

ELECTRO SENSORS INC  
Form 10-Q  
November 13, 2018  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

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

For the quarterly period ended September 30, 2018

Or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-09587

ELECTRO-SENSORS, INC.

(Exact name of registrant as specified in its charter)

Minnesota  
(State or other jurisdiction of incorporation or organization)

41-0943459  
(IRS Employer Identification No.)

6111 Blue Circle Drive  
Minnetonka, Minnesota 55343-9108

(Address of principal executive offices)

(952) 930-0100

(Registrant's telephone number, including area code)

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

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

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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," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  
Non-accelerated filer

Accelerated filer  
Smaller reporting company  
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The number of shares outstanding of the registrant's common stock, \$0.10 par value, on November 12, 2018 was 3,395,521.

ELECTRO-SENSORS, INC.

Form 10-Q

For the Periods Ended September 30, 2018

**TABLE OF CONTENTS**

**PART I – FINANCIAL INFORMATION**

Item 1. Financial Statements (unaudited):

Balance Sheets – As of September 30, 2018 and December 31, 2017

Statements of Comprehensive Income (Loss) – For the Three and Nine Months ended September 30, 2018 and September 30, 2017

Statements of Cash Flows – For the Nine Months ended September 30, 2018 and September 30, 2017

Notes to Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

**PART II – OTHER INFORMATION**

Item 1. Legal Proceedings

Item 1A. Risk Factors

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

Item 3. Defaults Upon Senior Securities

Item 4. Mine Safety Disclosures

Item 5. Other Information

Item 6. Exhibits

**SIGNATURES**

PART I. FINANCIAL INFORMATIONItem 1. Financial Statements

## ELECTRO-SENSORS, INC.

BALANCE SHEETS

(in thousands except share and per share amounts)

|  | September<br>30,<br>2018<br>(unaudited) | December<br>31,<br>2017 |
|--|---|-------------------------|
| <b>ASSETS</b>  |   |                         |
| Current assets   |   |                         |
| Cash and cash equivalents  | \$ 853                                  | \$ 963                  |
| Investments  | 7,749                                   | 7,756                   |
| Trade receivables, less allowance for doubtful accounts of \$11  | 1,044                                   | 902                     |
| Inventories  | 1,604                                   | 1,552                   |
| Other current assets   | 171                                     | 141                     |
| Income tax receivable  | 17                                      | 45                      |
| Total current assets   | 11,438                                  | 11,359                  |
| Deferred income tax asset, net   | 178                                     | 182                     |
| Intangible assets, net   | 624                                     | 800                     |
| Property and equipment, net  | 1,041                                   | 1,074                   |
| Total assets   | \$ 13,281                               | \$ 13,415               |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |   |                         |
| Current liabilities  |   |                         |
| Contingent earn-out  | \$ 0                                    | \$ 150                  |
| Accounts payable   | 193                                     | 178                     |
| Accrued expenses   | 425                                     | 380                     |
| Total current liabilities  | 618                                     | 708                     |
| Commitments and contingencies  |   |                         |
| Stockholders' equity   |   |                         |
| Common stock par value \$0.10 per share; authorized 10,000,000 shares; 3,395,521 shares issued and outstanding | 339                                     | 339                     |
| Additional paid-in capital   | 2,011                                   | 2,004                   |
| Retained earnings  | 10,287                                  | 10,352                  |

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|  |           |           |
|--|-----------|-----------|
| Accumulated other comprehensive gain (unrealized gain on available-for-sale securities, net of income tax) | 26        | 12        |
| Total stockholders' equity   | 12,663    | 12,707    |
| Total liabilities and stockholders' equity   | \$ 13,281 | \$ 13,415 |
| See accompanying notes to unaudited financial statements   |           |           |

4

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## ELECTRO-SENSORS, INC.

STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands except share and per share amounts)

(unaudited)

|  | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|--|-------------------------------------|---------|------------------------------------|---------|
|  | 2018                                | 2017    | 2018                               | 2017    |
| Net sales  | \$2,146                             | \$2,078 | \$5,642                            | \$6,075 |
| Cost of goods sold   | 951                                 | 944     | 2,559                              | 2,718   |
| Gross profit   | 1,195                               | 1,134   | 3,083                              | 3,357   |
| Operating expenses   |                                     |         |                                    |         |
| Selling and marketing  | 406                                 | 342     | 1,242                              | 1,127   |
| General and administrative   | 414                                 | 402     | 1,370                              | 1,225   |
| Research and development   | 176                                 | 168     | 628                                | 590     |
| Total operating expenses   | 996                                 | 912     | 3,240                              | 2,942   |
| Operating income (loss)  | 199                                 | 222     | (157 )                             | 415     |
| Non-operating income   |                                     |         |                                    |         |
| Interest income  | 36                                  | 9       | 83                                 | 22      |
| Other income   | 2                                   | 3       | 7                                  | 8       |
| Total non-operating income   | 38                                  | 12      | 90                                 | 30      |
| Income (loss) before income tax expense (benefit)                              | 237                                 | 234     | (67 )                              | 445     |
| Provision for (benefit from) income taxes                                      | 50                                  | 82      | (9 )                               | 154     |
| Net income (loss)  | \$187                               | \$152   | \$(58 )                            | \$291   |
| Other comprehensive income   |                                     |         |                                    |         |
| Change in unrealized value of available-for-sale securities, net of income tax | \$0                                 | \$6     | \$6                                | \$10    |
| Other comprehensive income   | 0                                   | 6       | 6                                  | 10      |
| Net comprehensive income (loss)  | \$187                               | \$158   | \$(52 )                            | \$301   |
| Net income (loss) per share data:  |                                     |         |                                    |         |
| Basic  |                                     |         |                                    |         |
| Net income (loss) per share  | \$0.06                              | \$0.04  | \$(0.02 )                          | \$0.09  |

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Weighted average shares                                  | 3,395,521 | 3,395,521 | 3,395,521 | 3,395,521 |
| Diluted  |           |           |           |           |
| Net income (loss) per share                              | \$0.06    | \$0.04    | \$(0.02)  | ) \$0.09  |
| Weighted average shares                                  | 3,398,238 | 3,400,988 | 3,395,521 | 3,396,899 |
| See accompanying notes to unaudited financial statements |           |           |           |           |

5

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## ELECTRO-SENSORS, INC.

STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

|   | Nine Months Ended<br>September 30, |          |
|---|------------------------------------|----------|
|   | <b>2018</b>                        | 2017     |
| Cash flows from (used in) operating activities  |                                    |          |
| Net income (loss)   | \$ (58 )                           | \$ 291   |
| Adjustments to reconcile net income (loss) to net cash from (used in) operating activities: |                                    |          |
| Depreciation and amortization   | 238                                | 233      |
| Deferred income taxes   | 0                                  | (62 )    |
| Stock-based compensation expense  | 7                                  | 48       |
| Change in contingent earn-out fair value  | 0                                  | (53 )    |
| Interest accrued on treasury bills  | (78 )                              | (21 )    |
| Change in:  |                                    |          |
| Trade receivables   | (142 )                             | (272 )   |
| Inventories   | (52 )                              | (13 )    |
| Other current assets  | (30 )                              | (3 )     |
| Accounts payable  | 15                                 | (106 )   |
| Accrued expenses  | 45                                 | 135      |
| Income tax receivable   | 28                                 | 139      |
| Net cash from (used in) operating activities  | (27 )                              | 316      |
| Cash flows from investing activities  |                                    |          |
| Purchases of treasury bills   | (10,654)                           | (5,956 ) |
| Proceeds from the maturity of treasury bills  | 10,750                             | 6,000    |
| Purchase of property and equipment  | (29 )                              | (15 )    |
| Net cash from investing activities  | 67                                 | 29       |
| Cash flows used in financing activities   |                                    |          |
| Payment of contingent earn-out  | (150 )                             | 0        |
| Net cash used in financing activities   | (150 )                             | 0        |
| Net increase (decrease) in cash and cash equivalents  | (110 )                             | 345      |
| Cash and cash equivalents, beginning  | 963                                | 840      |

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|                                    |        |          |
|------------------------------------|--------|----------|
| Cash and cash equivalents, ending  | \$ 853 | \$ 1,185 |
| Supplemental cash flow information |        |          |
| Cash paid for income taxes         | \$ 0   | \$ 125   |

See accompanying notes to unaudited financial statements

6

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ELECTRO-SENSORS, INC.

NOTES TO FINANCIAL STATEMENTS  
FOR THE PERIOD ENDED SEPTEMBER 30, 2018

(in thousands except share and per share amounts)

(unaudited)

Note 1. Basis of Presentation

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

This report should be read together with the Company's Annual Report on Form 10-K for the year ended December 31, 2017, including the audited financial statements and footnotes therein.

Management believes that the unaudited financial statements include all adjustments, consisting of normal recurring accruals, necessary to fairly state the financial position and results of operations as of September 30, 2018 and for the three and nine-month periods then ended in accordance with accounting principles generally accepted in the United States of America. The results of interim periods may not be indicative of results to be expected for the year.

Nature of Business

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

**Revenue Recognition**

On January 1, 2018, the Company adopted Accounting Standards Codification (ASC) *Revenue from Contracts with Customers* and all related amendments (the Standard), for all contracts using the modified retrospective method. The Standard implements a five-step process for revenue recognition that focuses on transfer of control and defines a contract as “an agreement between two or more parties that creates legally enforceable rights and obligations.” The adoption of the Standard did not materially affect the timing and measurement of our revenue recognition. As a result, we did not recognize a cumulative effect adjustment to the opening balance of retained earnings.

At contract inception, the Company assesses the goods and services promised to a customer and identifies a performance obligation for each promised good or service that is distinct. In addition, the transaction price for each performance obligation is determined at contract inception. Our contracts, generally in the form of a purchase order, specify the product or service that is promised to the customer. The typical contract life is less than one month and contains a single performance obligation, to provide conforming goods or services to the customer. Product revenue is recognized at the point in time when control of the product is transferred to the customer, which typically occurs when products are shipped. Service revenue is recognized at the point in time when the service has been provided.

#### Fair Value Measurements

The carrying value of trade receivables, accounts payable, and other financial working capital items approximates fair value at September 30, 2018 and December 31, 2017, due to the short maturity nature of these instruments.

ELECTRO-SENSORS, INC.

NOTES TO FINANCIAL STATEMENTS

FOR THE PERIOD ENDED SEPTEMBER 30, 2018

(in thousands except share and per share amounts)

(unaudited)

### Stock-Based Compensation

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

As of September 30, 2018, there was approximately \$9 of unrecognized compensation expense related to unvested stock options. The Company expects to recognize this expense over the next two years.

### Use of Estimates

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

### Recently Adopted Accounting Pronouncement

In January 2016, the FASB issued Accounting Standards Update No. 2016-01 (ASU 2016-01) "Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,"

which amends various aspects of the recognition, measurement, presentation, and disclosure of financial instruments. The Company adopted ASU 2016-01 as of January 1, 2018 using the modified retrospective method for marketable equity securities. This resulted in a \$7 reclassification of net unrealized losses from accumulated other comprehensive gain (AOCI) to retained earnings. The adoption of ASU 2016-01 increases the possibility of increased volatility of non-operating income, as a result of the requirement to remeasure our equity securities each reporting period. For further information on unrealized gains from equity securities, see Note 2.

### **Net Income (Loss) per Common Share**

Basic and diluted net income (loss) per common share is determined by dividing net income (loss) attributable to common stockholders by the weighted-average common shares outstanding during the period. For the nine months ended September 30, 2018, the common shares underlying stock options have been excluded from the calculation because their effect would be anti-dilutive. Therefore, the weighted-average shares outstanding used to calculate both basic and diluted loss per common shares are the same.

For the nine months ended September 30, 2018, 6,812 option share equivalents have been excluded from the computations of diluted weighted-average shares outstanding.

### **Reclassification**

Certain items related to freight costs in the 2017 financial statements have been reclassified to conform to the 2018 presentation. These reclassifications had no effect on stockholders' equity, net income, or cash flows.

ELECTRO-SENSORS, INC.

NOTES TO FINANCIAL STATEMENTS

FOR THE PERIOD ENDED SEPTEMBER 30, 2018

(in thousands except share and per share amounts)

(unaudited)

Note 2. Investments

The Company has investments in commercial paper, Treasury Bills, and common equity securities of a private U.S. company. The commercial paper investment is in U.S. debt with ratings of A-1+, P-1, and F1+. The Treasury Bills have terms ranging from one month to six months at September 30, 2018.

The Company classifies its investments in commercial paper and Treasury Bills as available-for-sale accounted for at fair value with unrealized gains and losses recognized in accumulated other comprehensive gain on the balance sheet.

Prior to January 1, 2018, the Company accounted for equity securities at fair value with unrealized gains and losses recognized in accumulated other comprehensive gain on the balance sheet. Realized gains and losses on equity securities sold or impaired were recognized in non-operating income on the statement of comprehensive income (loss).

On January 1, 2018, the Company adopted ASU 2016-01, which changed the way the Company accounted for equity securities. Equity securities are measured at fair value and starting January 1, 2018 unrealized gains and losses are recognized in non-operating income. Upon adoption, the Company reclassified \$7 net unrealized losses related to equity securities from accumulated other comprehensive gain to retained earnings.

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

|                    | Cost   | Gross<br>unrealized<br>gain | Gross<br>unrealized<br>loss | Fair<br>value |
|--------------------|--------|-----------------------------|-----------------------------|---------------|
| September 30, 2018 |        |                             |                             |               |
| Commercial Paper   | \$ 316 | \$ 0                        | \$ 0                        | \$ 316        |

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|                                       |          |       |       |   |          |
|---------------------------------------|----------|-------|-------|---|----------|
| Treasury Bills                        | 7,671    | 33    | 0     |   | 7,704    |
| Equity Securities                     | 54       | 0     | (9    | ) | 45       |
|                                       | 8,041    | 33    | (9    | ) | 8,065    |
| Less Cash Equivalents                 | 316      | 0     | 0     |   | 316      |
| Total Investments, September 30, 2018 | \$ 7,725 | \$ 33 | \$ (9 | ) | \$ 7,749 |
| December 31, 2017                     |          |       |       |   |          |
| Commercial Paper                      | \$ 568   | \$ 0  | \$ 0  |   | \$ 568   |
| Treasury Bills                        | 7,687    | 24    | 0     |   | 7,711    |
| Equity Securities                     | 54       | 0     | (9    | ) | 45       |
|                                       | 8,309    | 24    | (9    | ) | 8,324    |
| Less Cash Equivalents                 | 568      | 0     | 0     |   | 568      |
| Total Investments, December 31, 2017  | \$ 7,741 | \$ 24 | \$ (9 | ) | \$ 7,756 |



**ELECTRO-SENSORS, INC.**

## NOTES TO FINANCIAL STATEMENTS

FOR THE PERIOD ENDED SEPTEMBER 30, 2018

(in thousands except share and per share amounts)

(unaudited)

## Note 3. Fair Value Measurements

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

September 30, 2018

|                   | Carrying amount<br>in balance sheet | Fair Value | Fair Value Measurement Using |         |         |
|-------------------|-------------------------------------|------------|------------------------------|---------|---------|
|                   |                                     |            | Level 1                      | Level 2 | Level 3 |
| Assets:           |                                     |            |                              |         |         |
| Cash equivalents  |                                     |            |                              |         |         |
| Commercial paper  | \$ 316                              | \$ 316     | \$ 316                       | \$ 0    | \$ 0    |
| Treasury bills    | 7,704                               | 7,704      | 7,704                        | 0       | 0       |
| Equity Securities | 45                                  | 45         | 0                            | 0       | 45      |

December 31, 2017

|                     | Carrying amount<br>in balance sheet | Fair Value | Fair Value Measurement Using |         |         |
|---------------------|-------------------------------------|------------|------------------------------|---------|---------|
|                     |                                     |            | Level 1                      | Level 2 | Level 3 |
| Assets:             |                                     |            |                              |         |         |
| Cash equivalents    |                                     |            |                              |         |         |
| Commercial paper    | \$ 568                              | \$ 568     | \$ 568                       | \$ 0    | \$ 0    |
| Treasury bills      | 7,711                               | 7,711      | 7,711                        | 0       | 0       |
| Equity Securities   | 45                                  | 45         | 0                            | 0       | 45      |
| Liabilities:        |                                     |            |                              |         |         |
| Contingent earn-out | 150                                 | 150        | 0                            | 0       | 150     |

The fair value of the commercial paper and treasury bills is based on quoted market prices in an active market. There is not a significant market for the available-for-sale equity security owned by the Company. The Company has determined the fair value for this equity security based on financial and other factors that are considered level 3 inputs in the fair value hierarchy.

The contingent earn-out relates to the 2014 acquisition of the HazardPRO™ product line. Management estimated the probability of meeting the revenue targets over the measurement period to determine the fair value of the contingent earn-out, which is considered a level 3 input in the fair value hierarchy. The contingent earn-out was paid in full during the first quarter of 2018.

The change in level 3 liabilities at fair value on a recurring basis for the three and nine months ended September 30, 2018 and 2017 are as follows:

|                      | Three Months Ended September 30 |        | Nine Months Ended September 30 |        |
|----------------------|---------------------------------|--------|--------------------------------|--------|
|                      | 2018                            | 2017   | 2018                           | 2017   |
| Beginning Balance    | \$ 0                            | \$ 142 | \$ <b>150</b>                  | \$ 195 |
| Change in Fair Value | 0                               | 0      | <b>0</b>                       | (53 )  |
| Payments             | 0                               | 0      | <b>(150 )</b>                  | 0      |
| Ending Balance       | \$ 0                            | \$ 142 | \$ <b>0</b>                    | \$ 142 |

**ELECTRO-SENSORS, INC.**

NOTES TO FINANCIAL STATEMENTS

FOR THE PERIOD ENDED SEPTEMBER 30, 2018

(in thousands except share and per share amounts)

(unaudited)

**Note 4. Commitments**

**Lease commitments**

The Company is leasing office equipment under an operating lease expiring in 2023.

Minimum lease payments required under non-cancelable operating leases are as follows:

| Year                         | Amount |
|------------------------------|--------|
| 2018                         | \$ 2   |
| 2019                         | 7      |
| 2020                         | 7      |
| 2021                         | 7      |
| 2022                         | 7      |
| Thereafter                   | 6      |
| Total minimum lease payments | 36     |

Rental expense charged to operations was \$1 for the three months ended September 30, 2018.

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

FORWARD-LOOKING STATEMENTS

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

All forward-looking statements in this document are based on information available to us as of the date of this Form 10-Q, and we assume no obligation to update any of these forward-looking statements, other than as required by law. Our actual results could differ materially from those projected or indicated in these forward-looking statements. These forward-looking statements are subject to certain risks and uncertainties that could cause future results to differ materially from our recent results or those projected in the forward-looking statements, including the accuracy of management's assumptions with respect to industry trends, fluctuations in industry conditions, the accuracy of management's assumptions regarding expenses and our cash needs and those listed under the heading "Cautionary Statements" under "Item 1—Business," in our Annual Report on Form 10-K for the year ended December 31, 2017.

CRITICAL ACCOUNTING ESTIMATES

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make decisions based upon estimates, assumptions, and factors it considers relevant to the circumstances. These decisions include the selection of applicable accounting principles and the use of judgment in their application, and affect reported amounts and disclosures. Changes in economic conditions or other business circumstances may affect the outcomes of management's estimates and assumptions. An in-depth description of our accounting estimates can be found in the interim financial statements included in this report and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017. We have not developed new estimates subsequent to those discussed in our Annual Report.

## SELECTED FINANCIAL INFORMATION

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

|   | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|---|-------------------------------------|---------|------------------------------------|---------|
|   | 2018                                | 2017    | 2018                               | 2017    |
| Net sales   | 100.0 %                             | 100.0 % | 100.0 %                            | 100.0 % |
| Cost of goods sold                                | 44.3                                | 45.4    | 45.4                               | 44.7    |
| Gross profit                                      | 55.7                                | 54.6    | 54.6                               | 55.3    |
| Operating expenses                                |                                     |         |                                    |         |
| Selling and marketing                             | 18.9                                | 16.5    | 22.0                               | 18.6    |
| General and administrative                        | 19.3                                | 19.3    | 24.3                               | 20.2    |
| Research and development                          | 8.2                                 | 8.1     | 11.1                               | 9.7     |
| Total operating expenses                          | 46.4                                | 43.9    | 57.4                               | 48.5    |
| Operating income (loss)                           | 9.3                                 | 10.7    | (2.8 )                             | 6.8     |
| Non-operating income                              |                                     |         |                                    |         |
| Interest income                                   | 1.7                                 | 0.5     | 1.5                                | 0.4     |
| Other income                                      | 0.0                                 | 0.1     | 0.1                                | 0.1     |
| Total non-operating income                        | 1.7                                 | 0.6     | 1.6                                | 0.5     |
| Income (loss) before income tax expense (benefit) | 11.0                                | 11.3    | (1.2 )                             | 7.3     |
| Provision for (benefit from) income taxes         | 2.3                                 | 3.9     | (0.2 )                             | 2.5     |
| Net income (loss)                                 | 8.7 %                               | 7.4 %   | (1.0 )%                            | 4.8 %   |

The following paragraphs discuss the Company's performance for the three and nine months ended September 30, 2018 and 2017.

## RESULTS OF OPERATIONS (in thousands)

Net Sales

Net sales for the third quarter of 2018 were \$2,146, a increase of \$68, or 3.3%, over the same period in 2017. Net sales for the nine months ended September 30, 2018 were \$5,642, a decrease of \$433, or 7.1%, over the same period in 2017. The increase in the third quarter was primarily due to an increase in the number of orders in excess of \$5 during the quarter and a 31% increase in international sales. The increase in international sales was driven by increased activity in South America.

#### Gross Profit

Gross profit for the third quarter of 2018 increased \$61, or 5.4%, over the same period in 2017. Gross profit for the nine months ended September 30, 2018 decreased \$274, or 8.2%, over the same period in 2017. Gross margin, as a percentage of net sales, increased slightly in the third quarter of 2018 to 55.7%, versus 54.6% in the same period in 2017. Gross margin, as a percentage of net sales, decreased in the nine months ended September 30, 2018 to 54.6%, versus 55.3% in the same period in 2017. The change in the gross margin percentage for both periods was primarily due to a change in product mix.

## Operating Expenses

Total operating expenses increased \$84, or 9.2%, for the third quarter of 2018 compared to the same period in 2017, and also increased as a percentage of net sales to 46.4% from 43.9%. Total operating expenses increased \$298, or 10.1%, for the nine months ended September 30, 2018 compared to the same period in 2017, and also increased as a percentage of net sales to 57.4% from 48.5%. The increases in operating expenses were due to increased personnel, legal, and professional expenses.

Selling and marketing expenses in the third quarter of 2018 increased \$64, or 18.7%, from the same period in 2017, and also increased as a percentage of net sales to 18.9% from 16.5%. Selling and marketing expenses in the nine months ended September 30, 2018 increased \$115, or 10.2%, from the same period of 2017, and also increased as a percentage of net sales to 22.0% from 18.6%. The increase in the third quarter resulted primarily from an increase in commissions dollars accrued to outside sales representatives due to increased sales and expenses related to the hiring of a business development manager. The increase for the nine months ended September 30, 2018, as compared to the same period in 2017, resulted primarily from the hiring of a business development manager.

General and administrative expenses increased \$12, or 3.0%, for the third quarter of 2018 compared to the same period in 2017, and remained a constant percentage of net sales of 19.3%. General and administrative expenses increased \$145, or 11.8%, for the nine months ended September 30, 2018 compared to the same period in 2017 and also increased as a percentage of net sales to 24.3% from 20.2%. The increase for in the third quarter was due to higher expenses related to computer supplies, software, and testing. The increase for the nine-month period was due to increases in legal and professional expenses and computer supplies, software, and testing.

Research and development expenses increased \$8, or 4.8%, in the third quarter of 2018 from the same period in 2017, and also increased as a percentage of net sales to 8.2% from 8.1%. Research and development expenses increased \$38, or 6.4%, in the nine months ended September 30, 2018 compared to the same period in 2017, and also increased as a percentage of net sales to 11.1% from 9.7%. The increase for the third quarter was due to the hiring of additional personnel, partially offset by a decrease in contract engineering related to product enhancements. The increase for the nine-month period was due to the hiring of additional personnel and increased lab testing and certification expenses for a new product, partially offset by a decrease in contract engineering.

## Non-Operating Income

Non-operating income increased by \$26, or 216.7%, for the third quarter of 2018 compared to the same period in 2017. Non-operating income increased by \$60, or 200.0%, for the nine months ended September 30, 2018 compared to the same 2017 period. The increase was primarily due to higher interest income in both periods, as compared to the respective prior year periods, primarily the result of higher interest rates on Treasury Bills.

## Income (Loss) Before Income Taxes

Income before income taxes was \$237 for the third quarter of 2018, representing an increase of \$3, or 1.3%, compared to \$234 for the same period in 2017. Loss before income taxes was \$67 for the nine months ended September 30, 2018, representing a decrease of \$512, or 115.1%, when compared to income before income taxes of \$445 for the same period of 2017. The increase for the third quarter was the result of higher gross profit and interest income, partially offset by increased operating expenses discussed above. The decrease for the nine-month period was the result of lower revenues and higher operating expenses discussed above.

### ***Income Taxes***

The Company's income tax expense percentage decreased to 21.1% for the third quarter of 2018 from 35.0% in the third quarter of 2017 and decreased to 13.4% for the nine months ended September 30, 2018 from 34.6% for the nine months ended September 30, 2017 due to the enactment of the Tax Jobs and Cuts Act (the "Act") of 2017 in December 2017. The Act decreased the highest corporate rate to 21% from 39%.



## LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were \$853 at September 30, 2018 and \$963 at December 31, 2017. The decrease was primarily the result of the payment of the contingent earn-out of \$150 in the first quarter of 2018.

Cash used in operating activities was \$27 for the nine months ended September 30, 2018 as compared to cash generated from operations of \$316 for the nine months ended September 30, 2017. The \$343 decrease was due to the net loss experienced in 2018 and a decrease in accrued income taxes, partially offset by a decrease in trade receivables. The net loss in 2018, as compared to the prior year net income, was primarily due to decreased revenue and higher operating expenses for the nine-month period. The decrease in accrued income taxes is due to the net loss. The decrease in trade receivables is due to the timing of sales and collections on accounts.

Cash generated from investing activities was \$67 and \$29 for the nine months ended September 30, 2018 and 2017, respectively. During the nine months ended September 30, 2018 and 2017, the Company had net proceeds of Treasury Bills with a maturity date of more than three months of \$96 and \$44, respectively. In addition, we purchased \$29 and \$15 of property and equipment during the nine months ended of 2018 and 2017, respectively.

Cash used in financing activities in the nine months ended September 30, 2018 was \$150 to pay the contingent earn-out owed for the technology purchased from Harvest Engineering, Inc. in 2014. There was no cash used or provided by financing activities in the nine months ended September 30, 2017.

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

### Future Business Development Activities

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

### Off-balance Sheet Arrangements

As of September 30, 2018, the Company had no off-balance sheet arrangements or transactions.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not Applicable.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Based on an evaluation with the participation of the Company's management, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended ("Exchange Act") were effective as of September 30, 2018.

*Changes in Internal Control Over Financial Reporting*

There were no changes in the Company's internal control over financial reporting during the third quarter of 2018, which were identified in connection with management's evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings – None

Item 1A. Risk Factors – Not Applicable

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

Item 3. Defaults Upon Senior Securities – None

Item 4. Mine Safety Disclosures – Not Applicable

Item 5. Other Information – None

Item 6. Exhibits

Exhibit Description

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

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

101 The following financial information from Electro-Sensors, Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2018, formatted in eXtensible Business Reporting Language XBRL: (i) Balance Sheets as of September 30, 2018 and December 31, 2017, (ii) Statements of Comprehensive Loss for the three and nine months ended September 30, 2018 and September 30, 2017, (iii) Statements of Cash Flows for the nine months ended September 30, 2018 and September 30, 2017, and (iv) Notes to Financial Statements.

16

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SIGNATURES

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

Electro-Sensors, Inc.

November 13, 2018

/s/ David L. Klenk

David L. Klenk

Chief Executive Officer and Chief Financial Officer

(Principal Executive Officer and Principal Financial Officer)