net sales for the three-month period ended ending September 30, 2016 were \$1,837, a decrease of \$295 or 13.8% over the same period in 2015. Net sales for the 2016 nine-month period were \$5,562, a decrease of \$503 or 8.3% over the same period in 2015. The 2016 three-month decrease was primarily due to weaker performance in the east and southeastern regions of the U.S. Additionally, the strength of the U.S. dollar continued to negatively affect many of our international markets. Sales to Canada were particularly affected and were down 27% compared to the same three-month period in 2015.

Furthermore, during the quarter the Company experienced a lower average value per order, resulting in a decline in overall large order performance. We believe this was caused by a trend in our general manufacturing customers shifting their production from a build-to-stock to build-to-order strategy.

Gross Profit

Gross profit for the 2016 three-month period decreased \$210, or 17.3%, from \$1,212 to \$1,002, over the same period in 2015. Gross profit for the 2016 nine-month period decreased \$290 or 8.5%, from \$3,400 to \$3,110, over the 2015 period. Gross margin, as a percentage of net sales, decreased to 54.5% in the 2016 three-month period from 56.8% in the prior year, and decreased to 55.9% in the 2016 nine-month period compared to 56.1% in the prior year. The decrease in the gross margin was primarily due to product mix and under-utilization of capacity in production due to lower sales.

Operating Expenses

Total operating expenses increased \$55, or 6.0%, for the 2016 three-month period compared to the same period in 2015 and increased as a percentage of sales to 53.0% from 43.1%. Total operating expenses increased \$76, or 2.6%,

for the 2016 nine-month period compared to the same period in 2015 and increased as a percentage of sales to 54.3% from 48.6%. The increase in operating expenses as a percentage of sales was due primarily to the fact that 2016 third quarter sales decreased 13.8% from 2015 sales and the 2016 nine-month sales decreased 8.3% from 2015 sales.

Selling and marketing expenses increased \$19, or 5.2%, in the 2016 three-month period over the prior year, and increased as a percentage of net sales to 21.1% from 17.3%. Selling and marketing expenses increased \$76, or 6.4%, in the 2016 nine-month period over the prior year period, and increased as a percentage of net sales to 22.7% from 19.6%. The 2016 three-month period increase resulted from an increase in wages and benefits due to additional marketing personnel. The nine-month period increase resulted from higher wages and benefits due to hiring additional personnel, the cost of providing system demonstrations to potential customers, cost associated with attending a higher number of tradeshow, and increased travel.

General and administrative expenses decreased \$3, or 0.8%, for the 2016 three-month period compared to the same period in 2015, but increased as a percentage of net sales to 21.0% from 18.2%. For the 2016 nine-month period, general and administrative expenses increased \$5, or 0.4%, compared to the 2015 period and increased as a percentage of net sales to 21.5% from 19.7%. The decrease for the 2016 three-month period was primarily due to a decrease in amortization of our enterprise software and related hardware, which was fully amortized in 2015, partially offset by an increase in stock compensation expense for an option granted to the Chief Executive Officer in February 2016. The increase for the nine-month period resulted from an increase in wages and benefits, legal and professional fees, and director fees. This increase was partially offset by decreases in contract personnel, due to the 2015 expensing of post-closing deliverables related to the HazardPRO acquisition, and amortization of our enterprise software and related hardware, which was fully amortized in 2015.

Research and development expenses increased \$39, or 24.2%, in the 2016 three-month period from the same period in 2015 and increased as a percentage of net sales to 10.9% from 7.6%. For the 2016 nine-month period, research and development expenses decreased \$5, or 0.9%, over the 2015 period, but increased as a percentage of net sales to 10.1% from 9.3%. The increase for the 2016 three-month period resulted from lab testing costs for additional certifications for the HazardPRO product line and contract engineering fees related to HazardPRO software modifications and upgrades. The decrease for nine-month period is due to a decrease in lab testing and certifications on our HazardPRO product line and salaries due to reduced staffing, which was partially offset by an increase in third quarter costs in contract engineering related to HazardPRO software modifications and upgrades.

Operating Income

Three-month operating income decreased 90.1% to \$29 from \$294 and nine-month operating income decreased 80.6% to \$88 from \$454, due primarily to lower 2016 revenue.

Non-Operating Income

Non-operating income increased by \$1, or 20.0%, for the 2016 three-month period compared to the same 2015 period. Non-operating income decreased \$1,428, or 98.0%, in the nine months ended September 30, 2016, when compared to the same period in 2015. This decrease was due to the liquidation of 122,649 shares of Rudolph Technologies, Inc. stock during the first half of 2015, which resulted in a recognized gain of \$1,447.

Income Before Income Taxes

Income before income taxes was \$35 for the three months ended September 30, 2016, representing a decrease of \$264, or 88.3%, when compared to the same period in 2015. Income before income taxes was \$117 for the nine months ended September 30, 2016, representing a decrease of \$1,794, or 93.9%, when compared to the same period in 2015.

The decrease for both 2016 periods was the result of a decrease in revenue. In addition, the decrease for 2016 nine-month period was also the result of a decrease in the sale of available-for-sale securities recognized in 2016. During the 2015 nine-month period, we recognized \$1,449 of gain on sale of available-for-sale securities (see “Non-Operating Income (Expense)”).

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were \$792 at September 30, 2016, and \$569 at December 31, 2015. The increase was mainly from investing activities.

Cash used in operations was favorably affected by a decrease in inventories, and an increase in accounts payable and accrued expenses. For the 2016 nine-month period we used \$380 less cash in operations than in the 2015 nine-month period. In the 2016 period, the Company had a decrease in inventories due to delaying purchases as a result of lower revenues.

Cash generated from investing activities was \$462 and \$1,855 for the nine months ended September 30, 2016 and 2015, respectively. During the 2016 and 2015 nine-month periods, the Company had net proceeds of Treasury Bills with a maturity date of more than three months of \$464 and \$407, respectively. In addition, the Company generated \$1,467 in proceeds on the sale of available-for-sale securities during 2015 from the sale of Rudolph stock.

Cash used in financing activities was \$390 and \$381 for respective 2016 and 2015 nine-month periods. During the nine months ended September 30, 2016 and 2015, we paid \$390 and \$381, respectively, on the long-term debt owed to Harvest Engineering, Inc. (“Harvest”) for the technology purchased in February 2014. As of September 30, 2016, the note payable to Harvest has been paid in full.

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

Off-balance Sheet Arrangements

As of September 30, 2016, the Company had no off-balance sheet arrangements or transactions.

Future 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. Although the Company is continuing to explore these external opportunities, it currently has no agreements or understandings with any third parties.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not Applicable.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Based on an evaluation under the supervision and with the participation of the Company's management, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act") were effective as of September 30, 2016 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the third quarter of 2016, which were identified in connection with management's evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings - None.

Item 1A. Risk Factors - Not Applicable.

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

Item 3. Defaults Upon Senior Securities - None.

Item 4. Mine Safety Disclosures – Not Applicable.

Item 5. Other Information - None.

Item 6. Exhibits

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

SIGNATURES

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

Electro-Sensors, Inc.

November 10, 2016 /s/ David L. Klenk
David L. Klenk
Chief Executive Officer and Chief Financial Officer

November 10, 2016 /s/ Gloria M. Grundhoefer
Gloria M. Grundhoefer
Controller

EXHIBIT INDEX

ELECTRO-SENSORS, INC.

FORM 10-Q FOR QUARTER ENDED SEPTEMBER 30, 2016

Exhibit Description

31.1 Certification of CEO and CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101 The following financial information from Electro-Sensors, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2016, formatted in eXtensible Business Reporting Language (XBRL):
(i) Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015, (ii) Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2016 and September 30, 2015, (iii) Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and September 30, 2015, and (iv) Notes to Consolidated Financial Statements.