NORTECH SYSTEMS INC
Form 10-Q
August 14, 2018
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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, 2018

OR

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

For the transition period from to

NORTECH SYSTEMS INCORPORATED

Commission file number **0-13257**

State of Incorporation: **Minnesota**

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

Executive Offices: **7550 Meridian Circle N., Suite # 150, Maple Grove, MN 55369**

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth 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 o

Accelerated Filer o

Non-accelerated Filer o

Smaller Reporting Company x

Emerging growth company o

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. o

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

Number of shares of $.01 par value common stock outstanding at August 9, 2018 was 2,684,051

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PART

ITEM 1. FINANCIAL STATEMENTS

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

(UNAUDITED)

(IN THOUSANDS, EXCEPT SHARE DATA)

	THREE MONTHS ENDED JUNE 30, 2018	THREE MONTHS ENDED JUNE 30, 2017	SIX MONTHS ENDED JUNE 30, 2018	SIX MONTHS ENDED JUNE 30, 2017
Net Sales	$ 28,538	$ 30,134	$ 54,985	$ 58,452
Cost of Goods Sold	24,721	26,769	48,140	51,995
Gross Profit	3,817	3,365	6,845	6,457
Operating Expenses				
Selling Expenses	1,037	1,327	2,075	2,532
General and Administrative Expenses	2,046	1,944	4,155	4,065
Gain on Sale of Property and Equipment		(1)		(355)
Total Operating Expenses	3,083	3,270	6,230	6,242
Income From Operations	734	95	615	215
Other Expense				
Loss on Extinguishment of Debt		(175)		(175)
Interest Expense	(209)	(142)	(382)	(281)
Income (Loss) Before Income Taxes	525	(222)	233	(241)
Income Tax Expense (Benefit)	135	(206)	235	(211)
Net Income (Loss)	$ 390	$ (16)	$ (2)	$ (30)
Net Income (Loss) Per Common Share - Basic and Diluted	$ 0.14	$ (0.01)	$ (0.00)	$ (0.01)
Weighted Average Number of Common Shares Outstanding - Basic and Diluted	2,695,994	2,747,831	2,708,234	2,747,831
Other comprehensive income (loss)				
Foreign currency translation	(126)	1	(54)	(3)
Comprehensive income (loss), net of tax	$ 264	$ (15)	$ (56)	$ (33)

See Accompanying Condensed Notes to Condensed Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS, EXCEPT SHARE DATA)

	JUNE 30, 2018 (Unaudited)	DECEMBER 31, 2017(1)
ASSETS		
Current Assets		
Cash	$ 437	$ 473
Restricted Cash	234	306
Accounts Receivable, less allowances of $204 and $209	19,309	17,417
Inventories	13,969	18,527
Contract Assets	6,547	
Prepaid Expenses and Other Current Assets	1,259	1,044
Total Current Assets	41,755	37,767
Property and Equipment, Net	10,110	10,176
Goodwill	2,375	2,375
Other Intangible Assets, Net	1,633	1,739
Other Non Current Assets	28	28
Total Assets	$ 55,901	$ 52,085
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Current Maturities of Long-Term Debt	$ 1,014	$ 1,003
Current Portion of Capital Lease Obligation	346	295
Accounts Payable	15,676	11,699
Accrued Payroll and Commissions	3,275	2,900
Other Accrued Liabilities	2,340	2,148
Total Current Liabilities	22,651	18,045
Long-Term Liabilities		
Long Term Line of Credit	7,142	8,503
Long-Term Debt, Net	3,843	4,353
Long-Term Capital Lease Obligation, Net	1,105	1,222
Other Long-Term Liabilities	151	137
Total Long-Term Liabilities	12,241	14,215
Total Liabilities	34,892	32,260
Commitments and Contingencies		
Shareholders Equity		
Preferred Stock, $1 par value; 1,000,000 Shares Authorized: 250,000 Shares Issued and Outstanding	250	250
Common Stock - $0.01 par value; 9,000,000 Shares Authorized: 2,686,328 and 2,739,250 Shares Issued and Outstanding, respectively	27	27
Additional Paid-In Capital	15,619	15,760
Accumulated Other Comprehensive Loss	(155)	(101)
Retained Earnings	5,268	3,889
Total Shareholders Equity	21,009	19,825

Total Liabilities and Shareholders Equity	$	55,901	$	52,085

(1) The balance sheet at December 31, 2017 has been derived from the audited financial statements at that date

See Accompanying Condensed Notes to Condensed Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(IN THOUSANDS)

	SIX MONTHS ENDED JUNE 30, 2018	SIX MONTHS ENDED JUNE 30, 2017
Cash Flows From Operating Activities		
Net Loss	$ (2)	$ (30)
Adjustments to Reconcile Net Loss to Net Cash Provided by Operating Activities		
Depreciation and Amortization	1,108	1,233
Compensation on Stock-Based Awards and Equity Appreciation Rights	45	10
Loss on Extinguishment of Debt		17
Change in Contingent Consideration		(87)
Change in Accounts Receivable Allowance	(5)	(739)
Change in Inventory Reserves	73	229
Gain on Disposal of Property and Equipment		(355)
Changes in Current Operating Items		
Accounts Receivable	(1,886)	961
Inventories	(594)	(1,169)
Contract Assets	(88)	
Prepaid Expenses and Other Current Assets	(130)	(143)
Accounts Payable	3,722	1,288
Accrued Payroll and Commissions	374	(16)
Other Accrued Liabilities	124	94
Net Cash Provided by Operating Activities	2,741	1,293
Cash Flows from Investing Activities		
Proceeds from Sale of Property and Equipment		669
Purchase of Intangible Asset	(4)	(100)
Purchases of Property and Equipment	(557)	(359)
Net Cash (Used in) Provided by Investing Activities	(561)	210
Cash Flows from Financing Activities		
Net Change in Line of Credit	(1,361)	(672)
Proceeds from Long-Term Debt		5,123
Principal Payments on Long-Term Debt	(545)	(5,234)
Principal Payments on Capital Leases	(150)	
Loss on Extinguishment of Debt		(158)
Debt Issuance Costs		(268)
Share Repurchases	(186)	
Net Cash Used in Financing Activities	(2,242)	(1,209)
Effect of Exchange Rate Changes on Cash	(46)	(25)
Net Change in Cash	(108)	269
Cash - Beginning of Period	779	268
Cash - Ending of Period	$ 671	$ 537

Reconciliation of cash and restricted cash reported within the condensed consolidated balance sheets

Cash	$	437	$	191
Restricted Cash		234		346
Total cash and restricted cash reported in the condensed consolidated statements of cash flows	$	671	$	537
Supplemental Disclosure of Cash Flow Information:				
Cash Paid During the Period for Interest	$	317	$	263
Cash Refunded During the Period for Income Taxes		167		23
Supplemental Noncash Investing and Financing Activities:				
Property and Equipment Purchases in Accounts Payable		284		244
Equipment Acquired under Capital Lease		83		

See Accompanying Condensed Notes to Condensed Consolidated Financial Statements

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)
(UNAUDITED)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements for the interim periods have been prepared in accordance with Generally Accepted Accounting Principles in the United States of America (GAAP) for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the financial information and footnotes required by GAAP for complete financial statements, although we believe the disclosures are adequate to make the information presented not misleading. It is suggested that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year or for any other interim period. In our opinion, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included.

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

Principles of Consolidation

The condensed consolidated financial statements include the accounts of Nortech Systems Incorporated and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Revenue Recognition

Our revenue is comprised of product, engineering services and repair services. All revenue is recognized when the Company satisfies its performance obligation(s) under the contract by transferring the promised product or service to our customer either when (or as) our customer obtains control of the product or service, with the majority of our revenue being recognized over time including goods produced under contract manufacturing agreements and services revenue. A performance obligation is a promise in a contract to transfer a distinct product or service to a customer. A contract s transaction price is allocated to each distinct performance obligation. The majority of our contracts have a single performance obligation. Revenue is recorded net of returns, allowances and customer discounts. Our net sales for services were less than 10% of our total sales for all periods presented, and accordingly, are included in net sales in the Condensed Consolidated Statements of Operations and Comprehensive Income (Loss). Sales, value add, and other taxes collected from customers and remitted to governmental authorities are accounted for on a net (excluded from revenues) basis. Shipping and handling costs charged to our customers are included in net sales, while the corresponding shipping expenses are included in cost of goods sold.

Effective January 1, 2018, we adopted the FASB issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606) (ASU 2014-09), which supersedes the revenue recognition requirements in ASC 605, Revenue Recognition. ASU 2014-09 is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. It also requires additional disclosure about the nature, amount, timing, and uncertainty of revenue, cash flows arising from

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customer contracts, including significant judgments and changes in judgments, and assets recognized from costs incurred to obtain or fulfill a contract. ASU 2014-09 is effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period. The Company adopted the provisions of ASU 2014-09 using the modified retrospective approach with application to contracts that were not completed as of January 1, 2018. The adoption of ASU 2014-09 had a significant impact to the Company s results of operations, cash flow and financial position, and as a result we now recognize the majority of our revenue over time rather than upon shipment resulting in an adjustment to retained earnings of $1,381 on January 1, 2018. The Company has presented the disclosures required by this new standard, refer to Note 3.

Stock-Based Awards

Following is the status of all stock options as of June 30, 2018:

	Shares		Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)		Aggregate Intrinsic Value (in thousands)
Outstanding - January 1, 2018	187,750	$	3.70			
Granted	134,000		3.77			
Exercised						
Cancelled						
Outstanding - June 30, 2018	321,750	$	3.56	8.53	$	18
Exercisable - June 30, 2018	87,750	$	4.00	6.21	$	3

The 2005 Plan has not been renewed, and therefore no further grants may be made under the 2005 Plan. In May 2017, the shareholders approved the 2017 Stock Incentive Plan which authorized the issuance of 350,000 shares. There were 114,000 and 134,000 stock options granted during the three and six months ended June 30, 2018, respectively.

Total compensation expense related to stock options for the three months ended June 30, 2018 and 2017 was $25 and $9, respectively and $45 and $9 for the six months ended June 30, 2018 and 2017, respectively. As of June 30, 2018, there was $315 of unrecognized compensation which will vest over the next 3.44 years.

In November 2010, the Board of Directors adopted the Nortech Systems Incorporated Equity Appreciation Rights Plan (2010 Plan). The total number of Equity Appreciation Right Units (Units) that can be issued under the 2010 Plan shall not exceed an aggregate of 1,000,000 Units as amended and restated on March 11, 2015. The 2010 Plan provides that Units issued shall fully vest three years from the base date as defined in the agreement unless terminated earlier. Units give the holder a right to receive a cash payment equal to the appreciation in book value per share of common stock from the base date, as defined, to the redemption date. Unit redemption payments under the 2010 Plan shall be paid in cash within 90 days after we determine the book value of the Units as of the calendar year immediately preceding the redemption date. The Units are adjusted to market value for each reporting period.

During the three and six months ended June 30, 2018, no additional Units were granted. During the three and six months ended June 30, 2017, a total of 100,000 Units were granted.

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Total compensation expense (income) related to the vested outstanding Units based on the estimated appreciation over their remaining terms was $0 and ($7) for the three months ended June 30, 2018 and 2017, respectively and $0 and $1 for the six months ended June 30, 2018 and 2017, respectively.

As of both June 30, 2018 and December 31, 2017, no amounts were accrued under this plan.

Net Income (Loss) per Common Share

For both the three months and six months ended June 30, 2018 and 2017 all stock options are deemed to be antidilutive and, therefore, were not included in the computation of loss per common share amount.

Share Repurchase Program

As of June 30, 2018, we have a $250 share repurchase program which was authorized by our Board of Directors in August 2017. Under this repurchase program, we repurchased 18,495 and 52,922 shares in the open market transactions totaling $61 and $186 for the three and six months ended June 30, 2018, respectively. As of June 30, 2018, we had $27 remaining under this authorization. The par value of repurchased shares is deducted from common stock and the excess repurchase price over par value is deducted from additional paid-in capital.

Segment Reporting Information

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

Restricted Cash

Cash and cash equivalents classified as restricted cash on our condensed consolidated balance sheets are restricted as to withdrawal or use under the terms of certain contractual agreements. The June 30, 2018 balance included lockbox deposits that are temporarily restricted due to timing at the period end. The lockbox deposits are applied against our line of credit the next business day. As of June 30, 2018, we had no outstanding letters of credit.

Accounts Receivable and Allowance for Doubtful Accounts

Credit is extended based upon an evaluation of the customer s financial condition and, while collateral is not required, the Company periodically receives surety bonds that guarantee payment. Credit terms are consistent with industry standards and practices. The amounts of trade accounts receivable have been reduced by an allowance for doubtful accounts of $204 at June 30, 2018 and $209 at December 31, 2017.

Inventories

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

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Inventories are as follows (in thousands):

	June 30, 2018	December 31, 2017
Raw Materials	$ 14,397	$ 13,870
Work in Process	307	3,112
Finished Goods	182	2,389
Reserves	(917)	(844)
Total	$ 13,969	$ 18,527

The primary decrease in work in process and finished goods inventory as of June 30, 2018 as compared to December 31, 2017 primarily relates to the adoption of ASU 2014-09 and the recognition of revenue over time rather than upon shipment of inventory. Refer to Note 3 for further information.

Other Intangible Assets

Other intangible assets at June 30, 2018 and December 31, 2017 are as follows (in thousands):

	June 30, 2018			
	Years	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Customer Relationships	9	$ 1,302	$ 434	$ 868
Trade Names	3	100	44	56
Intellectual Property	20	814	122	692
Patents	7	17		17
Totals		$ 2,233	$ 600	$ 1,633

	December 31, 2017			
	Years	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Customer Relationships	9	$ 1,302	$ 361	$ 941
Intellectual Property	3	100	28	72
Trade Names	20	814	102	712
Patents	7	14		14
Totals		$ 2,230	$ 491	$ 1,739

Amortization expense for the three and six months ended June 30, 2018 was $55 and $109, respectively. Amortization expense for the three and six months ended June 30, 2017 was $56 and $106, respectively. Estimated future annual amortization expense (not including projects in process) related to these assets is approximately as follows (in thousands):

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Year		Amount
Remainder of 2018	$	110
2019		219
2020		191
2021		185
2022		185
Thereafter		726
Total	$	1,616

Impairment of Goodwill and Other Intangible Assets

In accordance with ASC 350, *Goodwill and Other Intangible Assets*, goodwill is not amortized but is required to be reviewed for impairment at least annually or when events or circumstances indicate that carrying value may exceed fair value. We test impairment annually as of October 1st. No events were identified during the six months ended June 30, 2018 that would require us to test for impairment. In testing goodwill for impairment we perform a quantitative impairment test, including computing the fair value of the reporting unit and comparing that value to its carrying value. If the fair value is less than its carrying value, then the goodwill is determined to be impaired. In the event that goodwill is impaired, an impairment charge to earnings would become necessary.

Impairment Analysis

We evaluate long-lived assets, primarily property and equipment and intangible assets, as well as the related depreciation periods, whenever current events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. Recoverability for assets to be held and used is based on our projection of the undiscounted future operating cash flows of the underlying assets. To the extent such projections indicate that future undiscounted cash flows are not sufficient to recover the carrying amounts of related assets, a charge might be required to reduce the carrying amount to equal estimated fair value. No impairment expense was recorded during the three and six months ended June 30, 2018 and 2017, respectively.

Recently Issued Accounting Standards

During February 2016, the FASB issued ASU 2016-02, Leases. ASU 2016-02 was issued to increase transparency and comparability among organizations by recognizing all lease transactions (with terms in excess of 12 months) on the balance sheet as a lease liability and a right-of-use asset (as defined). ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, with earlier application permitted. Upon adoption, the lessee will apply the new standard on a modified retrospective basis to all periods presented. We are currently assessing the effect that ASU 2016-02 will have on our consolidated financial statements.

In March 2018, we adopted FASB ASU 2018-05, *Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118*, which updates the income tax accounting in U.S. GAAP to reflect the Securities and Exchange Commission (SEC) interpretive guidance released on December 22, 2017, when the Tax Cuts and Jobs Act (the Tax Act) was signed into law. Additional information regarding the adoption of this standard is contained in Note 5, *Income Taxes* .

NOTE 2. CONCENTRATION OF CREDIT RISK AND MAJOR CUSTOMERS

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash and accounts receivable. With regard to cash, we maintain our excess cash balances in checking accounts at primarily two financial institutions, one in the United States and one in China. The account in the United States may at times exceed federally insured limits. Of the $671 in cash at June 30, 2018, approximately $436 was held at banks located in China. We grant credit to customers in the normal course of business and do not require collateral on our accounts receivable.

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Our largest customer has two divisions that together accounted for 10% or more of our net sales during the three and six months ended June 30, 2018 and 2017. One division accounted for approximately 21% and 20% of net sales for the three and six months ended June 30, 2018, respectively, and approximately 25% for both the three and six months ended June 30, 2017. The other division accounted for approximately 1% and 1% of net sales for the three months and six ended June 30, 2018, respectively, and approximately 1% and 2% of net sales for the three and six months ended June 30, 2017, respectively. Together they accounted for approximately 22% and 21% of net sales for the three and six months ended June 30, 2018, respectively, and approximately 27% of both the three and six months ended June 30, 2017. Accounts receivable from the customer at June 30, 2018 and December 31, 2017 represented approximately 19% and 16% of our total accounts receivable, respectively.

Export sales represented approximately 21% and 17% of net sales for the three months ended June 30, 2018 and 2017, respectively. Export sales represented 20% and 16% of net sales for the six months ended June 30, 2018 and 2017, respectively.

NOTE 3. REVENUE

Revenue recognition

Our revenue is comprised of product, engineering services and repair services. All revenue is recognized when the Company satisfies its performance obligation(s) under the contract by transferring the promised product or service to our customer either when (or as) our customer obtains control of the product or service, with the majority of our revenue being recognized over time including goods produced under contract manufacturing agreements and services revenue. A performance obligation is a promise in a contract to transfer a distinct product or service to a customer. A contract s transaction price is allocated to each distinct performance obligation. The majority of our contracts have a single performance obligation, as the promise to transfer products or services is not separately identifiable from other promises in the contract and, therefore, not distinct.

Revenue is measured as the amount of consideration we expect to receive in exchange for transferring products or providing services. As such, revenue is recorded net of returns, allowances and customer discounts. Sales, value add, and other taxes collected from customers and remitted to governmental authorities are accounted for on a net (excluded from revenues) basis. Shipping and handling costs are included in cost of goods sold.

The majority of our revenue is derived from the transfer of goods produced under contract manufacturing agreements which have no alternative use and we have an enforceable right to payment for our performance completed to date. Our performance obligations within our contract manufacturing agreements are generally satisfied over time as the goods are produced based on customer specifications and we have an enforceable right to payment for the goods produced. If these requirements are not met, the revenue is recognized at a point in time, generally upon shipment. Revenue under contract manufacturing agreements that was recognized over time accounted for approximately 91% of our revenue for both the three and six months ended June 30, 2018. Revenues under these agreements are generally recognized over time using an input measure based upon the proportion of actual costs incurred.

Accounting for contract manufacturing agreements involves the use of various techniques to estimate total revenue and costs. We estimate profit on these agreements as the difference between total estimated revenue and expected costs to complete the performance obligation within the terms of the agreement and recognize the respective profit as the goods are produced. The estimates to determine the profit earned on the performance obligation are based on anticipated selling prices and historical cost of goods sold and represent our best judgement at the time. Changes in judgements on these above estimates could impact the timing and amount of revenue recognized with a resulting impact on the timing and amount of associated profit.

On occasion our customers provide materials to be used in the manufacturing process and the fair value of the materials is included in revenue as noncash consideration at the point in time when the manufacturing process

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commences along with the same corresponding amount recorded as cost of goods sold. The inclusion of noncash consideration has no impact on overall profitability.

Contract Assets

Contract assets, recorded as such in the Condensed Consolidated Balance Sheet, consist of unbilled amounts related to revenue recognized over time. Significant changes in the contract assets balance during the three and six months ended June 30, 2018 was as follows (in thousands):

Six Months Ended June 30, 2018		
Outstanding at January 1, 2018	$	6,459
Increase (decrease) attributed to:		
Transferred to receivables from contract assets recognized		(5,648)
Product transferred over time		5,736
Outstanding at June 30, 2018	$	6,547

We expect substantially all of the remaining performance obligations for the contract assets recorded as of June 30, 2018, to be transferred to receivables within 90 days, with any remaining amounts to be transferred within 180 days. We bill our customers upon shipment with payment terms of up to 120 days.

The following tables summarize our net sales by market for the three and six months ended June 30, 2018 (in thousands):

	Three Months Ended June 30, 2018							
	Product/ Service Transferred Over Time		**Product Transferred at Point in Time**		**Noncash Consideration**		**Total Net Sales by Market**	
Aerospace and Defense	$	4,001	$	72	$	196	$	4,269
Medical		11,934		87		544		12,565
Industrial		10,023		1,206		475		11,704
Total net sales	$	25,958	$	1,365	$	1,215	$	28,538

	Six Months Ended June 30, 2018							
	Product/ Service Transferred Over Time		**Product Transferred at Point in Time**		**Noncash Consideration**		**Total Net Sales by Market**	
Aerospace and Defense	$	8,717	$	120	$	393	$	9,230
Medical		21,201		569		945		22,715
Industrial		20,089		2,049		902		23,040
Total net sales	$	50,007	$	2,738	$	2,240	$	54,985

Impact of New Revenue Guidance on Financial Statement Line Items

The following table compares the reported condensed consolidated statement of operations and comprehensive loss, balance sheet and cash flows, as of and for the three and six months ended June 30, 2018, to the pro-forma amounts had the previous guidance been in effect (in thousands):

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	Three Months Ended June 30, 2018		Six Months Ended June 30, 2018	
	As Reported	Pro forma as if the previous accounting guidance was in effect	As Reported	Pro forma as if the previous accounting guidance was in effect
Condensed Consolidated Statement of Operations				
Net Sales	$ 28,538	$ 26,928	$ 54,985	$ 52,658
Cost of Goods Sold	24,721	23,106	48,140	45,836
Gross Profit	3,817	3,822	6,845	6,822
Income from Operations	734	739	615	592
Income Before Income Taxes	525	530	233	210
Income Tax Expense	135	135	235	235
Net Income (Loss)	$ 390	$ 395	$ (2)	$ (25)
Net Income (Loss) Per Common Share - Basic and Diluted	$ 0.14	$ 0.15	$	$ (0.01)

	As of June 30, 2018	
	As Reported	Pro forma as if the previous accounting guidance was in effect
Condensed Consolidated Balance Sheet		
Assets		
Inventories	$ 13,969	$ 19,111
Contract Assets	$ 6,547	$
Shareholders Equity		
Retained Earnings	$ 5,268	$ 3,864

	Six Months Ended June 30, 2018	
	As Reported	Pro forma as if the previous accounting guidance was in effect
Condensed Consolidated Statement of Cash Flows		
Net Loss	$ (2)	$ (25)
Adjustments to Reconcile Net Loss to Net Cash Provided by Operating Activities		
Change in Current Operating Items		
Inventories	(594)	658
Contract Asset	(88)	
Net Cash Provided by Operating Activities	$ 2,741	$ 2,741

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NOTE 4. FINANCING ARRANGEMENTS

We have a credit agreement with Bank of America which was entered into on June 15, 2017 and amended effective December 29, 2017 and provides for a line of credit arrangement of $16,000 that expires on June 15, 2022. The credit arrangement also has a $5,000 real estate term note outstanding with a maturity date of June 15, 2022. The Bank of America credit agreement replaced our previous credit agreement with Wells Fargo Bank which terminated on June 20, 2017 and resulted in a loss on the extinguishment of debt of $175 primarily related to legal and terminations fees.

Under the Bank of America credit agreement, both the line of credit and real estate term notes are subject to variations in the LIBOR rate. Our line of credit bears interest at a weighted-average interest rate of 4.5% as of June 30, 2018. We had borrowings on our line of credit of $7,142 and $8,503 outstanding as of June 30, 2018 and December 31, 2017, respectively. There are no subjective acceleration clauses under the credit agreement that would accelerate the maturity of our outstanding borrowings.

The line of credit and real estate term notes with Bank of America contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. The availability under our line is subject to borrowing base requirements, and advances are at the discretion of the lender. The line of credit is secured by substantially all of our assets.

The Bank of America credit agreement as amended provides for, among other things, a fixed charge coverage ratio of not less than (i) 1.0 to 1.0 for each period of four fiscal quarters, commencing with the period of four fiscal quarters ending December 31, 2018. In addition, the agreement requires that the Company comply with certain minimum levels of cumulative EBITDA for measurement periods during fiscal 2018, including cumulative EBITDA of $1,970 for the twelve months ending December 31, 2018.

The availability under the line is subject to borrowing base requirements, and advances are at the discretion of the lender. At June 30, 2018, we had unused availability under our line of credit of $6,315, supported by our borrowing base. The line is secured by substantially all of our assets.

As part of the July 1, 2015 Devicix acquisition we entered into two unsecured subordinated promissory notes payable to the seller in the principal amounts of $1,000 and $1,300. The $1,000 promissory note has a four-year term, bearing interest at 4% per annum, requiring monthly principal and interest payments of $23 and is subject to offsets if certain revenue levels are not met. The $1,300 promissory note has a four-year term and bears interest at 4% per annum, requiring monthly principal and interest payments of $29 and is not subject to offset.

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Long-term debt at June 30, 2018 and December 31, 2017 consisted of the following (in thousands):

		June 30, 2018		December 31, 2017
Real estate term notes bearing interest at one-month LIBOR + 2.25% (4.3% as of June 30, 2018) maturing June 15, 2022 with monthly payments of approximately $41 plus interest secured by substantially all assets.	$	4,502	$	4,751
Devicix Acquistion Note 1 payable to DeLange Holdings bears interest rate of 4.0% per annum, maturing July 1, 2019		265		394
Devicix Acquistion Note 2 payable to DeLange Holdings bears interest rate of 4.0% per annum, maturing July 1, 2019		345		512
		5,112		5,657
Discount on Devicix Notes Payable		(43)		(63)
Debt issuance Costs		(212)		(238)
Total long-term debt		4,857		5,356
Current maturities of long-term debt		(1,014)		(1,003)
Long-term debt - net of current maturities	$	3,843	$	4,353

The Company has lease financing facilities for property and equipment. The obligations are collateralized by the property underlying lease. Total cost of the leased equipment was $1,607 at June 30, 2018 and $1,524 at December 31, 2017.

Current maturities of capital leases were $346 at June 30, 2018 and $295 at December 31, 2017.

Interest expense related to the leased assets was $26 and $0 for the three months ended June 30, 2018 and 2017, respectively and $52 and $0 for the six months ended June 30, 2018 and 2017, respectively. Depreciation expense related to the leased assets was $41 and $0 for the three months ended June 30, 2018 and 2017, respectively and $81 and $0 for the six months ended June 30, 2018 and 2017, respectively.

Approximate future minimum lease payments under non-cancelable capital leases subsequent to June 30, 2018 are as follows (in thousands):

Year		Amount
Remainder of 2018	$	180
2019		337
2020		356
2021		376
2022		218
Thereafter		1
Total noncancelable future lease commitments	$	1,468
Less: interest		173
Present value of obligations under capital leases	$	1,641

The above table includes the future minimum lease payments related to a portion of a lease that has not been received as of June 30, 2018 for $17 which is expected to be received during 2018.

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NOTE 5. INCOME TAXES

On a quarterly basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision based on the anticipated rate. As the year progresses, we refine our estimate based on the facts and circumstances, including discrete events, by each tax jurisdiction. Our effective tax rate for the three and six months ended June 30, 2018 was 26% and 101%, respectively. Our effective tax rate for the three and six months ended June 30, 2017 was (93%) and (87%), respectively. Our effective tax rate for the year ended December 31, 2018 is expected to be 65% compared to (18%) for the year ended December 31, 2017. The increase is due mainly to the effects of the tax reform changes that were enacted on December 22, 2017, and the increase in the effective tax rate expected in China.

There was no unrecognized tax benefit as of June 30, 2018 and the $52 of unrecognized tax benefits as of December 31, 2017, included amounts which, if ultimately recognized, will reduce our annual effective tax rate. The amount has been netted against the applicable deferred tax asset as any adjustment would reduce the recorded asset.

NOTE 6. COMMITMENTS AND CONTINGENCIES

We have various operating leases for production and office equipment, office space, and buildings under non-cancelable lease agreements expiring on various dates through 2028.

Rent expense for the three months ended June 30, 2018 and 2017 amounted to approximately $319 and $332 respectively and $654 and $649 for the six months ended June 2018 and 2017, respectively.

Approximate future minimum lease payments under non-cancelable leases subsequent to June 30, 2018 are as follows (in thousands):

Years Ending December 31,		**Amount**
2018		434
2019		882
2020		713
2021		566
2022		591
Thereafter		3,640
Total	$	6,826

NOTE 7. PLANT CLOSURE

On January 31, 2017 the Company closed its manufacturing operations in Augusta, Wisconsin. On March 31, 2017, the Company closed on the sale of the Augusta building and building improvements for $715. The Augusta building and building improvements had a net book value of $314, recognizing a gain on the sale, net of related expenses, of $354, and applied the net proceeds of $668 towards the outstanding real estate term note.

NOTE 8. RELATED PARTY TRANSACTIONS

During 2016, the Company entered into a consulting arrangement with a company co-owned by Matt Mahmood, who became the Chief Operating Officer of the Company on May 20, 2017. For the three months

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ended June 30, 2018 and 2017, expenses were incurred in the amounts of $17, and $30 respectively and $29 and $75 for the six months ended June 30, 2018 and 2017, respectively.

On February 22, 2018, the Company entered into a Consulting Agreement with Crosscourt Group, LLC, a limited liability company owned and managed by William Murray, formerly an independent director of the Company. Mr. Murray resigned from this position in May 2018. The term of the Consulting Agreement is three months. Under the Consulting Agreement, services performed are limited to a maximum daily fee of $2. For the three and six months ended June 30, 2018, expenses were incurred in the amount of $32 and $68, respectively.

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

Overview

We are a Maple Grove, Minnesota based full-service electronics manufacturing services (EMS) contract manufacturer of wire and cable assemblies, printed circuit board assemblies, higher-level assemblies and box builds for a wide range of industries. We provide value added engineering services and technical support including design, testing, prototyping and supply chain management to customers mainly in the aerospace and defense, medical, and industrial equipment markets. We maintain facilities in Bemidji, Blue Earth, Eden Prairie, Mankato, Merrifield, and Milaca, Minnesota; Monterrey, Mexico; and Suzhou, China. All of our facilities are certified to one or more of the ISO/AS standards, including 9001, AS9100 and 13485, with most having additional certifications based on the needs of the customers they serve.

Results of Operations

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	**2017**	**2018**	**2017**
Net Sales	100.0%	100.0%	100.0%	100.0%
Cost of Goods Sold	86.6	88.8	87.6	89.0
Gross Profit	13.4	11.2	12.4	11.0
Selling Expenses	3.6	4.4	3.8	4.3
General and Administrative Expenses	7.2	6.5	7.6	7.0
Gain on Sale of Property and Equipment	0.0	0.0	0.0	(0.6)
Income from Operations	2.6	0.3	1.0	0.3
Other Expenses	(0.7)	(1.0)	(0.7)	(0.8)
Income (Loss) Before Income Taxes	1.9	(0.7)	0.3	(0.5)
Income Tax Expense (Benefit)	0.5	(0.7)	0.4	(0.4)
Net Income (Loss)	1.4%	0.0%	(0.1)%	(0.1)%

Net Sales