COMMUNICATIONS SYSTEMS INC
Form 10-Q
August 14, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **June 30, 2008**

OR

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

For the transition period from __________________ to __________________

Commission File Number: **001-31588**

COMMUNICATIONS SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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

(952) 996-1674

Registrant s telephone number, including area code

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

Indicate by a check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined by 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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Name of Exchange On Which Registered**	**Outstanding at August 5, 2008**
Common Stock, par value $.05 per share	NASDAQ	8,620,384

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

	June 30 2008	**December 31 2007**
CURRENT ASSETS:		
Cash and cash equivalents	$27,564,030	$29,427,879
Trade accounts receivable, less allowance for doubtful accounts of $159,000 and $198,000, respectively	21,891,620	17,550,391
Inventories	27,227,309	28,102,468
Prepaid income taxes	728,952	1,418,576
Other current assets	1,745,031	993,881
Deferred income taxes	3,194,889	3,291,009
TOTAL CURRENT ASSETS	82,351,831	80,784,204
PROPERTY, PLANT AND EQUIPMENT, net	12,847,149	13,944,597
OTHER ASSETS:		
Goodwill	4,560,217	5,264,095
Deferred income taxes	1,352,614	232,011
Funded pension assets	394,733	395,465
Other assets	137,238	139,941
TOTAL OTHER ASSETS	6,444,802	6,031,512
TOTAL ASSETS	$101,643,782	$100,760,313
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	$336,710	$322,309
Accounts payable	4,487,714	$3,941,648
Accrued compensation and benefits	2,738,817	3,739,987
Other accrued liabilities	2,192,020	1,864,355
Income taxes payable	1,211,585	887,397
Dividends payable	1,034,632	1,029,130
TOTAL CURRENT LIABILITIES	12,001,478	11,784,826
LONG TERM LIABILITIES:		
Long-term compensation plans	492,287	596,280
Income taxes payable	363,184	325,778
Long term debt - mortgage payable	2,951,626	3,122,847
TOTAL LONG-TERM LIABILITIES	3,807,097	4,044,905
STOCKHOLDERS EQUITY		
Preferred stock, par value $1.00 per share; 3,000,000 shares authorized; none issued		
	430,481	427,060

Common stock, par value $.05 per share; 30,000,000 shares authorized; 8,609,628 and 8,541,205 shares issued and outstanding, respectively		
Additional paid-in capital	34,319,620	33,521,963
Retained earnings	50,097,250	49,784,593
Accumulated other comprehensive income	987,856	1,196,966
TOTAL STOCKHOLDERS EQUITY	85,835,207	84,930,582
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$101,643,782	$100,760,313

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

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF

INCOME AND COMPREHENSIVE (LOSS) INCOME

	Three Months Ended June 30		**Six Months Ended June 30**	
	2008	**2007**	**2008**	**2007**
Sales from operations	$31,291,042	$33,255,998	$61,612,277	$59,701,166
Costs and expenses:				
Cost of sales	20,029,342	19,678,122	38,900,023	37,279,486
Selling, general and administrative expenses	8,553,281	8,137,513	16,584,438	16,365,604
Impairment and other charges related to JDL (Notes 4 and 11)	(221,313)	0	2,999,441	0
Total costs and expenses	28,361,310	27,815,635	58,483,902	53,645,090
Operating income	2,929,732	5,440,363	3,128,375	6,056,076
Other income and (expenses):				
Investment and other income	130,504	266,323	319,260	478,494
Gain (loss) on sale of assets	80,987	0	86,204	
Interest and other expense	(51,638)	(6,431)	(87,762)	(13,022)
Other income, net	159,853	259,892	317,702	465,472
Income before income taxes	3,089,585	5,700,255	3,446,077	6,521,548
Income tax expense	829,000	1,980,000	999,000	2,265,000
Net income	2,260,585	3,720,255	2,447,077	4,256,548
Other comprehensive (loss) income:				
Unrecognized actuarial gain (loss) to pension obligation	(44,367)	0	43	0
Foreign currency translation adjustment	33,822	53,044	(209,153)	67,167
Total other comprehensive income	(10,545)	53,044	(209,110)	67,167
Comprehensive Net income	$2,250,040	$3,773,299	$2,237,967	$4,323,715
Basic net income per share:	$.26	$.42	$.28	$.48
Diluted net income per share:	$.26	$.42	$.28	$.48

Average Basic Shares Outstanding	8,609,628	8,857,720	8,593,851	8,833,452
Average Dilutive Shares Outstanding	8,652,053	8,926,387	8,635,834	8,905,370
Dividends per share	$ .12	$ .10	$ .24	$ .20

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

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(Unaudited)

	Common Stock		**Additional**		**Cumulative Other**	
	Shares	**Amount**	**Paid-in Capital**	**Retained Earnings**	**Comprehensive Income (Loss)**	**Total**
BALANCE AT DECEMBER 31, 2007	8,541,205	$427,060	$33,521,964	$49,784,593	$ 1,196,966	$84,930,582
Net income				2,447,077		$2,447,077
Issuance of common stock under Employee Stock Purchase Plan	3,757	188	42,178			$42,366
Issuance of common stock to Employee Stock Ownership Plan	38,296	1,915	454,574			$456,489
Issuance of common stock under Employee Stock Option Plan	35,800	1,790	262,405			$264,195
Tax benefit from non-qualified employee stock options			34,216			$34,216
Share based compensation			41,824			$41,824
Purchase of common stock	(9,430)	(471)	(37,541)	(65,919)		$(103,931)
Shareholder dividends				(2,068,501)		$(2,068,501)
Other comprehensive income					(209,110)	$(209,110)
BALANCE AT JUNE 30, 2008	8,609,628	430,481	34,319,620	50,097,250	987,856	85,835,207

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

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June. 30	
	2008	**2007**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$2,447,077	$4,256,548
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,107,339	1,131,476
Share based compensation	41,824	49,205
Deferred income taxes	(1,024,482)	(29,689)
Impairment and other charges related to JDL (Notes 4 and 11)	2,999,441	0
(Gain) loss on sale of assets	(86,204)	0
Excess tax benefit from stock based payments	(34,216)	(49,740)
Changes in assets and liabilities:		
Trade receivables	(4,346,423)	(797,650)
Inventories	933,428	(1,596,652)
Prepaid income taxes	689,624	322,907
Other current assets	(946,866)	(1,376,698)
Accounts payable	546,307	(599,519)
Accrued compensation and benefits	(1,105,164)	184,638
Other accrued expenses	794,308	336,314
Income taxes payable	395,836	1,602,767
Net cash provided by operating activities	2,411,829	3,433,907
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(2,408,985)	(836,015)
Proceeds from sale of fixed assets	127,906	0
Purchases of other assets	0	(108,845)
Net cash used in investing activities	(2,281,079)	(944,860)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Cash dividends paid	(2,062,999)	(1,757,409)
Mortgage principal payments	(156,820)	0
Proceeds from issuance of common stock	306,559	694,289
Excess tax benefit from stock based payments	34,216	49,740
Purchase of common stock	(103,932)	(4,082)
Net cash used in financing activities	(1,982,976)	(1,017,462)
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	(11,623)	(1,871)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(1,863,849)	1,469,714
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	29,427,879	28,751,172
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$27,564,030	$30,220,886

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Income taxes paid	$449,260	$369,015
Interest paid	89,079	13,022
Dividends declared not paid	1,034,632	886,243

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

COMMUNICATIONS SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of business

Communications Systems, Inc. (herein collectively called CSI , our or the Company) is a Minnesota corporation organized in 1969 which operates directly and through its subsidiaries located in the United States, Costa Rica, the United Kingdom and China. CSI is principally engaged through its Suttle and Austin Taylor business units in the manufacture and sale of modular connecting and wiring devices for voice and data communications, digital subscriber line filters, and structured wiring systems and through its Transition Networks business unit in the manufacture and sale of media and rate conversion products for telecommunications networks. CSI also provides through its JDL Technologies business unit general contracting of computer infrastructure installations, provisioning of high-speed internet access and maintenance support of network operation centers for K-12 schools.

Financial statement presentation

The consolidated balance sheets and consolidated statement of changes in stockholders equity as of June 30, 2008 and 2007 and the related consolidated statements of income and comprehensive income, and the consolidated statements of cash flows for the periods ended June 30, 2008 and 2007 have been prepared by Communications Systems, Inc. and Subsidiaries (the Company or we). In the opinion of management, all adjustments (which include only normal recurring adjustments except where noted) necessary to present fairly the financial position, results of operations, and cash flows at June 30, 2008 and 2007 and for the periods then ended have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted. We recommend these consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Company s December 31, 2007 Annual Report to Shareholders and form 10-K. The results of operations for the periods ended June 30 are not necessarily indicative of the operating results for the entire year.

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

Except to the extent updated or described below, the significant accounting policies set forth in Note 1 to the consolidated financial statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2007, appropriately represent, in all material respects, the current status of accounting policies, and are incorporated herein by reference.

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Revenue Recognition

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

JDL Technologies records revenue on service contracts on a straight-line basis over the contract period (unless evidence suggests that the revenue is earned or obligations are fulfilled in a different pattern). Each contract is individually reviewed to determine when the earnings process is complete. Contracts with the Virgin Islands Department of Education (VIDE) are 90% funded by the federal government s E-RATE program and must be approved by the Schools and Libraries Division (SLD) of the Universal Service Administrative Company (USAC) before payment can be made to JDL. Prior to 2006 due to our history of receiving funding and our direct involvement in the application process we had followed a policy to recognize revenue prior to funding approval being received from the SLD so long as we can conclude that it is remote that funding will not be approved.

During 2006, as a result of its experience with the E-RATE funding process, it became apparent that JDL s ability to receive E-RATE funds was affected by actions that might have been taken by other individuals or companies involved with the VIDE and E-RATE programs. This gave rise to the possibility that if the VIDE were to be sanctioned by the E-RATE program due to the actions of others, JDL might be unable to collect for provided services even though JDL s conduct was compliant with the E-RATE program. It also became apparent in 2006 that JDL s contracts with the VIDE would not be approved for payment by the SLD until the SLD was satisfied that the VIDE was operating within the E-RATE program s legal guidelines. Accordingly, after considering the uncertainties created by a pending U.S. Department of Justice investigation of VIDE (see Note 6 below), SLD s review of VIDE s compliance with the E-RATE program and JDL s inability to collect for services that began in April 2006 provided without SLD approval, the Company determined it could not recognize revenue on JDL s VIDE contracts in 2006, until it received a Funding Commitment Decision Letter (FCDL) from the SLD approving the contracts. The Company subsequently received FCDLs and has been paid in full under contracts for the 2005-2006 and 2006 2007 school years. However, the Company will maintain this approach until it becomes convinced that such approvals are routine and that it is remote funding will not be approved.

In March 2008, JDL Technologies contracts to provide interconnection and internet access services to the U.S. Virgin Islands Department of Education for the 2007 2008 school years were approved by the Schools and Libraries Division (SLD) of the Universal Service Administrative Company. The Company recognized $1.3 million of revenue from these contracts for services provided between July 1, 2007 and December 31, 2007 in the three and six month periods ending March 31, 2008 and June 30, 2008. Expenses related to the contracts in the amount of $1.069 million were recognized in the financial statements as they were incurred in 2007.

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Comprehensive income

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

	June 30 2008	December 31 2007
Foreign currency translation	$355,884	$492,904
Minimum pension liability	631,972	704,062
	$987,856	$1,196,966

NOTE 2 - STOCK-BASED COMPENSATION

Common shares are reserved in connection with the Company s 1992 stock plan under which 2,500,000 shares of common stock may be issued pursuant to stock options, stock appreciation rights, restricted stock or deferred stock granted to officers and key employees. Exercise prices of stock options under the plan cannot be less than fair market value of the stock on the date of grant. Rules and conditions governing awards of stock options, stock appreciation rights and restricted stock are determined by the Compensation Committee of the Board of Directors, subject to certain limitations incorporated into the plan. At June 30, 2008, 970,789 shares remained available to be issued under the plan. All currently outstanding awards under the 1992 stock plan are vested. The options expire five years from date of grant.

Shares of common stock are also reserved for issuance in connection with a nonqualified stock option plan under which up to 200,000 shares may be issued to nonemployee directors. The plan provides for the automatic grant of nonqualified options for 3,000 shares of common stock annually to each nonemployee director concurrent with the annual stockholders meeting. Exercise price is the fair market value of the stock at the date of grant. Options granted under this plan vest when issued and expire 10 years from date of grant. At June 30, 2008, 28,000 shares are available to be issued under the plan.

The Company also has an Employee Stock Purchase Plan (ESPP) for which 300,000 common shares have been reserved. Employees are able to acquire shares under the plan at 95% of the price at the end of the current semi-annual plan term, which is June 30, 2008. This plan is non-compensatory under current rules and does not give rise to compensation cost under SFAS No. 123(R).

Stock compensation expense recognized for the six month periods ended June 30, 2008 was $42,000 before income taxes and $27,000 after income taxes. Stock compensation expense recognized for the six month periods ended June 30, 2007 was $49,000 before income taxes and $32,000 after income taxes. Excess tax benefits from the exercise of stock options included in financing cash flows for the six month periods

ended June 30, 2008 and 2007, were $34,000 and $50,000, respectively.

The following table summarizes the stock option transactions for the three months ended June 30, 2008. All outstanding stock options are currently exercisable.

		Options	Weighted average exercise price per share	Weighted average remaining contractual term
Outstanding	December 31, 2007	397,450	$ 10.01	2.97 years
Issued		18,000	11.41	
Canceled		(25,300)	15.04	
Exercised		(35,800)	7.38	
Outstanding	June 30, 2008	354,350	10.04	3.26 years

18,000 director stock options were granted during the six month period ended June 30, 2008. The aggregate intrinsic value of options (the amount by which the market price of the stock on the last day of the period exceeded the market price of the stock on the date of grant) outstanding at June 30, 2008 was $0. The intrinsic value of options exercised during the six months ended June 30, 2008 was $101,000. Net cash proceeds from the exercise of stock options were $239,000 and $644,000 for the six months ended June 30, 2008 and 2007, respectively.

The fair value of stock options issued was $42,000 and $49,000 in the six month periods ended June 30, 2008 and 2007, respectively. The fair value of each stock option was estimated on the date of the grant using the Black-Scholes option-pricing model. The following table presents a summary of the significant assumptions used during the six-months ended June 30, 2008 and 2007 to estimate the fair value of stock options:

Black-Scholes Option Valuation Assumptions (1)	**2008**	**2007**
Risk-free interest rate (2)	3.8 %	5.2 %
Expected dividend yield	4.0 %	3.9 %
Expected stock price volatility (3)	26.6 %	31.4 %
Expected term of stock options (in years) (4)	7.0 %	7.0 %

(1) Forfeitures are estimated based on historical experience.
(2) Based on the ten-year Treasury constant maturity interest rate whose term is consistent with the expected life of our stock options.
(3) Volatility is based on historical data.
(4) The expected life of stock options is estimated based upon historical experience.

NOTE 3 INVENTORIES

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

	June 30 2008	December 31 2007
Finished goods	$16,615,129	$19,212,773
Raw and processed materials	10,612,180	8,889,695
Total	$27,227,309	$28,102,468

NOTE 4 GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill is required to be evaluated for impairment on an annual basis and between annual tests upon the occurrence of certain events or circumstances, according to SFAS No. 142, Goodwill and Other Intangible Assets. The standard requires a two-step process be performed to analyze whether or not goodwill has been impaired. Step one is to test for potential impairment, and requires that the fair value of the reporting unit be compared to its book value including goodwill. If the fair value is higher than the book value, no impairment is recognized. If the fair value is lower than the book value, a second step must be performed. The second step is to measure the amount of impairment loss, if any, and requires that a hypothetical purchase price allocation be done to determine the implied fair value of goodwill. This fair value is then compared to the carrying value of goodwill. If the implied fair value is lower than the carrying value, an impairment adjustment must be recorded.

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On January 17, 2008, VIDE, a major customer of the JDL Technologies segment for the last several years, notified the company that JDL was not selected as a vendor to provide services to VIDE for the 2008-2009 school year. The loss of the VIDE contract for 2008 - 2009 represents an event that requires goodwill to be tested for impairment in accordance with SFAS 142. The Company completed the SFAS No. 142 evaluation at March 31, 2008 and recorded a goodwill impairment for the JDL Technologies segment of $704,000.

NOTE 5 WARRANTY

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

The following table presents the changes in the Company s warranty liability for the six months ended June 30, 2008 and 2007, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

	2008	2007
Beginning Balance	$518,000	$530,000
Actual warranty costs paid	(159,000)	(183,000)
Amounts charged to expense	260,000	174,000
Ending balance	$619,000	$521,000

NOTE 6 CONTINGENCIES

In the ordinary course of business, the Company is exposed to legal actions and threatened claims and incurs costs to defend against such legal actions and claims. Company management is not aware of any such outstanding, pending or threatened action, claim or other circumstance that would materially affect the Company s financial position or results of operations, except as follows:

Department of Justice Investigation

In April 2006, the Company s JDL Technologies, Inc. subsidiary (along with other parties) was notified it was the subject of a civil investigation by the U.S. Department of Justice (DOJ) into whether false claims under the federal government s E-RATE program were made in connection with work performed for the Virgin Islands Department of Education (VIDE). In addition to voluntarily cooperating with DOJ investigators over the past 24 months, the Company has conducted its own internal investigation of its business dealings with VIDE and its compliance with the E-RATE program. While the DOJ has not indicated to the Company that it has discontinued its investigation, no legal action has been initiated against the Company by the DOJ or any other agency as of the date of this report. In addition, as a result of its own investigation, the Company believes it has acted ethically and legally in its business dealings with the VIDE and in its compliance with E-RATE program requirements and believes that the DOJ investigation will be resolved without material cost to the Company. Nevertheless, the possibility exists that the DOJ may assert claims against JDL that, if proved, could result in materially adverse financial consequences to the Company. In addition, the Company s ability to receive E-RATE funds may be affected by actions taken by other individuals or companies involved with the VIDE and E-RATE programs. If the VIDE were to be sanctioned by the E-RATE program as a result of the DOJ investigation, JDL may be unable to collect for provided services even though JDL s conduct is compliant with the E-RATE program.

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Other contingencies

There has been no change in the status of the claim reported under Other contingencies in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

In the ordinary course of business, the Company is exposed to legal actions and incurs costs to pursue and defend legal claims. Company management is not aware of any other outstanding or pending legal actions that would materially affect the Company s financial position or results of operations.

NOTE 7 INCOME TAXES

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

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized a decrease in the liability for unrecognized income tax benefits of $427,000, which is reported as a cumulative effect of a change in accounting principle, and is reported as an adjustment to the beginning balance of retained earnings. Consistent with prior periods and upon adoption of FIN 48 the Company records interest and penalties related to income taxes as income tax expense in the Consolidated Statements of Income.

The Company is subject to U.S. federal income tax as well as income tax of multiple state and foreign jurisdictions. The tax years 2004-2007 remain open to examination by the Internal Revenue Service and the various state tax departments. The tax years from 2004-2007 remain open in Costa Rica.

The Company s effective income tax rate was 29% for the first six months of 2008. The effective tax rate was lower than the federal tax rate of 34% due to state income taxes and provisions for interest charges and settlement of uncertain income tax positions as described below. The Company s effective income tax rate was approximately 34% for the six months ended June 30, 2007.

Distributions by Suttle Caribe, Inc. to the parent company of income earned prior to December 31, 2000 were subject to a Puerto Rico tollgate tax at rates which, depending on various factors, range from 3.5% to 10%. The cumulative amount of prior earnings which had been distributed to the parent company on which no tollgate tax had been paid was approximately $11,054,000 at June 30, 2008. The Company had recorded a cumulative reserve of $675,000 for this uncertain tax position in prior years. The Company signed an agreement with the Puerto Rico Internal Revenue Code on May 29, 2008 for the tollgate tax payment which was determined to be $280,000 based on the agreement. The resolution of this uncertain tax position resulted in an income tax benefit of $395,000 which caused a decrease in the effective income tax rate.

NOTE 8 SEGMENT INFORMATION

The Company classifies its businesses into four segments: Suttle, which manufactures U.S. standard modular connecting and wiring devices for voice and data communications; Transition Networks, which designs and markets data transmission, computer network and media conversion products and print servers; JDL Technologies, (JDL), which provides telecommunications network design, specification and maintenance to educational institutions; and Austin Taylor which manufactures British standard telephone equipment and equipment enclosures for the U.K and international markets. Other includes non-allocated corporate general and administrative expenses. Management has chosen to organize the enterprise and disclose reportable segments based on products and services. There are no material intersegment revenue.

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Information concerning the Company s continuing operations in the various segments for the six-month and three-month periods ended June 30, 2008 and 2007 is as follows:

SEGMENT INFORMATION SIX MONTHS

	Suttle	Transition Networks	JDL Technologies	Austin Taylor	Other	Total
Six months ended June 30, 2008:						
Sales	$22,601,241	$30,324,633	$5,574,530	$3,111,873	$	$61,612,277
Cost of sales	17,018,734	15,921,759	3,392,070	2,567,460		$38,900,023
Gross profit	5,582,507	14,402,874	2,182,460	544,413		22,712,254
Selling, general and administrative expenses	3,491,766	10,100,759	484,686	549,218	1,958,009	$16,584,438
Impairment and other charges related to JDL			2,999,441			$2,999,441
Operating income (loss)	$2,090,741	$4,302,115	$(1,301,667)	$(4,805)	$(1,958,009)	$3,128,375
Depreciation and amortization	$366,149	$285,073	$286,200	$44,477	$125,440	$1,107,339
Capital expenditures	$438,574	$339,968	$	$11,156	$1,619,287	$2,408,985
Assets	$24,345,248	$25,930,045	$6,385,685	$5,468,501	$39,514,303	$101,643,782

	Suttle	Transition Networks	JDL Technologies	Austin Taylor	Other	Total
Six months ended June 30, 2007:						
Sales	$23,567,299	$24,690,698	$8,084,647	$3,358,522	$	$59,701,166
Cost of sales	17,163,182	13,359,235	4,174,306	2,582,763		$37,279,486
Gross profit	6,404,117	11,331,463	3,910,341	775,759		22,421,680
Selling, general and administrative expenses	3,582,175	8,945,062	1,575,914	637,292	1,625,161	$16,365,604
Operating income (loss)	$2,821,942	$2,386,401	$2,334,427	$138,467	$(1,625,161)	$6,056,076
Depreciation and amortization	$406,461	$208,454	$411,399	$69,162	$36,000	$1,131,476
Capital expenditures	$133,195	$630,327	$50,587	$12,343	$9,563	$836,015
Assets	$44,926,256	$28,855,331	$8,737,953	$5,885,703	$9,717,544	$98,122,787

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SEGMENT INFORMATION THREE MONTHS

	Suttle	Transition Networks	JDL Technologies	Austin Taylor	Other	Total
Three months ended June 30, 2008:						

Sales	$10,153,658	$17,276,055	$ 2,414,995	$1,446,334	$	$31,291,042
Cost of sales	8,058,266	9,077,894	1,667,929	1,225,253		$20,029,342
Gross profit	2,095,392	8,198,161	747,066	221,081		11,261,700
Selling, general and administrative expenses	1,818,586	5,316,733	255,982	266,596	895,384	$8,553,281
Impairment and other charges related to JDL			(221,313)			$(221,313)
Operating income (loss)	$276,806	$2,881,428	$ 712,397	$(45,515)	$(895,384)	$2,929,732
Depreciation and amortization	$186,069	$166,683	$ 49,800	$23,101	$66,462	$492,115
Capital expenditures	$104,445	$237,468	$	$5,855	$823,871	$1,171,639
Assets	$24,345,248	$25,930,045	$ 6,385,685	$5,468,501	$39,514,303	$101,643,782

	Suttle	**Transition Networks**	**JDL Technologies**	**Austin Taylor**	**Other**	**Total**
Three months ended June 30, 2007:						
Sales	$11,781,976	$13,087,934	$ 6,687,103	$1,698,985	$	$33,255,998
Cost of sales	8,707,071	6,814,905	2,887,607	1,268,539		$19,678,122
Gross profit	3,074,905	6,273,029	3,799,496	430,446		13,577,876
Selling, general and administrative expenses	1,832,632	4,571,150	630,014	319,203	784,514	$8,137,513
Operating income (loss)	$1,242,273	$1,701,879	$ 3,169,482	$111,243	$(784,514)	$5,440,363
Depreciation and amortization	$201,742	$100,291	$ 205,701	$34,817	$18,000	$560,551
Capital expenditures	$51,516	$542,406	$ 15,433	$3,833	$5,393	$618,581
Assets	$44,926,256	$28,855,331	$ 8,737,953	$5,885,703	$9,717,544	$98,122,787

NOTE 9 PENSIONS

The Company s U.K. based subsidiary Austin Taylor maintains defined benefit pension plans that cover approximately 10 active employees. The Company does not provide any other post-retirement benefits to its employees. Components of net periodic benefit cost of the pension plans were:

	Six Months Ended June 30	
	2008	**2007**
Service cost	$26,000	$24,000
Interest cost	157,000	156,000
Expected return on plan assets	(156,000)	(152,000)
Amortization of unrecognized (gain)/loss		70,000
	$27,000	$98,000

NOTE 10 NET INCOME PER SHARE

Basic net income per common share is based on the weighted average number of common shares outstanding during each year. Diluted net income per common share takes into effect the dilutive effect of potential common shares outstanding. The Company s only potential common shares outstanding are stock options, which resulted in a dilutive effect of 42,426 shares and 41,983 shares for the respective three and six month periods ended June 30, 2008. The dilutive effect of stock options for the three and six month periods ended June 30, 2007 was 68,667 shares and 71,918 shares, respectively. The Company calculates the dilutive effect of outstanding options using the treasury stock method. The number of shares not included in the computation of diluted earnings per share because the options exercise price was greater than the average market price of common stock during the period was 116,900 at June 30, 2008 and 2007.

NOTE 11 ASSET IMPAIRMENT

We are required to test for asset impairment relating to property and equipment whenever events or changes in circumstances indicate that the carrying value of an asset might not be recoverable. We apply SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, in order to determine whether or not an asset is impaired. This standard requires an impairment analysis when indicators of impairment are present. If such indicators are present, the standard requires that if the sum of the future expected cash flows from a company s asset, undiscounted and without interest charges, is less than the carrying value, an asset impairment must be recognized in the financial statements. The amount of the impairment is the difference between the fair value of the asset and the carrying value of the asset.

On January 17, 2008 the Company was notified by the United States Virgin Island Department of Education (VIDE), a long term customer of JDL Technologies since 1998 that the Company was not selected as a vendor to provide services for the period from July 1, 2008 to June 30, 2009. This notification was completely unexpected by the Company.

The loss of the VIDE contract for relationship represented an event that required the related asset group to be tested for impairment. The Company completed this evaluation in the first quarter of fiscal 2008 and identified an impairment of the network infrastructure supporting services provided to VIDE to the extent of its total net book value of $2,517,000.

NOTE 12 FAIR VALUE MEASUREMENTS

Effective Jan. 1, 2008, the Company adopted SFAS No. 157, Fair Value Measurements, for recurring fair value measurements. SFAS No. 157 provides a single definition of fair value and requires enhanced disclosures about assets and liabilities measured at fair value. SFAS No. 157 establishes a hierarchal framework for disclosing the observability of the inputs utilized in measuring assets and liabilities at fair value. The three levels defined by the SFAS No. 157 hierarchy and examples of each level are as follows:

Level 1 Observable inputs that reflect unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access at the measurement date. The Company s financial instruments categorized as Level 1 relate to cash equivalents.

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Level 2 Observable inputs such as quoted prices for similar instruments and quoted prices in markets that are not active, and inputs that are directly observable or can be corroborated by observable market data. The types of assets and liabilities included in Level 2 are typically either comparable to actively traded securities or contracts, such as treasury securities with pricing interpolated from recent trades of similar securities, or priced with models using highly observable inputs, such as commodity options priced using observable forward prices and volatilities.

Level 3 Significant inputs to pricing have little or no observability as of the reporting date. The types of assets and liabilities included in Level 3 are those with inputs requiring significant management judgment or estimation, such as the complex and subjective models and forecasts used to determine the fair value of financial instruments.

The Company s assets and liabilities that are measured at fair value on a recurring basis as of June 30, 2008 include cash equivalents of $20,627,000 classified as level one within the SFAS No. 157 hierarchy.

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

Forward looking statements

In this report and, from time to time, in reports filed with the Securities and Exchange Commission, in press releases, and in other communications to shareholders or the investing public, the Company may make forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 concerning possible or anticipated future financial performance, business activities, plans, pending claims, investigations or litigation which are typically preceded by the words believes , expects , anticipates , intends or similar expressions. For such forward-looking statements, the Company claims the protection of the safe harbor for forward-looking statements contained in federal securities laws. Shareholders and the investing public should understand that such forward looking statements are subject to risks and uncertainties which could cause actual performance, activities, anticipated results, outcomes or plans to differ significantly from those indicated in the forward-looking statements. Such risks and uncertainties include, but are not limited to: lower sales to major telephone companies and other major customers; the introduction of competitive products and technologies; our ability to successfully reduce operating expenses at certain business units; the general health of the telecom sector, successful integration and profitability of acquisitions; delays in new product introductions; higher than expected expense related to new sales and marketing initiatives; unfavorable resolution of claims and litigation, availability of adequate supplies of raw materials and components; fuel prices; government funding of education technology spending; and other factors discussed from time to time in the Company s filings with the Securities and Exchange Commission, including risk factors presented under Item 1A of the Company s most recently filed report on Form 10-K.

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Six Months Ended June 30, 2008 Compared to

Six Months Ended June 30, 2007

Consolidated sales increased 3% in 2008 to $61,612,000 compared to $59,701,000 in 2007. Consolidated operating income in 2008 decreased to $3,128,000 compared to $6,056,000 in the first six months of 2007. The sharp decline in operating income stems from the decision by a customer of the Company s JDL Technologies Inc. subsidiary, the U.S. Virgin Islands Department of Education (VIDE), to select another vendor to provide wireless network services for the contract year beginning July 1, 2008. JDL had supplied network services to VIDE under one year contracts since 2002. Notification of this decision by VIDE, which was totally unexpected by the Company, was given to JDL on January 17, 2008, and after unsuccessful attempts to reverse VIDE s decision, the Company decided to withdraw its operations in the Virgin Islands effective June 30, 2008. In accordance with applicable accounting principles, the Company conducted an evaluation of this event for impairment, and identified an impairment of goodwill of $704,000 and impairment of the network infrastructure with a total net book value of $2,517,000. The process of winding up JDL s Virgin Islands operations is mostly complete and the Company will continue to explore all options for selling the remaining VIDE related assets.

The Company s six month results for 2008 and 2007 also reflect the impact of revenue recognition policies adopted to account for federal government funding of services that were provided under successive one year contracts by JDL to VIDE. For reasons discussed in Note 1 to the condensed consolidated financial statements, the Company adopted a revenue recognition policy in early 2007 that it would not recognize income for its work under contracts with VIDE until a funding commitment was approved under the federal government s E-Rate program. In the second quarter of 2007, funding commitments for several contracts were received for work performed in earlier periods. As a result, in its 2007 six month financial statements the Company recognized $2,555,000 of revenue for services performed in 2006. In the current year, during first quarter of 2008 funding commitments for contracts with VIDE for work performed in 2007 were received, and the Company has recognized $1,300,000 of revenue in the 2008 first six months period.

Net income in 2008 decreased to $2,447,000 compared to $4,257,000 in the first six months of 2007.

Suttle sales decreased 4% in the first six months of 2008 to $22,601,000 compared to $23,567,000 in the same period of 2007. Sales to the major telephone companies (the Regional Bell Operating Companies (RBOCs) remained stable at $10,318,000 in 2008 compared to $10,316,000 in 2007. Sales to these customers accounted for 47% of Suttle s sales in the first six months of 2008 compared to 44% of sales in 2007. Sales to distributors, original equipment manufacturers (OEMs), and electrical contractors decreased 9% to $8,319,000 in 2008 compared to $9,119,000 in 2007, primarily due to the contraction of the housing and building sectors of the economy. This customer segment accounted for 37% and 39% of sales in the first six months of 2008 and 2007, respectively. International sales decreased 25% to $1,258,000 and accounted for 6% of Suttle s first six months 2008 sales. Sales to other customers increased 11% to $2,706,000.

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The following table summarizes Suttle s 2008 and 2007 sales by its major product groups:

	Suttle Sales by Product Group	
	2008	2007
Modular connecting products	$10,130,000	$13,217,000
DSL products	4,523,000	5,160,000
Structured cabling products	7,497,000	4,667,000
Other products	451,000	523,000
	$22,601,000	$23,567,000

Modular connecting products sales have decreased due to a slowing of the home building business, whereas structured cabling products have increased because of an increasing fiber to home market.

Suttle s gross margins decreased 13% in the first six months of 2008 to $5,582,000 compared to $6,404,000 in the same period of 2007. Gross margin percentage decreased to 25% in 2008 from 27% in 2007 due to underabsorbed overhead in their factories and product mix changes. Selling, general and administrative expenses decreased $90,000 or 3% in the first six months of 2008 compared to the same period in 2007 due to decreased sales and marketing programs. Suttle s operating income was $2,091,000 in the first six months of 2008 compared to operating income of $2,822,000 in 2007.

JDL Technologies reported 2008 first six months sales of $5,575,000 compared to $8,085,000 in 2007. The Company currently does not recognize revenue on JDL s VIDE contracts until the contacts have been approved by the E-Rate program administrator and the required services have been performed and accepted by the VIDE. (A further discussion of revenue recognition policies can be found in Note 1 to the condensed consolidated financial statements.) For the six month period ending June 30, 2007, the revenues include $2,555,000 for services provided to the VIDE in 2006 for which E-Rate approval of these contracts was received in April and May of 2007. The Company s 2008 first six months revenue includes $1,300,000 for contracts of services provided to the VIDE in 2007 which was approved in March 2008.

JDL s revenues by customer group were as follows:

	JDL Revenue by Customer Group	
	2008	2007
Broward County FL schools	$2,573,000	$2,456,000
U.S. Virgin Islands Dept. of Education (VIDE)	2,921,000	4,398,000
All other	81,000	1,231,000
	$5,575,000	$8,085,000

JDL gross margins were $2,182,000 in the first six months of 2008 compared to $3,910,000 in the same period in 2007. Gross margins in 2008 and 2007 were significantly impacted by the timing of the recognition of revenues from JDL s VIDE contracts. Costs of $1,400,000 were recorded in 2007, when the services were provided, however, the $1,300,000 revenue related to these costs was recognized in the first six months of 2008 when the E-Rate funding was approved. Similarly, the Company s 2007 revenues in the first six months include $2,555,000 for services provided to the VIDE in 2006. 2007 gross margins due to the timing of revenue recognition were partially offset by increased depreciation charges due to higher levels of plant investments in the U.S. Virgin Islands and reduced volumes of equipment sales to Broward County. VIDE s decision to select another vendor for the 2008-2009 contract year has resulted in reduced selling, general and administrative expenses. These costs decreased in 2008 to $485,000 compared to $1,576,000 in 2007 due to lower legal and professional fees, staff reductions and reductions in marketing and administrative costs. JDL reported an operating loss of $1,302,000 in the first six months of 2008 compared to $2,334,000 operating income in the same period of 2007.

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Transition Networks sales increased 23% to $30,325,000 in the first six months of 2008 compared to $24,691,000 in 2007. Sales by customer regions in the 2008 and 2007 first six months were:

	Transition Networks Sales by Region	
	2008	**2007**
North America	$ 20,548,000	$ 17,742,000
Europe, Middle East, Asia	4,753,000	3,066,000
Rest of world	5,024,000	3,883,000
	$ 30,325,000	$ 24,691,000

Sales in North America increased $2,806,000 or 16%. The increase was largely due to sales to government customers. International sales increased $2,828,000, or 41% primarily due to higher sales to Slovenia.

The following table summarizes Transition Networks 2008 and 2007 first six months sales by its major product groups:

	Transition Networks Sales by Product Group	
	2008	**2007**
Media converters	$ 23,186,000	$ 22,070,000
Ethernet switches	2,928,000	1,875,000
Ethernet adapters	2,572,000	257,000
Other products	1,639,000	489,000
	$ 30,325,000	$ 24,691,000

Gross margin on first six months Transition Networks sales increased to $14,403,000 in 2008 from $11,331,000 in 2007. Gross margin as a percentage of sales was 47% in 2008, compared to 46% in the 2007 period, due to decreased manufacturing costs and better pricing on raw material purchases. Selling, general and administrative expenses increased to $10,101,000 (33% of net revenues) in 2008 compared to $8,945,000 (36% of net revenues) in 2007. Operating income increased to $4,302,000 in 2008 compared to $2,386,000 in 2007.

Austin Taylor s revenues decreased to $3,112,000 compared to $3,359,000 for the first six months of 2007. Gross margin decreased 30% to $544,000 in 2008 from $776,000 in 2007. This decrease was due to greatly increased material costs during the first six months of 2008, a trend that has accelerated. Gross margin as a percentage of sales was 17% in 2008 compared to 23% in 2007. Austin Taylor reported an operating loss in 2008 of $5,000 compared to operating income of $138,000 in 2007.

Net investment income was $318,000 in 2008 compared to $465,000 in 2007 due to decreased cash and investment balances and lower rates earned on funds invested. Income before income taxes decreased to $3,446,000 in 2008 compared to $6,522,000 in 2007. The Company s effective income tax rate was 29% during the first six months of 2008 compared to 35% for the same period in 2007 because, due to the settlement of the Puerto Rico toll gate tax as discussed in Note 7, the Company was able to reduce its reserve for certain state and foreign tax

liabilities.

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Three Months Ended June 30, 2008 Compared to

Three Months Ended June 30, 2007

Consolidated sales decreased 6% in 2008 to $31,291,000 compared to $33,256,000 in 2007. Consolidated operating income in 2008 decreased to $2,930,000 compared to $5,440,000 in the first six months of 2007 primarily due to the impairment charge discussed under management s discussion of results for the first six months of 2008 compared to the same period in 2007.

Net income in 2008 decreased to $2,261,000 compared to $3,720,000 in the second quarter of 2007.

Suttle sales decreased 14% in the second quarter of 2008 to $10,154,000 compared to $11,782,000 in the same period of 2007 due to a general slow down in the housing market. Sales to the major telephone companies (the Regional Bell Operating Companies (RBOCs) decreased 16% to $4,301,000 in 2008 compared to $5,109,000 in 2007 due to lower sales of modular connecting products. Sales to these customers accounted for 42% of Suttle s sales in the 2008 second quarter compared to 43% of sales in 2007. Sales to distributors, original equipment manufacturers (OEMs), and electrical contractors decreased 6% to $4,238,000 in 2008 compared to $4,510,000 in 2007, primarily due to the contraction of the housing and building sectors of the economy. This customer segment accounted for 42% and 38% of sales in the second quarters of 2008 and 2007, respectively. International sales decreased 47% to $552,000 and accounted for 5% of Suttle s second quarter 2008 sales. Suttle s products do not have a large international market, due to product mix differences internationally. Sales to other customers decreased 6% to $1,063,000.

The following table summarizes Suttle s 2008 and 2007 sales by its major product groups:

	Suttle Sales by Product Group	
	2008	**2007**
Modular connecting products	$4,153,000	$6,616,000
DSL products	2,185,000	2,652,000
Structured cabling products	3,727,000	2,337,000
Other products	89,000	177,000
	$10,154,000	$11,782,000

Modular connecting products sales have decreased due to a slowing of the home building business, whereas structured cabling products have increased because of an increasing fiber to home market.

Suttle s gross margins decreased 32% in the second quarter of 2008 to $2,095,000 compared to $3,075,000 in the same period of 2007. Gross margin percentage decreased to 21% in 2008 from 26% in 2007 due to underabsorbed overhead in their factories and product mix changes. Selling, general and administrative expenses decreased $14,000 or 1% in the second quarter of 2008 and remained consistent with the same period in 2007. Suttle s operating income was $277,000 in the second quarter of 2008 compared to operating income of $1,242,000 in 2007.

JDL Technologies reported 2008 second quarter sales of $2,415,000 compared to $6,687,000 in 2007.

JDL s revenues by customer group were as follows:

	JDL Revenue by Customer Group	
	2008	**2007**
Broward County FL schools	$1,581,000	$1,425,000
U.S. Virgin Islands Dept. of Education (VIDE)	834,000	4,313,000
All other		949,000
	$2,415,000	$6,687,000

The Company currently does not recognize revenue on JDL s VIDE contracts until the contacts have been approved by the E-Rate program administrator and the required services have been performed and accepted by the VIDE. (A further discussion of revenue recognition policies can be found in Note 1 to the consolidated financial statements.)

The Company s second quarter results for 2007 reflect the impact of revenue recognition policies discussed above to account for federal government funding of services that were provided by JDL to VIDE. In April and May 2007 funding commitments for several contracts were received. As a result, the Company recognized $2,555,000 of revenue for services provided to VIDE in 2006.

JDL gross margins were $747,000 in the second quarter of 2008 compared to $3,799,000 in the same period in 2007. Gross margins in 2007 and 2008 were significantly impacted by the timing of the recognition of revenues from JDL s VIDE contracts. Selling, general and administrative expenses decreased in 2008 to $256,000 compared to $630,000 in 2007 due to lower legal and professional fees, staff reductions and cuts in marketing and administrative costs. JDL reported operating income of $712,000 in the second quarter of 2008 compared to $3,169,000 in the same period of 2007.

Transition Networks sales increased 32% to $17,276,000 in the second quarter of 2008 compared to $13,088,000 in 2007. Sales by customer regions in the 2008 and 2007 second quarters were:

	Transition Networks Sales by Region	
	2008	**2007**
North America	$10,914,000	$9,824,000

Europe, Middle East, Asia	3,476,000	1,519,000
Rest of world	2,886,000	1,745,000
	$ 17,276,000	$ 13,088,000

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Sales in North America increased $1,090,000 or 11%. The increase was largely due to sales to government customers. International sales increased $3,098,000, or 95% primarily due to higher sales to Slovenia.

The following table summarizes Transition Networks 2008 and 2007 second quarter sales by its major product groups:

	Transition Networks Sales by Product Group	
	2008	**2007**
Media converters	$ 11,899,000	$ 11,340,000
Ethernet switches	2,326,000	1,114,000
Ethernet adapters	2,019,000	257,000
Other products	1,032,000	377,000
	$ 17,276,000	$ 13,088,000

Gross margin on second quarter Transition Networks sales increased to $8,198,000 in 2008 from $6,273,000 in 2007. Gross margin as a percentage of sales was 47% in 2008, compared to 48% in the 2007 period, due to decreased manufacturing costs and better pricing on raw material purchases. Selling, general and administrative expenses increased to $5,317,000 in 2008 compared to $4,571,000 in 2007. Operating income increased to $2,881,000 in 2008 compared to $1,702,000 in 2007.

Austin Taylor s revenues decreased to $1,446,000 for the second quarter of 2008, compared to $1,699,000 for the second quarter of 2007. Gross margin decreased 49% to $221,000 in 2008 from $430,000 in 2007. Gross margin as a percentage of sales was 15% in 2008 compared to 25% in 2007. Austin Taylor reported an operating loss in 2008 of $46,000 compared to operating income of $111,000 in 2007.

Net investment income was $160,000 in 2008 compared to $260,000 in 2007 due to decreased cash and investment balances and lower rates earned on funds invested. Income before income taxes decreased to $3,090,000 in 2008 compared to $5,700,000 in 2007. The Company s effective income tax rate was 27% in 2008 compared to 35% in 2007 and decreased because, due to the settlement of the Puerto Rico toll gate tax as discussed in Note 7, the Company was able to reduce its reserve for certain state and foreign tax liabilities.

Liquidity and Capital Resources

At June 30, 2008, the Company had approximately $27,564,000 of cash and cash equivalents compared to $29,428,000 of cash and cash equivalents at December 31, 2007. The Company had current assets of approximately $82,352,000 and current liabilities of $12,001,000 at June

30, 2008 compared to current assets of $80,784,000 and current liabilities of $11,785,000 at December 31, 2007.

Net cash provided by operating activities was $2,412,000 in the first six months of 2008 compared to $3,434,000 provided in the same period in 2007. Significant working capital changes from December 31, 2007 to June 30, 2008 included increased accounts receivables of $4,346,000 due to increased sales and the timing of collections, an increase in other assets of $947,000 due to a prepayment for inventory at Transition and decreased amounts of accrued compensation of $1,105,000 due to payment of accrued bonuses.

Net cash used in investing activities was $2,281,000 in the first six months in 2008 compared to cash used of $945,000 in the same period in 2007, primarily due to capital expenditures at the Company s new building in Minnetonka, Minnesota. In July, 2007 the Company completed the acquisition of this new building to house its Twin Cities based operations. Cash investments in other plant and equipment totaled $2,409,000 compared to $836,000 in 2007. Spending on other capital additions in 2008 is expected to total $1,900,000 in the third and fourth quarters of 2008.

Net cash used in financing activities was $1,983,000 and $1,017,000 in the first six months of 2008 and 2007, respectively. Cash dividends paid in the first six months of 2008 were $2,063,000 ($0.24 per common share) compared to $1,757,000 ($.20 per common share) in the same period in 2007. The Company s Board of Directors has authorized the purchase and retirement, from time to time, of shares of the Company s stock on the open market, or in private transactions consistent with overall market and financial conditions. In the first six months of 2008, the Company purchased and retired 9,430 of its common shares at a cost of $104,000. At June 30, 2008, 321,532 additional shares could be repurchased under outstanding Board authorizations. The Company has a $10,000,000 line of credit from U.S. Bank. Interest on borrowings on the credit line is at the LIBOR rate plus 1.5% (4.2% at June 30, 2008). There were no borrowings on the line of credit during the first six months of 2008 or 2007. The credit agreement expires September 30, 2008 and is secured by assets of the Company. As part of the acquisition of the new Minnetonka headquarters building in July 2007, the Company assumed an outstanding mortgage of $4,380,000. The mortgage is payable in monthly installments and carries an interest rate of 6.83%. The mortgage matures on March 1, 2016. Remaining mortgage payments on principal totaled $81,000 during the second quarter of 2008. The outstanding balance on the mortgage was $3,288,000 at June 30, 2008.

In the opinion of management, based on the Company s current financial and operating position and projected future expenditures, sufficient funds are available to meet the Company s anticipated operating and capital expenditure needs.

Critical Accounting Policies

Our critical accounting policies, including the assumptions and judgments underlying them, are discussed in our 2007 Form 10-K in Note 1 Summary of Significant Accounting Policies included in our Consolidated Financial Statements. There were no significant changes to our critical accounting policies during the six months ended June 30, 2008, except for the adoption of SFAS No. 157 as discussed below.

The Company s accounting policies have been consistently applied in all material respects and disclose such matters as allowance for doubtful accounts, sales returns, inventory valuation, warranty expense, income taxes, revenue recognition, asset and goodwill impairment recognition and foreign currency translation. On an ongoing basis, we evaluate our estimates based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the result of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Results may differ from these estimates due to actual outcomes being different from those on which we based our assumptions. Management on an ongoing basis reviews these estimates and judgments.

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Recently Issued Accounting Pronouncements

In February 2007 the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The amendment to SFAS No. 115 applies to all entities with investments in available-for-sale or trading securities. The statement is effective for fiscal years beginning after November 15, 2007. As of June 30, 2008 the Company had not opted, nor does it currently plan to opt, to apply fair value accounting to any financial instruments or other items that it is not currently required to account for at fair value.

In December 2007, the FASB issued SFAS No. 141 (revised). SFAS No. 141 (revised) requires an acquirer to recognize and measure the assets acquired, liabilities assumed and any non-controlling interests in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exception. In addition, SFAS No. 141 (revised) requires that acquisition-related costs will be generally expensed as incurred. SFAS No. 141 (revised) also expands the disclosure requirements for business combinations. SFAS No. 141 (revised) will be effective for the Company on January 1, 2009. The Company is evaluating the effects of the adoption of SFAS No. 141 (revised).

In December 2007, the FASB issued SFAS No. 160. SFAS No. 160 establishes accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 will be effective for the Company on January 1, 2009. The Company is evaluating the effects of the adoption of SFAS No. 160.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements. SFAS No. 162 is effective 60 days following the Securities and Exchange Commission s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company does not expect that this standard will have a material impact on its results of operations, financial position or cash flows.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

The Company has no freestanding or embedded derivatives. The Company s policy is to not use freestanding derivatives and to not enter into contracts with terms that cannot be designated as normal purchases or sales.

The vast majority of our transactions are denominated in U.S. dollars; as such, fluctuations in foreign currency exchange rates have historically not been material to the Company. At June 30, 2008 our bank line of credit carried a variable interest rate based on the London Interbank Offered Rate (Libor) plus 1.5%. The Company s investments are money market type of investments that earn interest at prevailing market rates and as such do not have material risk exposure.

Based on the Company s operations, in the opinion of management, no material future losses or exposure exist relative to market risk.

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Item 4. Controls and Procedures

The Company, under the supervision and with the participation of management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), evaluated the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rule 13a 15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on that evaluation, the CEO and CFO concluded that, as of the end of the period covered by this report, the Company s disclosure controls and procedures were not effective due to deficiencies in the controls over the financial close and reporting processes at the Company s headquarters.

Operating Effectiveness of Accounting and Control Procedures. We concluded that, in the aggregate, a material weakness existed as of June 30, 2008 related to documentation and review of significant accounting judgments and estimates, balance sheet account reconciliations, financial closing processes and financial reporting processes at period ends. We had implemented control procedures in the last quarter of fiscal 2007 as described below, however these controls have not operated effectively for a sufficient period of time. Therefore, we have concluded that these control procedures were not effective. Once we have performed the procedures on a repeated basis, we will be able to reevaluate their effectiveness.

Changes in Internal Control over Financial Reporting

The following changes to our internal controls over financial reporting were substantially completed during the fourth quarter of fiscal 2007 and had positively affected, or were reasonably likely to positively affect, our internal control over financial reporting:

- We have developed detailed methodologies for all items requiring management s estimate and judgment and these methodologies formally document management s thought processes used to determine the amounts in estimates and such analyses are shared with the audit committee;
- We have developed formal processes to document completion and review and approval of balance sheet account reconciliations;

We have implemented processes to provide for supporting documentation and evidence of independent review and approval of journal entries, processes to require execution of sub-certifications of appropriate officers, processes to ensure that monthly close checklists are implemented and followed, processes to ensure formal review and approval of final subsidiary trial balances to reconcile agreement to consolidating schedule and processes to ensure review of posted journal entries;
We have developed templates and checklists for disclosure items and preparation of periodic reports.

During the period covered by this Report there was no additional change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Not Applicable

Item 1A. Risk Factors

In addition to the risk factors disclosed elsewhere in this report or in the Company s 2007 Annual Report on Form 10-K, the following risk factor should be considered when reviewing other information set forth in this report and previously filed reports.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that disclosure controls and procedures will prevent all possible error or fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations, include, the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of persons, by collusion of two or more persons, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies and procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

Department of Justice Investigation

In April 2006, the Company s JDL Technologies, Inc. subsidiary (along with other parties) was notified it was the subject of a civil investigation by the U.S. Department of Justice (DOJ) into whether false claims under the federal government s E-RATE program were made in connection with work performed for the Virgin Islands Department of Education (VIDE). In addition to voluntarily cooperating with DOJ investigators over the past 24 months, the Company has conducted its own internal investigation of its business dealings with VIDE and its compliance with the

E-RATE program. While the DOJ has not indicated to the Company that it has discontinued its investigation, neither the Company, nor its counsel has received a direct communication from the DOJ in over a year and no legal action has been initiated against the Company by the DOJ or any other agency as of the date of this report. In addition, as a result of its own investigation, the Company believes it has acted ethically and legally in its business dealings with the VIDE and in its compliance with E-RATE program requirements and believes that the DOJ investigation will be resolved without material cost to the Company. Nevertheless, the possibility exists that the DOJ may assert claims against JDL that, if proved, could result in materially adverse financial consequences to the Company. In addition, the Company s ability to receive E-RATE funds may be affected by actions taken by other individuals or companies involved with the VIDE and E-RATE programs. If the VIDE were to be sanctioned by the E-RATE program as a result of the DOJ investigation, JDL may be unable to collect for provided services even though JDL s conduct is compliant with the E-RATE program.

Items 2 5. Not Applicable

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Item 6. Exhibits.

The following exhibits are included herein:

31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rules 13a-14 and 15d-14 of the Exchange Act).
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rules 13a-14 and 15d-14 of the Exchange Act).
32.	Certifications pursuant Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350).

Signatures

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

Communications Systems, Inc.

By /s/ Jeffrey K. Berg
Jeffrey K. Berg
President and Chief Executive Officer

Date: August 14, 2008

	/s/ David T. McGraw
	David T. McGraw
Date: August 14, 2008	Chief Financial Officer