NORTECH SYSTEMS INC
Form 10-Q
November 05, 2014
Table of Contents

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 September 30, 2014

OR

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

For the transition period from to

NORTECH SYSTEMS INCORPORATED

Commission file number 0-13257

State of Incorporation: **Minnesota**

IRS Employer Identification No. **41-1681094**

Executive Offices: **1120 Wayzata Blvd E., Suite 201, Wayzata, MN 55391**

Telephone number: **(952) 345-2244**

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 Regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

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

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

Number of shares of $.01 par value common stock outstanding at November 1, 2014 - 2,742,992

(The remainder of this page was intentionally left blank.)

Table of Contents

TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION

			PAGE
Item 1	-	Financial Statements	
		Consolidated Balance Sheets	3
		Consolidated Statements of Income	4-5
		Consolidated Statements of Cash Flows	6
		Condensed Notes to Consolidated Financial Statements	7-13
Item 2	-	Management_s Discussion and Analysis of Financial Condition And Results of Operations	13-19
Item 4	-	Controls and Procedures	19
		PART II - OTHER INFORMATION	
Item 1	-	Legal Proceedings	20
Item 6	-	Exhibits	20
SIGNATURES			20

Table of Contents

PART 1

ITEM 1. FINANCIAL STATEMENTS

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

	SEPTEMBER 30 2014 (Unaudited)	DECEMBER 31 2013
ASSETS		
Current Assets		
Cash	$ 203,482	$
Accounts Receivable, Less Allowance for Uncollectible Accounts	15,606,066	16,030,848
Inventories	20,416,199	17,427,470
Prepaid Expenses	974,602	634,350
Income Taxes Receivable	400,051	140,174
Deferred Income Taxes	683,000	683,000
Total Current Assets	38,283,400	34,915,842
Property and Equipment, Net	11,033,721	11,037,160
Other Assets	118,450	122,419
Total Assets	$ 49,435,571	$ 46,075,421
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Line of Credit	$	$ 7,234,983
Current Maturities of Long-Term Debt	737,961	632,176
Accounts Payable	9,346,406	8,185,012
Accrued Payroll and Commissions	3,282,766	2,595,393
Other Accrued Liabilities	938,842	718,974
Total Current Liabilities	14,305,975	19,366,538
Long-Term Liabilities		
Line of Credit	7,831,089	
Long-Term Debt, Net of Current Maturities	4,144,139	4,246,914
Deferred Income Taxes	333,680	282,000
Other Long-Term Liabilities	197,240	244,521
Total Long-Term Liabilities	12,506,148	4,773,435
Total Liabilities	26,812,123	24,139,973
Shareholders Equity		
Preferred Stock, $1 par value; 1,000,000 Shares Authorized:		
250,000 Shares Issued and Outstanding	250,000	250,000
Common Stock - $0.01 par value; 9,000,000 Shares Authorized:		
2,742,992 Shares Issued and Outstanding	27,430	27,430
Additional Paid-In Capital	15,760,678	15,738,233
Accumulated Other Comprehensive Loss	(62,936)	(62,936)
Retained Earnings	6,648,276	5,982,721

Total Shareholders Equity		22,623,448		21,935,448
Total Liabilities and Shareholders Equity	$	49,435,571	$	46,075,421

See Accompanying Condensed Notes to Consolidated Financial Statements

Table of Contents

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30	
	2014	**2013**
Net Sales	$ 28,037,865	$ 27,389,275
Cost of Goods Sold	24,510,862	24,373,696
Gross Profit	3,527,003	3,015,579
Operating Expenses		
Selling Expenses	1,303,920	1,228,583
General and Administrative Expenses	1,749,593	1,410,815
Total Operating Expenses	3,053,513	2,639,398
Income From Operations	473,490	376,181
Other Expense		
Interest Expense	(89,598)	(103,977)
Miscellaneous Income (Expense), net	(13,195)	32,713
Total Other Expense	(102,793)	(71,264)
Income Before Income Taxes	370,697	304,917
Income Tax Expense	38,000	87,000
Net Income	$ 332,697	$ 217,917
Earnings Per Common Share:		
Basic	$ 0.12	$ 0.08
Weighted Average Number of Common Shares Outstanding - Basic	2,742,992	2,742,992
Diluted	$ 0.12	$ 0.08
Weighted Average Number of Common Shares Outstanding - Diluted	2,747,943	2,742,992

See Accompanying Condensed Notes to Consolidated Financial Statements

Table of Contents

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30	
	2014	**2013**
Net Sales	$ 81,595,474	$ 81,765,375
Cost of Goods Sold	71,711,557	72,153,707
Gross Profit	9,883,917	9,611,668
Operating Expenses		
Selling Expenses	3,570,066	3,618,354
General and Administrative Expenses	5,256,963	5,020,405
Total Operating Expenses	8,827,029	8,638,759
Income From Operations	1,056,888	972,909
Other Expense		
Interest Expense	(271,661)	(302,997)
Miscellaneous Income (Expense), net	(46,672)	40,314
Total Other Expense	(318,333)	(262,683)
Income Before Income Taxes	738,555	710,226
Income Tax Expense	73,000	164,000
Net Income	$ 665,555	$ 546,226
Earnings Per Common Share:		
Basic	$ 0.24	$ 0.20
Weighted Average Number of Common Shares Outstanding - Basic	2,742,992	2,742,992
Diluted	$ 0.24	$ 0.20
Weighted Average Number of Common Shares Outstanding - Diluted	2,747,552	2,742,992

See Accompanying Condensed Notes to Consolidated Financial Statements

Table of Contents

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30	
	2014	**2013**
Cash Flows From Operating Activities		
Net Income	$ 665,555	$ 546,226
Adjustments to Reconcile Net Income to Net Cash Provided by (Used in) Operating Activities		
Depreciation	1,517,153	1,505,367
Amortization	3,969	3,969
Compensation on Stock-Based Awards	22,445	9,945
Impairment on Assets	1,150	74,003
Deferred Taxes	51,680	171,000
(Gain) Loss on Disposal of Property and Equipment	687	(1,007)
Changes in Current Operating Items		
Accounts Receivable	424,782	(1,474,677)
Inventories	(2,988,729)	(983,539)
Prepaid Expenses	(340,252)	(340,481)
Income Taxes Receivable	(259,877)	(200,126)
Income Taxes Payable		(60,878)
Accounts Payable	1,443,580	(650,810)
Accrued Payroll and Commissions	687,373	1,259,687
Other Accrued Liabilities	175,669	120,092
Net Cash Provided by (Used in) Operating Activities	1,405,185	(21,229)
Cash Flows from Investing Activities		
Proceeds from Sales of Assets	250	56,810
Purchases of Property and Equipment	(1,801,069)	(1,006,874)
Net Cash Used in Investing Activities	(1,800,819)	(950,064)
Cash Flows from Financing Activities		
Borrowings on Line of Credit	83,477,209	
Repayments on Line of Credit	(82,881,103)	
Net Borrowings on Line of Credit		59,653
Proceeds from Long-Term Debt	510,000	1,884,000
Principal Payments on Long-Term Debt	(506,990)	(489,729)
Net Cash Provided by Financing Activities	599,116	1,453,924
Net Increase in Cash	203,482	482,631
Cash - Beginning		
Cash - Ending	$ 203,482	$ 482,631
Supplemental Disclosure of Cash Flow Information		
Cash Paid During the Period for Interest	$ 268,371	$ 278,387
Cash Paid During the Period for Income Taxes	417,615	187,300
Supplemental Noncash Investing and Financing Activities		
Capital Expenditures in Accounts Payable	35,720	105,468

See Accompanying Condensed Notes to Consolidated Financial Statements

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated financial statements for the interim periods have been prepared in accordance with Generally Accepted Accounting Principles in the United States of America (GAAP) for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the financial information and footnotes required by GAAP for complete financial statements, although we believe the disclosures are adequate to make the information presented not misleading. It is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in our latest shareholders annual report on Form 10-K. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year or for any other interim period. In our opinion, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included.

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. In preparing these consolidated financial statements, we have made our best estimates and judgments of certain amounts included in the consolidated financial statements, giving due consideration to materiality. Changes in the estimates and assumptions used by us could have a significant impact on our financial results, since actual results could differ from those estimates.

Principles of Consolidation

The consolidated financial statements include the accounts of Nortech Systems Incorporated and its wholly owned subsidiary, Manufacturing Assembly Solutions of Monterrey, Inc. All significant intercompany accounts and transactions have been eliminated.

Revenue Recognition

We recognize revenue upon shipment of manufactured products to customers, when title has passed, all contractual obligations have been satisfied and collection of the resulting receivable is reasonably assured. We also provide engineering services separate from the manufacture of a product. Revenue for engineering services is recognized upon completion of the engineering process, providing standalone fair value to our customers. Our engineering services are short-term in nature. In addition, we have another separate source of revenue that comes from short-term repair services, which are recognized upon completion of the repairs and shipment of product back to the customer. Shipping and handling costs charged to our customers are included in net sales, while the corresponding shipping expenses are included in cost of goods sold.

Table of Contents

Stock Options

Following is the status of all stock options outstanding as of September 30, 2014:

	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding - January 1, 2014	216,000	$ 6.46		
Granted				
Cancelled	(20,000)	7.46		
Outstanding - September 30, 2014	196,000	$ 6.36	3.16	$ 50,023
Exercisable - September 30, 2014	172,918	$ 6.70	2.44	$ 16,677

There were no options exercised during the three and nine months ended September 30, 2014 and 2013. There were no stock options granted during the three and nine months ended September 30, 2014 and the three months ended September 30, 2013. The weighted-average fair value of options granted during the nine months ended September 30, 2013 was $1.65 per share.

Total compensation expense related to stock options for the three months ended September 30, 2014 and 2013 was $7,482 and $4,444, respectively. Total compensation expense related to stock options for the nine months ended September 30, 2014 and 2013 was $22,445 and $9,945, respectively. As of September 30, 2014, there was approximately $24,000 of unrecognized compensation related to unvested option awards that we expect to recognize over a weighted-average period of 1.18 years.

Equity Appreciation Rights Plan

In November 2010, the Board of Directors approved the adoption of the Nortech Systems Incorporated Equity Appreciation Rights Plan (the 2010 Plan). The total number of Equity Appreciation Right Units (Units) the Plan can issue shall not exceed an aggregate of 750,000 Units. The 2010 Plan provides that Units issued shall fully vest three years from the base date as defined in the agreement unless terminated earlier. Units give the holder a right to receive a cash payment equal to the appreciation in book value per share of common stock from the base date, as defined, to the redemption date. Unit redemption payments under this plan shall be paid in cash within 90 days after we determine the value as of the redemption date.

As of September 30, 2014, we had granted all 750,000 Units and 650,000 remain outstanding with vesting dates ranging from December 31, 2014 through December 31, 2019.

Total compensation expense related to these Units based on the estimated appreciation over their remaining terms was approximately $38,000 and $12,000 for the three months ended September 30, 2014 and 2013, respectively and approximately $119,000 and $49,000 for the nine

months ended September 30, 2014 and 2013, respectively.

Table of Contents

As of September 30, 2014 and December 31, 2013, approximately $199,000 and $81,000 have been accrued under this plan, respectively. As of September 30, 2014, approximately $43,000 of this balance was included in Other Accrued Liabilities and the remaining $156,000 balance was included in Other Long-term Liabilities. As of December 31, 2013, approximately $29,000 of this balance is included in Other Accrued Liabilities and the remaining $52,000 was included in Other Long-term Liabilities.

Earnings per Common Share

For the three and nine months ended September 30, 2013, the effect of all stock options was antidilutive. Therefore, no outstanding options were included in the computation of per-share amounts. For both the three and nine months ended September 30, 2014, 26,750 stock options were included in the computation of diluted per share amounts as their impact was dilutive. For the three and nine months ended September 30, 2014, stock options of 169,250 and 178,139, respectively were excluded because their inclusion would be antidilutive.

Segment Reporting Information

All of our operations fall under the Contract Manufacturing segment within the Electronic Manufacturing Services industry. We strategically direct production between our various manufacturing facilities based on a number of considerations to best meet our customers requirements. We share resources for sales, marketing, engineering, supply chain, information services, human resources, payroll, and all corporate accounting functions. Consolidated financial information is available that is evaluated regularly by the chief operating decision maker in assessing performance and allocating resources.

Accounts Receivable and Allowance for Doubtful Accounts

We grant credit to customers in the normal course of business. Accounts receivable are unsecured and are presented net of an allowance for doubtful accounts. The allowance for doubtful accounts was $211,000 and $138,000 at September 30, 2014 and December 31, 2013, respectively. We determine our allowance by considering a number of factors, including the length of time accounts receivable are past due, our previous loss history, the customers current ability to pay their obligations to us, and the condition of the general economy and the industry as a whole. We write-off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for uncollectible accounts.

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market (based on the lower of replacement cost or net realizable value). Costs include material, labor, and overhead required in the warehousing and production of our products. Inventory reserves are maintained for the estimated value of the inventories that may have a lower value than stated or quantities in excess of future production needs.

Table of Contents

Inventories are as follows:

	September 30 2014	December 31 2013
Raw Materials	$ 13,748,286	$ 12,282,902
Work in Process	4,612,452	3,317,573
Finished Goods	2,877,220	2,926,512
Reserve	(821,759)	(1,099,517)
Total	$ 20,416,199	$ 17,427,470

Impairment Analysis

We evaluate long-lived assets, primarily property and equipment, as well as the related depreciation periods, whenever current events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. Recoverability for assets to be held and used is based on our projection of the undiscounted future operating cash flows of the underlying assets. To the extent such projections indicate that future undiscounted cash flows are not sufficient to recover the carrying amounts of related assets, a charge might be required to reduce the carrying amount to equal estimated fair value.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This standard outlines a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that revenue is recognized when a customer obtains control of a good or service. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Transfer of control is not the same as transfer of risks and rewards, as it is considered in current guidance. We will also need to apply new guidance to determine whether revenue should be recognized over time or at a point in time. This standard will be effective for the first interim period within annual reporting periods beginning after December 15, 2016, with no early adoption permitted, using either of two methods: *(a)* retrospective to each prior reporting period presented with the option to elect certain practical expedients as defined within ASU 2014-09; or *(b)* retrospective with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application and providing certain additional disclosures as defined in ASU 2014-09. We have not yet selected a transition method and are currently evaluating the impact of the pending adoption of ASU 2014-09 on the consolidated financial statements.

Table of Contents

NOTE 2. CONCENTRATION OF CREDIT RISK AND MAJOR CUSTOMERS

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash and accounts receivable. With regard to cash, we maintain our excess cash balances in checking accounts at two high-credit quality financial institutions. These accounts may at times exceed federally insured limits. We grant credit to customers in the normal course of business and do not require collateral on our accounts receivable.

Our largest customer has two divisions which accounted for 10% or more of our net sales for the three and nine months ended September 30, 2014 and 2013. The first division accounted for 23% and 24% of net sales for the three and nine months ended September 30, 2014 and 22% and 20% of net sales for the three and nine months ended September 30, 2013. The second division accounted for 7% and 5% of net sales for the three and nine months ended September 30, 2014, respectively and 6% of net sales for the three and nine months ended September 30, 2013. Together the divisions accounted for 30% and 29% of net sales for the three and nine months ended September 30, 2014, respectively and 28% and 26% for the three and nine months ended September 30, 2013, respectively.

Combined accounts receivable from both divisions represented 20% of total accounts receivable at September 30, 2014 and December 31, 2013.

Export sales represented 13% of net sales for the three and nine months ended September 30, 2014 and 2013.

NOTE 3. FINANCING ARRANGEMENTS

We have a credit agreement with Wells Fargo Bank (WFB) which was most recently amended on May 16, 2014 and provides for a line of credit arrangement of $13.5 million that expires, if not renewed, on May 31, 2018. The credit arrangement also has a $1.8 million real estate term note outstanding with a maturity date of March 31, 2027, an additional $1.7 million real estate term note outstanding that is due, if not renewed, on December 31, 2027, an equipment loan for $1.6 million and a new term loan facility of up to $1.0 million for capital expenditures, both with maturity dates of May 31, 2018. As of September 30, 2014, we have borrowed $0.3 million against the $1.0 million capital term note.

Table of Contents

Long-term debt at September 30, 2014 and December 31, 2013 consisted of the following:

	September 30 2014	December 31 2013
Real Estate Term Loan 1, interest at three month LIBOR + 3.0%, due in installments through March 31, 2027	$ 1,445,078	$ 1,533,928
Real Estate Term Loan 2, interest at three month LIBOR + 3.0%, due in installments through December 31, 2027	1,488,000	1,571,700
Equipment loan, interest at three month LIBOR + 3.0%, due January 31, 2016	126,666	197,916
Equipment loan, interest at three month LIBOR + 3.0%, due May 31, 2018	1,182,356	1,135,546
Equipment loan, interest at three month LIBOR + 3.0%, due May 31, 2018	280,000	
Blue Earth Bond, which bears a variable interest rate, due in installments through June 30, 2021	360,000	440,000
Total debt	4,882,100	4,879,090
Less current maturities	737,961	632,176
Long-term debt	$ 4,144,139	$ 4,246,914

Under the credit agreement, both the line of credit and real estate term notes are subject to variations in the LIBOR rate. Our line of credit bears interest at three-month LIBOR + 2.5% (approximately 2.75% at September 30, 2014) while our real estate term notes bear interest at three-month LIBOR + 3.0% (approximately 3.25% at September 30, 2014). The weighted-average interest rate on our line of credit was 2.7% and 2.9% for the three and nine months ended September 30, 2014, respectively. The weighted-average rate on our real estate term notes was 3.3% and 3.4% for the three and nine months ended September 30, 2014, respectively. At December 31, 2013, we had borrowing on our line of credit of $7,234,983, included in current debt on the balance sheet. At September 30, 2014, we had borrowings on our line of credit of $7,831,089. In the second quarter, the line of credit was extended and reclassified to long-term on our balance sheet to reflect its long-term nature. The line of credit requires a lock box arrangement; however there are no acceleration clauses that would accelerate the maturity of our outstanding borrowings.

The credit agreement contains certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures.

The availability under the line is subject to borrowing base requirements, and advances are at the discretion of the lender. At September 30, 2014, we have net unused availability under our line of credit of approximately $4.3 million. The line is secured by substantially all of our assets.

NOTE 4. INCOME TAXES

On a quarterly basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision based on the anticipated rate. As the year progresses, we refine our estimate based on the facts and circumstances, including discrete events, by each tax jurisdiction. Our effective tax rate for the three months ended September 30, 2014 was 10%, compared with 29% for the three months ended September 30, 2013. The decrease in the

12

Table of Contents

effective tax rate in the third quarter of 2014 was the result of a favorable return to provision true-up discrete item primarily related to additional research and development credits that were determined when filing the return. Our effective tax rate for the nine months ended September 30, 2014 was 10% compared with 23% for the nine months ended September 30, 2013. The decrease in the effective tax rate is primarily due to the favorable return to provision true-up and the audit settlement with Minnesota Department of Revenue which included the acceptance of our research and development credits of $100,000 which were previously reserved for as an uncertain position.

The differences between federal income taxes computed at the federal statutory rate and reported income taxes for the three and nine months ended September 30, 2014 and 2013 are as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Statutory federal tax provision	$ 129,000	$ 105,000	$ 259,000	$ 245,000
State income taxes	14,000	16,000	33,000	39,000
Income tax credits	(19,000)	(48,000)	(33,000)	(151,000)
Change in uncertain tax positions	1,000	11,000	(99,000)	33,000
Return to provision true-up	(84,000)		(84,000)	
Other	(3,000)	3,000	(3,000)	(2,000)
Income tax expense (benefit)	$ 38,000	$ 87,000	$ 73,000	$ 164,000

At September 30, 2014, we had $44,000 of net uncertain tax benefit positions remaining in other long-term liabilities related to research and development credits that would reduce our effective income tax rate if recognized.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview:

We are a Wayzata, Minnesota based full-service electronics manufacturing services (EMS) contract manufacturer of wire and cable assemblies, printed circuit board assemblies, higher-level assemblies and box builds for a wide range of industries. We provide value added engineering services and technical support including design, testing, prototyping and supply chain management to customers mainly in the aerospace and defense, medical, and industrial equipment markets. We maintain manufacturing facilities in Baxter, Bemidji, Blue Earth, Mankato, Merrifield, and Milaca, Minnesota; Augusta, Wisconsin; and Monterrey, Mexico. All of the our facilities are certified to one or more of the ISO standards, including 9001 and 13485, with most having additional certifications based on the needs of the customers they serve.

Table of Contents

Summary of Results:

Revenue and operating profit for the third quarter of 2014 continued to improve compared to the first two quarters of 2014. Backlog and pipeline activities also continued to increase, with 90 day backlog ending the quarter 9% up from the beginning of the quarter and 11% over third quarter 2013. Increased opportunities to our medical customers in Q3 played a large role in the higher revenue and backlog for third quarter. Industrial customers are showing signs of recovery as the economy improves and the defense customers are adjusting to the decreased demand from budget and program cuts.

For the quarter ended September 30, 2014, we reported net sales of $28.0 million compared to $27.4 million reported in the same quarter of 2013. Increased sales to our medical customers were offset by decreased sales to our aerospace and defense customers. Industrial sales were flat compared to prior year but with an improving backlog.

Our gross profit percentage for the three months ended September 30, 2014 was 12.6% compared to 11.0% for the three months ended September 30, 2013. Leveraging and plant utilization as well as continued process improvements in the third quarter of 2014 positively impacted gross margin. Gross profit percentage for the nine months ended September 30, 2014 and 2013 was 12.1% and 11.8%, respectively.

Income from operations increased 26% to $473,000 for the three months ended September 30, 2014 versus $376,000 for the three months ended September 30, 2013. Income from operations increased 9% to $1,057,000 for the nine months ended September 30, 2014 versus $973,000 for the nine months ended September 30, 2013.

Net income for the third quarter of 2014 was $332,697 or $0.12 per diluted common share, compared to net income of $217,917 or $0.08 per diluted common share for the same period in 2013. Net income for the nine months ended September 30, 2014 was $665,555 or $0.24 per diluted common share, while net income from the same period in 2013 totaled $546,226 or $0.20 per diluted common share.

Cash provided by operating activities in the first nine months of 2014 was $1.4 million. Cash provided in the first nine months of 2014 came primarily from profits, noncash addback of depreciation and the timing of payments on our accounts payable, offset by increased inventories to support our backlog increases. Cash used by operating activities in the first nine months of 2013 was $21,000 due to increased inventories and slower than expected collections on our accounts receivable.

Table of Contents

Results of Operations:

The following table presents statements of income data as percentages of total net sales for the periods indicated:

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Net Sales	100.0%	100.0%	100.0%	100.0%
Cost of Goods Sold	87.4	89.0	87.9	88.2
Gross Profit	12.6	11.0	12.1	11.8
Selling Expenses	4.7	4.5	4.4	4.4
General and Administrative Expenses	6.2	5.1	6.4	6.2
Income from Operations	1.7	1.4	1.3	1.2
Other Expenses, Net	(0.4)	(0.3)	(0.4)	(0.3)
Income Before Income Taxes	1.3	1.1	0.9	0.9
Income Tax Expense	0.1	0.3	0.1	0.2
Net Income	1.2%	0.8%	0.8%	0.7%

Net Sales:

We reported net sales of $28.0 million and $27.4 million for the three months ended September 30, 2014 and 2013, respectively. Net sales for the nine months ended September 30, 2014 and 2013 were $81.6 million and $81.8 million, respectively. Revenue increases to our medical customers were offset by decreases to our aerospace and defense customers. Decreases in aerospace and defense revenue resulted from reduced demand from several of our existing customers, some of which were due to delays in government funding. Defense contract length and size continue to decrease in this post war environment with several large programs eliminated or substantially reduced.

Net sales by our major EMS industry markets for the three and nine month periods ended September 30, 2014 and 2013 are as follows:

	Three Months Ended September 30			Nine Months Ended September 30		
(in thousands)	2014 $	2013 $	% Change	2014 $	2013 $	% Change
Aerospace and Defense	3,656	4,693	(22)	11,737	14,394	(18)
Medical	10,792	9,045	19	30,837	24,959	24
Industrial	13,590	13,651	(0)	39,021	42,412	(8)
Total Sales	28,038	27,389	2	81,595	81,765	(0)

Table of Contents

Backlog:

Our 90-day order backlog as of September 30, 2014 was approximately $20.9 million, a 9% increase compared to approximately $19.2 million at the beginning of the quarter. Our medical customers backlog has continued to increase. Aerospace and defense backlog decreased from the prior year due to lower Department of Defense funding and the post war transition. Our industrial customers are beginning to gain traction as the overall economy has been improving. Our backlog consists of firm purchase orders and we expect a major portion of the current 90 day backlog to be realized as revenue during the following quarter.

90 Day backlog by our major EMS industry markets are as follows:

	Backlog as of the Quarter Ended		
(in thousands)	September 30 2014	June 30 2014	September 30 2013
Aerospace and Defense	$ 3,690	$ 3,647	$ 5,222
Medical	10,112	8,638	5,576
Industrial	7,127	6,917	7,994
Total Backlog	$ 20,929	$ 19,202	$ 18,792

Our 90 day backlog varies due to order size, manufacturing delays, contract terms and conditions and timing from customer delivery schedules and releases. These variables cause inconsistencies in comparing the backlog from one period to the next.

Gross Profit:

Gross profit as a percent of net sales for the three months ended September 30, 2014 and 2013 was 12.6% and 11.0%, respectively. Leveraging and plant utilization and continued process improvements in the third quarter of 2014 positively impacted gross margin. Gross profit percentage for the nine months ended September 30, 2014 and 2013 was 12.1% and 11.8%, respectively

Selling Expense:

Our selling expenses were $1.3 million or 4.7% of net sales and $1.2 million or 4.5% of net sales for the three months ended September 30, 2014 and 2013, respectively. Selling expenses were $3.6 million or 4.4% of net sales for the nine months ended September 30, 2014 and 2013.

General and Administrative Expense:

Our general and administrative expenses were $1.7 million or 6.2% of net sales and $1.4 million or 5.1% of net sales for the three months ended September 30, 2014 and 2013, respectively. General and administrative expenses were $5.3 million or 6.4% of net sales and $4.9 million or 6.1% of net sales for the nine months ended September 30, 2014 and 2013, respectively. The increase is mainly due to infrastructure investments.

Table of Contents

Income Taxes:

Our effective tax rate for the nine months ended September 30, 2014 was 10% compared with 23% for the nine months ended September 30, 2013. The decrease in the effective tax rate is primarily due to the favorable return to provision true-up and the audit settlement with Minnesota Department of Revenue which included the acceptance of our research and development credits of $100,000 which were previously reserved for as an uncertain position.

The differences between federal income taxes computed at the federal statutory rate and reported income taxes for the three and nine months ended September 30, 2014 and 2013 are as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Statutory federal tax provision	$ 129,000	$ 105,000	$ 259,000	$ 245,000
State income taxes	14,000	16,000	33,000	39,000
Income tax credits	(19,000)	(48,000)	(33,000)	(151,000)
Change in uncertain tax positions	1,000	11,000	(99,000)	33,000
Return to provision true-up	(84,000)		(84,000)	
Other	(3,000)	3,000	(3,000)	(2,000)
Income tax expense	$ 38,000	$ 87,000	$ 73,000	$ 164,000

Liquidity and Capital Resources:

We have satisfied our liquidity needs over the past several years with cash flows generated from operations and an operating line of credit through WFB. We also have real estate and equipment term loans. Both the line of credit and real estate term notes are subject to fluctuations in the LIBOR rates. The line of credit, real estate term notes, and equipment loans with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. The availability under our line is subject to borrowing base requirements, and advances are at the discretion of the lender. The line of credit is secured by substantially all of our assets.

On September 30, 2014, we had outstanding advances of $7.8 million under the line of credit and unused availability of $4.3 million supported by our borrowing base. We believe our financing arrangements and cash flows to be provided by operations will be sufficient to satisfy our future working capital needs. Our working capital was $24.0 million and $15.5 million as of September 30, 2014 and December 31, 2013, respectively. The increase in working capital relates primarily to the line of credit which was extended in second quarter and reclassified to long term on our balance sheet at September 30, 2014 to reflect its long-term nature.

Net cash provided by operating activities for the nine months ended September 30, 2014 was $1.4 million. Cash provided in the first nine months of 2014 came primarily from profits,

17

Table of Contents

noncash addback of depreciation and the timing of payments on our accounts payable, offset by increased inventories to support the increase in our 90 day backlog.

Net cash used in investing activities of $1.8 million for the nine months ended September 30, 2014 is comprised of property and equipment purchases to support the business.

Critical Accounting Policies and Estimates:

Our significant accounting policies and estimates are summarized in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2013. There have been no significant changes in these critical accounting policies since December 31, 2013. Some of our accounting policies require us to exercise significant judgment in selecting the appropriate assumptions for calculating financial estimates. Such judgments are subject to an inherent degree of uncertainty. These judgments are based on our historical experience, known trends in our industry, terms of existing contracts and other information from outside sources, as appropriate. Actual results could differ from these estimates.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This standard outlines a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that revenue is recognized when a customer obtains control of a good or service. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Transfer of control is not the same as transfer of risks and rewards, as it is considered in current guidance. The Company will also need to apply new guidance to determine whether revenue should be recognized over time or at a point in time. This standard will be effective for the first interim period within annual reporting periods beginning after December 15, 2016, with no early adoption permitted, using either of two methods: *(a)* retrospective to each prior reporting period presented with the option to elect certain practical expedients as defined within ASU 2014-09; or *(b)* retrospective with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application and providing certain additional disclosures as defined in ASU 2014-09. The Company has not yet selected a transition method and is currently evaluating the impact of the pending adoption of ASU 2014-09 on the consolidated financial statements.

Forward-Looking Statements:

Those statements in the foregoing report that are not historical facts are forward-looking statements made pursuant to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements generally will be accompanied by words such as anticipate, believe, estimate, expect, forecast, intend, possible, potential, predict, project, or other similar words that convey the uncertainty of future ev outcomes. Although we believe these forward-looking statements are reasonable, they are based upon a number of assumptions concerning future conditions, any or all of which may ultimately prove to be inaccurate. Forward-looking statements involve a number of risks and uncertainties.

Table of Contents

Important factors that could cause actual results to differ materially from the forward-looking statements include, without limitation:

- Volatility in the marketplace which may affect market supply and demand for our products;
- Increased competition;
- Changes in the reliability and efficiency of operating facilities or those of third parties;
- Risks related to availability of labor;
- Increase in certain raw material costs such as copper;
- Commodity and energy cost instability;
- General economic, financial and business conditions that could affect our financial condition and results of operations; and
- Availability of raw material components.

The factors identified above are believed to be important factors (but not necessarily all of the important factors) that could cause actual results to differ materially from those expressed in any forward-looking statement made by us. Unpredictable or unknown factors not discussed herein could also have material adverse effects on forward-looking statements. All forward-looking statements included in this Form 10-Q are expressly qualified in their entirety by the forgoing cautionary statements. We undertake no obligations to update publicly any forward-looking statement (or its associated cautionary language) whether as a result of new information or future events.

Please refer to forward-looking statements and risks as previously disclosed in our report on Form 10-K for the fiscal year ended December 31, 2013.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures:

In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q, our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer have concluded that the disclosure controls and procedures were effective as of the date of such evaluation in ensuring that information required to be disclosed in our Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow

timely decisions regarding required disclosure.

Table of Contents

Changes in Internal Control Over Financial Reporting:

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

ITEM 1. LEGAL PROCEEDINGS

We are subject to various legal proceedings and claims that arise in the ordinary course of business.

ITEM 6. EXHIBITS

Exhibits

31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
32	Certification of the Chief Executive Officer and Chief Financial Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	Financial statements from the quarterly report on Form 10-Q for the quarter ended September 30, 2014, formatted in XBRL: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Cash Flows, and (iv) the Condensed Notes to Consolidated Financial Statements.

Signatures

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

Nortech Systems Incorporated and Subsidiary

Date: November 5, 2014 by /s/ Richard G. Wasielewski

Richard G. Wasielewski
Chief Executive Officer and President
Nortech Systems Inc.

Date: November 5, 2014 by /s/ Paula M. Graff

Paula M. Graff
Vice President and Chief Financial Officer
Nortech Systems Inc.