

NORTECH SYSTEMS INC
Form 10-Q
November 14, 2012
[Table of Contents](#)

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

OR

**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

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Commission file number **0-13257**

State of Incorporation: **Minnesota**

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

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

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

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

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

Large Accelerated Filer

Accelerated Filer

Non-accelerated Filer

Smaller Reporting Company

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

Number of shares of \$.01 par value common stock outstanding at November 1, 2012 - 2,742,992

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Table of Contents

TABLE OF CONTENTS

	PAGE
<u>PART I - FINANCIAL INFORMATION</u>	
<u>Item 1 - Financial Statements</u>	
<u>Consolidated Balance Sheets</u>	3
<u>Consolidated Statements of Income</u>	4-5
<u>Consolidated Statements of Cash Flows</u>	6
<u>Condensed Notes to Consolidated Financial Statements</u>	7-13
<u>Item 2 - Management's Discussion and Analysis of Financial Condition And Results of Operations</u>	13-18
<u>Item 4 - Controls and Procedures</u>	18-19
<u>PART II - OTHER INFORMATION</u>	
<u>Item 1 - Legal Proceedings</u>	19
<u>Item 6 - Exhibits</u>	19
<u>INDEX TO EXHIBITS</u>	19
<u>SIGNATURES</u>	20

Table of Contents**PART 1****ITEM 1. FINANCIAL STATEMENTS****NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS**

	SEPTEMBER 30 2012 (Unaudited)	DECEMBER 31 2011
ASSETS		
Current Assets		
Cash	\$	\$
Accounts Receivable, Less Allowance for Uncollectible Accounts	15,493,550	16,720,462
Inventories	17,686,322	19,029,593
Prepaid Expenses	811,677	572,140
Income Taxes Receivable	46,024	170,292
Deferred Income Taxes	855,000	805,000
Total Current Assets	34,892,573	37,297,487
Property and Equipment, Net	9,143,005	9,083,874
Finite Life Intangible Assets, Net of Accumulated Amortization	46,301	61,547
Other Assets	339,235	339,235
Total Assets	\$ 44,421,114	\$ 46,782,143
	SEPTEMBER 30 2012	DECEMBER 31 2011
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of Credit	\$ 7,875,648	\$ 9,345,044
Current Maturities of Long-Term Debt	438,349	1,310,210
Accounts Payable	8,427,581	11,333,013
Accrued Payroll and Commissions	2,596,216	2,170,852
Other Accrued Liabilities	979,406	852,936
Total Current Liabilities	20,317,200	25,012,055
Long-Term Liabilities		
Long-Term Debt, Net of Current Maturities	2,860,242	812,917
Deferred Income Taxes	241,000	271,000
Other Long-Term Liabilities	142,983	180,378
Total Long-Term Liabilities	3,244,225	1,264,295
Total Liabilities	23,561,425	26,276,350
Shareholders' Equity		
Preferred Stock, \$1 par value; 1,000,000 Shares Authorized; 250,000 Shares Issued and Outstanding	250,000	250,000
	27,430	27,430

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Common Stock - \$0.01 par value; 9,000,000 Shares Authorized: 2,742,992 Shares Issued and Outstanding			
Additional Paid-In Capital		15,725,392	15,725,392
Accumulated Other Comprehensive Loss		(62,936)	(62,936)
Retained Earnings		4,919,803	4,565,907
Total Shareholders' Equity		20,859,689	20,505,793
Total Liabilities and Shareholders' Equity	\$	44,421,114	\$ 46,782,143

See Accompanying Condensed Notes to Consolidated Financial Statements

Table of Contents

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30	
	2012	2011
Net Sales	\$ 25,520,963	\$ 28,318,158
Cost of Goods Sold	22,736,923	25,029,395
Gross Profit	2,784,040	3,288,763
Operating Expenses:		
Selling Expenses	992,295	900,849
General and Administrative Expenses	1,463,074	1,967,776
Total Operating Expenses	2,455,369	2,868,625
Income From Operations	328,671	420,138
Other Expense		
Interest Expense	(111,999)	(130,152)
Miscellaneous Expense, net	(54,507)	(9,121)
Total Other Expense	(166,506)	(139,273)
Income Before Income Taxes	162,165	280,865
Income Tax Expense	57,000	98,000
Net Income	\$ 105,165	\$ 182,865
Earnings Per Common Share:		
Basic and Diluted	\$ 0.04	\$ 0.07
Weighted Average Number of Common Shares Outstanding Used for Basic and Diluted Earnings Per Common Share	2,742,992	2,742,992

See Accompanying Condensed Notes to Consolidated Financial Statements

Table of Contents

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30	
	2012	2011
Net Sales	\$ 81,915,222	\$ 85,112,931
Cost of Goods Sold	73,031,193	75,392,663
Gross Profit	8,884,029	9,720,268
Operating Expenses:		
Selling Expenses	3,232,919	2,701,642
General and Administrative Expenses	4,675,422	5,972,692
Total Operating Expenses	7,908,341	8,674,334
Income From Operations	975,688	1,045,934
Other Income (Expense)		
Interest Expense	(349,062)	(392,237)
Bargain Purchase Gain		791,615
Miscellaneous Expense, net	(80,730)	(55,165)
Total Other Income (Expense)	(429,792)	344,213
Income Before Income Taxes	545,896	1,390,147
Income Tax Expense	192,000	435,000
Net Income	\$ 353,896	\$ 955,147
Earnings Per Common Share:		
Basic and Diluted	\$ 0.13	\$ 0.35
Weighted Average Number of Common Shares Outstanding Used for Basic and Diluted Earnings Per Common Share	2,742,992	2,742,992

See Accompanying Condensed Notes to Consolidated Financial Statements

Table of Contents

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30	
	2012	2011
Cash Flows From Operating Activities		
Net Income	\$ 353,896	\$ 955,147
Adjustments to Reconcile Net Income to Net Cash Provided by (Used in) Operating Activities:		
Depreciation	1,382,757	1,446,212
Amortization	15,246	105,452
Stock-Based Compensation		23,792
Interest on Swap Valuation		(18,140)
Bargain Purchase Gain		(791,615)
Deferred Income Taxes	(80,000)	185,000
Loss on Disposal of Property and Equipment	3,490	941
Changes in Current Operating Items, Net of Effects of Business Acquisitions		
Accounts Receivable	1,226,912	(198,970)
Inventories	1,343,271	(5,287,685)
Prepaid Expenses and Other Assets	(239,537)	(165,016)
Income Taxes Receivable / Payable	124,268	224,941
Accounts Payable	(2,905,432)	1,220,948
Accrued Payroll and Commissions	425,364	142,454
Other Accrued Liabilities	83,709	(50,470)
Net Cash Provided by (Used in) Operating Activities	1,733,944	(2,207,009)
Cash Flows from Investing Activities:		
Proceeds from Sale of Property and Equipment	36,856	1,400
Business Acquisitions		(1,042,389)
Purchase of Property and Equipment	(1,476,868)	(560,022)
Net Cash Used in Investing Activities	(1,440,012)	(1,601,011)
Cash Flows from Financing Activities:		
Net Borrowings (Repayments) on Line of Credit	(1,469,396)	3,648,695
Proceeds from Long-Term Debt	1,600,970	1,380,904
Principal Payments on Long-Term Debt	(425,506)	(1,452,161)
Net Cash Provided by (Used in) Financing Activities	(293,932)	3,577,438
Net Decrease in Cash		(230,582)
Cash - Beginning		230,582
Cash - Ending	\$	\$
Supplemental Disclosure of Cash Flow Information:		
Cash Paid During the Period for Interest	\$ 293,740	386,612
Cash Paid During the Period for Income Taxes	116,155	
Supplemental Noncash Investing and Financing Activities		
Due to Seller for Business Acquisition	\$	250,000
Capital Expenditures in Accounts Payable		117,324

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See Accompanying Condensed Notes to Consolidated Financial Statements

Table of Contents

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

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

Principles of Consolidation

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

Revenue Recognition

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

Table of Contents**Stock Options**

Following is the status of all stock options as of September 30, 2012, including changes during the nine-month period then ended:

	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding - January 1, 2012	623,600	\$ 7.33		
Forfeited	(11,250)	\$ 7.83		
Cancelled	(319,600)	\$ 7.43		
Outstanding - September 30, 2012	292,750	\$ 7.19	2.72	\$
Exercisable - September 30, 2012	292,750	\$ 7.19	2.72	\$

There were no options exercised during the three and nine months ended September 30, 2012 and 2011.

Total compensation expense related to stock options for the three months ended September 30, 2012 and 2011 was \$0 and \$7,930, respectively. Total compensation expense related to stock options for the nine months ended September 30, 2012 and 2011 was \$0 and \$23,792, respectively. As of September 30, 2012, there was no unrecognized compensation expense as all options were fully vested.

In January 2012, the Board of Directors terminated the 2007 FOCUS Incentive plan and as a result all 319,600 outstanding stock options under this plan were cancelled.

Equity Appreciation Rights Plan

In November 2010, the Board of Directors approved the adoption of the Nortech Systems Incorporated Equity Appreciation Rights Plan (the 2010 Plan). The total number of Equity Appreciation Right Units (Units) the Plan can issue shall not exceed an aggregate of 750,000 Units, of which 100,000 Units were granted during the year ended December 31, 2010 with a redemption date of December 31, 2012. On March 7, 2012, we granted an additional 250,000 Units with redemption dates ranging from December 31, 2014 through December 31, 2016.

The 2010 Plan provides that Units granted shall fully vest three years from the designated base date unless terminated earlier. Units give the holder a right to receive a cash payment equal to the appreciation in book value per share of common stock from the base date, as defined, to the redemption date. Unit redemption payments under this plan shall be paid in cash within 90 days after we determine the book value of the Units as of the calendar year immediately preceding the redemption date.

Table of Contents

Total compensation expense related to these Units based on the estimated appreciation over their remaining terms was \$4,690 and \$10,193 for the three months ended September 30, 2012 and 2011, respectively, and \$18,695 and \$42,655 for the nine months ended September 30, 2012 and 2011, respectively. At September 30, 2012 and December 31, 2011, approximately \$81,000 and \$62,000 have been accrued under this plan. As of September 30, 2012, approximately \$74,000 of this balance is included in Other Accrued Liabilities as it is an estimate of the amount to be paid within 12 months. The remaining \$7,000 balance at September 30, 2012 and all of the balance at December 31, 2011 are included in Other Long-Term Liabilities.

Earnings per Common Share

For the three and nine months ended September 30, 2012 and 2011, the effect of all stock options is antidilutive. Therefore, no outstanding options were included in the computation of per-share amounts.

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 management, cash and risk management, banking, credit and collections, human resources, payroll, internal control, audit, taxes, SEC reporting and corporate accounting. Consolidated financial information is available that is evaluated regularly by the chief operating decision maker in assessing performance and allocating resources.

Inventories

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

Inventories are as follows:

	September 30 2012	December 31 2011
Raw Materials	\$ 13,713,514	\$ 13,056,955
Work in Process	3,006,721	3,202,002
Finished Goods	2,447,632	3,880,764
Reserve	(1,481,545)	(1,110,128)
Total	\$ 17,686,322	\$ 19,029,593

Table of Contents*Finite Life Intangible Assets*

Finite life intangible assets at September 30, 2012 and December 31, 2011 are as follows:

		September 30, 2012		
	Remaining Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Bond Issue Costs	9	\$ 79,373	\$ 33,072	\$ 46,301
Customer Base	0	676,557	676,557	
Totals		\$ 755,930	\$ 709,629	\$ 46,301

		December 31, 2011		
	Remaining Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Bond Issue Costs	10	\$ 79,373	\$ 29,106	\$ 50,267
Customer Base	1	676,557	665,277	11,280
Totals		\$ 755,930	\$ 694,383	\$ 61,547

Amortization expense for the three months ended September 30, 2012 and 2011 was \$1,363 and \$35,150, respectively. Amortization expense for the nine months ended September 30, 2012 and 2011 was \$15,246 and \$105,452, respectively. Estimated future amortization expense related to these assets is as follows:

Remainder of 2012	\$ 1,000
2013	5,000
2014	5,000
2015	5,000
2016	5,000
Thereafter	25,000
Total	\$ 46,000

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 one high-credit quality financial institution. These accounts may at times exceed federally insured limits. We grant credit to customers in the normal course of business and do not require collateral on our accounts receivable.

One customer accounted for 10% or more of our net sales for the three and nine months ended September 30, 2012 and 2011:

Table of Contents

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
GE Medical Division	16%	18%	17%	16%
GE Transportation Division	7	9	7	8
Total GE Medical & Transportation Division	23%	27%	24%	24%

Accounts receivable from G.E.'s Medical and Transportation Divisions represented 17% of total accounts receivable at September 30, 2012 and December 31, 2011.

Export sales represented 6% of consolidated net sales for the three and nine months ended September 30, 2012 and 2011.

NOTE 3. FINANCING ARRANGEMENTS

On May 2, 2012 we entered into the fourth amendment to the third amended and restated credit agreement with Wells Fargo Bank (WFB). The credit agreement with WFB provides for a line of credit arrangement of \$13.5 million, which expires if not renewed, on May 31, 2015. The credit arrangement also has a \$1.8 million real estate term note with a maturity date of March 31, 2027 which replaces the \$0.9 million real estate term note that was to expire on May 31, 2012, and a new term loan of up to \$2.0 million for capital expenditures to be made prior to December 31, 2013 with a maturity date of May 31, 2015. At September 30, 2012 we've used \$0.7 million of the \$2.0 million

Both the line of credit and real estate term note are subject to variations in LIBOR rates. The weighted-average interest rate on our line of credit was 3.8% for the three and nine months ended September 30, 2012, while the weighted-average rate on our real estate term loan was 4.1% and 4.0% for the same periods, respectively. The line of credit, real estate term note, and equipment term loans with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. On September 30, 2012, we had outstanding advances of \$7.9 million under the line of credit, with unused availability of \$4.5 million supported by our borrowing base and we were in compliance with all covenants.

NOTE 4. INCOME TAXES

On a quarterly basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision based on the anticipated rate. As the year progresses, we refine our estimate based on the facts and circumstances by each tax jurisdiction. Our effective tax rate for the three months ended September 30, 2012 and 2011 was 35%. The effective tax rate for the year ended December 31, 2012 is expected to be 36% compared to 32% for the year

Table of Contents

ended December 31, 2011. The increase is principally due to the fact that the federal government has not yet extended the research and development credit for the 2012 tax year.

The differences between federal income taxes computed at the federal statutory rate and reported income taxes for the three and nine months ended September 30, 2012 and 2011 are as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Statutory federal tax provision	\$ 61,000	\$ 96,000	\$ 186,000	\$ 473,000
State income taxes	2,000	8,000	18,000	41,000
Income tax credits	(4,000)	(20,000)	(10,000)	(52,000)
Tax authority closing agreement				(96,000)
Change in uncertain tax positions	10,000	5,000	18,000	95,000
Other	(12,000)	9,000	(20,000)	(26,000)
Income tax expense	\$ 57,000	\$ 98,000	\$ 192,000	\$ 435,000

At September 30, 2012, we had \$136,000 of net uncertain tax benefit positions recorded in other long-term liabilities that would reduce our effective income tax rate if recognized. The \$18,000 increase from December 31, 2011 was mostly related to 2012 state research and experimentation credits.

NOTE 5. ACQUISITIONS

On January 1, 2011, we completed the purchase of certain assets and certain liabilities relating to Winland Electronics, Inc.'s EMS operations (Winland) located in Mankato, MN. Winland is a designer and manufacturer of custom electronic control products and systems. This purchase provided needed manufacturing capacity, particularly for supporting medical and industrial customers with printed circuit board assemblies and higher-level builds. The acquisition was accounted for as a business combination and results of operations since the date of acquisition are included in the consolidated financial statements.

We paid \$1,042,389 in cash at closing, \$212,233 on July 1, 2011 and \$250,000 on October 1, 2011. As provided for in the purchase agreement, our July 1, 2011 required payment of \$250,000 was reduced by \$37,767 for acquired accounts receivable which were deemed uncollectible in the second quarter and assigned back to Winland.

The following table presents the allocation of the acquisition cost to the assets acquired and liabilities assumed, based on their estimated fair values at the time of the acquisition:

Table of Contents

Accounts receivable	\$	1,914,723
Property, plant and equipment		2,451,000
Accounts payable assumed		(1,772,334)
Lease payoff		(259,385)
Net assets acquired		2,334,004
Purchase price		1,542,389
Bargain purchase gain	\$	791,615

We recognized a \$791,615 bargain purchase gain related to the excess fair value over the purchase price for the assets acquired in the first quarter of 2011.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONSOverview:

We are a Wayzata, Minnesota based full-service Electronics Manufacturing Services (EMS) contract manufacturer of wire and cable assemblies, printed circuit board assemblies, higher-level assemblies and box builds for a wide range of industries. We provide value added services and technical support including design, testing, prototyping and supply chain management to customers mainly in the Aerospace and Defense, Medical, and Industrial Equipment markets. We maintain manufacturing facilities in Baxter, Bemidji, Blue Earth, Mankato, Merrifield, and Milaca, Minnesota; Augusta, Wisconsin; and Monterrey, Mexico.

Summary of Results:

For the quarter ended September 30, 2012, we reported net sales of \$25.5 million compared to \$28.3 million reported in the same quarter of 2011, a 10% decrease. Our 90-day backlog at September 30, 2012 was \$16.8 million, down from \$17.3 at June 30, 2012. Our industrial customers continue to be impacted the hardest by economic uncertainty and a sluggish economy and account for the majority of the decrease in sales and backlog.

Our gross profit percentage for the three and nine months ended September 30, 2012 was 10.9% and 10.8%, respectively. The gross profit percentage for the three and nine months ended September 30, 2011 was 11.6% and 11.4%, respectively. Gross profit percentage is being negatively affected by the underutilization of plant capacity mostly offset by a favorable product mix.

Income from operations was approximately \$329,000 and \$976,000 for the three and nine months ended September 30, 2012, respectively and \$420,000 and \$1,046,000 for the three and nine months ended September 30, 2011, respectively. We implemented a number of cost reduction and cost containment actions in the third quarter to help soften the impact of the sales decrease.

Table of Contents

Net income for the third quarter of 2012 was \$105,165 or \$0.04 per diluted common share, compared to net income of \$182,865 or \$0.07 per diluted common share for the same period in 2011. Net income for the nine months ended September 30, 2012 was \$353,896 or \$0.13 per diluted common share, while net income for the same period in 2011 totaled \$955,147 or \$0.35 per diluted common share, with the net after tax impact of the non-operating gain increasing net income by \$0.5 million or \$0.20 per diluted common share.

Cash provided from operating activities was \$0.4 million in the third quarter and \$1.7 million in the first nine months of 2012. Cash used in operating activities for the first nine months of 2011 was \$2.2 million. The cash used in 2011 was needed to fund the working capital needs of our Mankato acquisition.

(1.) Results of Operations:

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

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Net Sales	100.0%	100.0%	100.0%	100.0%
Cost of Goods Sold	89.1	88.4	89.2	88.6
Gross Profit	10.9	11.6	10.8	11.4
Selling Expenses	3.9	3.2	3.9	3.2
General and Administrative Expenses	5.7	6.9	5.7	7.0
Income from Operations	1.3	1.5	1.2	1.2
Bargain Purchase Gain	0.0	0.0	0.0	0.9
Other Expenses, Net	(0.7)	(0.5)	(0.5)	(0.5)
Income Before Income Taxes	0.6	1.0	0.7	1.6
Income Tax Expense	0.2	0.3	0.2	0.5
Net Income	0.4%	0.7%	0.5%	1.1%

Net Sales:

We reported net sales of \$25.5 million and \$28.3 million for the three months ended September 30, 2012 and 2011, respectively. Net sales for the nine months ended September 30, 2012 and 2011 were \$81.9 million and \$85.1 million, respectively.

Net sales by industry markets for the three and nine month periods ended September 30, 2012 and 2011 are as follows:

Table of Contents

(in thousands)	Three Months Ended September 30			Nine Months Ended September 30		
	2012 \$	2011 \$	% Change	2012 \$	2011 \$	% Change
Aerospace and Defense	3,756	3,774	(0)	11,823	10,949	8
Medical	8,192	8,503	-4	24,084	24,293	-1
Industrial	13,573	16,041	-15	46,008	49,871	-8
Total Sales	25,521	28,318	-10	81,915	85,113	-4

Our Aerospace and Defense sales were flat for the quarter and up for the nine months due to 2011 funding delays. We continue to see activity in smaller new projects but not large multi-year opportunities. Our Medical customers began adjusting their inventory levels down as a result of not experiencing the growth anticipated for the second half of 2012. And our Industrial customers are being negatively affected by the poor economic conditions in the markets they serve.

Backlog:

Our 90-day order backlog as of September 30, 2012 was approximately \$16.8 million, compared to approximately \$17.3 million at the beginning of the quarter. Again, as we end the quarter we are getting mixed results. Our Aerospace and Defense backlog is flat, our Medical backlog is experiencing increased activity with our medical device customers and our Industrial backlog is down due to the economy.

Backlog by industry market is shown below:

(in thousands)	Backlog as of the Quarter Ended			
	September 30 2012		June 30 2012	
Aerospace and Defense	\$	3,196	\$	3,275
Medical		6,288		5,858
Industrial		7,308		8,161
Total Backlog	\$	16,792	\$	17,294

Gross Profit:

Gross profit as a percent of net sales for the three months ended September 30, 2012 and 2011 was 10.9% and 11.6% of net sales, respectively. Gross profit percentage for the nine months ended September 30, 2012 and 2011 was 10.8% and 11.4%, respectively. Gross profit percentage is being negatively affected by the underutilization of plant capacity mostly offset by favorable mix of product.

Table of Contents

Selling Expense:

Our selling expenses were \$1.0 million or 3.9% of net sales and \$0.9 million or 3.2% of net sales for the three months ended September 30, 2012 and 2011, respectively. Selling expenses were \$3.2 million or 3.9% of net sales and \$2.7 million or 3.2% of net sales for the nine months ended September 30, 2012 and 2011, respectively. Our selling expenses are up slightly as we continue to invest in business development infrastructure and marketing initiatives in an effort to stimulate sales.

General and Administrative Expense:

Our general and administrative expenses were \$1.5 million or 5.7% of net sales and \$2.0 million or 6.9% of net sales for the three months ended September 30, 2012 and 2011, respectively. General and administrative expenses were \$4.7 million or 5.7% of net sales and \$6.0 million or 7.0% of net sales for the nine months ended September 30, 2012 and 2011, respectively. People and positions were redeployed into manufacturing and sales functions in 2012 and additional budget cuts were implemented as a result of the lower customer demand.

Other Income (Expense):

Other expense was \$0.2 million and \$0.1 million for the three months ended September 30, 2012 and 2011, respectively. Other expense was \$0.4 million for the nine months ended September 30, 2012 compared to other income of \$0.3 million for the nine months ended September 30, 2011. Other income in the first nine months of 2011 relates primarily to a bargain purchase gain of \$0.8 million from the Mankato acquisition in the first quarter of 2011.

Income Taxes:

Our effective tax rate for the three and nine months ended September 30, 2012 was 35% compared with 35% and 31% for the three and nine months ended September 30, 2011, respectively. The nine month increase is due to the fact that the federal government has not yet extended the research and development credit for the 2012 tax year. The differences between federal income taxes computed at the federal statutory rate and reported income taxes for the three and nine months ended September 30, 2012 and 2011 are as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Statutory federal tax provision	\$ 61,000	\$ 96,000	\$ 186,000	\$ 473,000
State income taxes	2,000	8,000	18,000	41,000
Income tax credits	(4,000)	(20,000)	(10,000)	(52,000)
Tax authority closing agreement				(96,000)
Change in uncertain tax positions	10,000	5,000	18,000	95,000
Other	(12,000)	9,000	(20,000)	(26,000)
Income tax expense	\$ 57,000	\$ 98,000	\$ 192,000	\$ 435,000

Table of Contents

Liquidity and Capital Resources:

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

On September 30, 2012, we had outstanding advances of \$7.9 million under the line of credit and unused availability of \$4.5 million supported by our borrowing base. We believe our financing arrangements (see Note 3) and cash flows provided by operations will be sufficient to satisfy our future working capital needs. Our working capital was \$14.6 million and \$12.3 million as of September 30, 2012 and December 31, 2011, respectively. The increase in working capital relates primarily to the reclassification of the real estate term note from current liabilities to long term liabilities as a result of our new financing arrangement and a reduction in accounts payable and advances outstanding under the line of credit.

Net cash provided by operating activities for the nine months ended September 30, 2012 was \$1.7 million. Income and non-cash addbacks for depreciation and amortization, and decreases in inventories and accounts receivable accounted for the majority of the operating cash provided, offset by decreased accounts payable. Net cash used in operating activities for the nine months ended September 30, 2011 was \$2.2 million. The cash flow used in operations for the nine months ended September 30, 2011 was primarily the result of working capital requirements needed to support the newly acquired Mankato operation, which included the purchase of approximately \$4.1 million of inventory.

Net cash used in investing activities of \$1.4 million for the nine months ended September 30, 2012 is comprised primarily of property and equipment purchases to support the business.

Net cash used in financing activities for the nine months ended September 30, 2012 was \$0.3 million, mainly due to repayments on the line of credit of \$1.5 million and payments on long-term debt of \$0.4 million, offset by loan proceeds of \$1.6 million.

Critical Accounting Policies and Estimates

Our significant accounting policies and estimates are summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2011. There have been no significant changes in these critical accounting policies since December 31, 2011. Some of our accounting policies require us to exercise significant judgment in selecting the appropriate assumptions for calculating financial estimates. Such judgments are subject to an inherent degree of uncertainty. These judgments are based on our historical experience, known trends in our industry, terms of existing

Table of Contents

contracts and other information from outside sources, as appropriate. Actual results could differ from these estimates.

Forward-Looking Statements:

Those statements in the foregoing report that are not historical facts are forward-looking statements made pursuant to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements generally will be accompanied by words such as anticipate, believe, estimate, expect, forecast, intend, possible, potential, predict, project, or other similar words that convey the uncertainty of future outcomes. Although we believe these forward-looking statements are reasonable, they are based upon a number of assumptions concerning future conditions, any or all of which may ultimately prove to be inaccurate. Forward-looking statements involve a number of risks and uncertainties. Important factors that could cause actual results to differ materially from the forward-looking statements include, without limitation:

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

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

Please refer to forward-looking statements and risks as previously disclosed in our report on Form 10-K for the fiscal year ended December 31, 2011.

ITEM 4. CONTROLS AND PROCEDURES

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Evaluation of Disclosure Controls and Procedures:

In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q, our management evaluated, with the participation of our Chief Executive Officer and Executive Vice President and Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the

Table of Contents

Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer have concluded that the disclosure controls and procedures were effective as of the date of such evaluation in ensuring that information required to be disclosed in our Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting:

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

PART II

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 6. EXHIBITS

Exhibits

- | | |
|------|---|
| 31.1 | Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended. |
| 31.2 | Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended. |
| 32.1 | Certification of the Chief Executive Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of the Chief Financial Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101 | Financial statements from the quarterly report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL: (i) Condensed Balance Sheets, (ii) Condensed Statements of Operations, (iii) Condensed Statements of Cash Flows, and (iv) the Notes to Condensed Financial Statements. |

Table of Contents

Signatures

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

Nortech Systems Incorporated and Subsidiary

Date: November 14, 2012

by

/s/ Michael J. Degen

Michael J. Degen
President and Chief
Executive Officer

Date: November 14, 2012

by

/s/ Richard G. Wasielewski

Richard G. Wasielewski
Chief Financial Officer