

COMMUNICATIONS SYSTEMS INC
Form 10-K
March 18, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2009

Commission File Number: 001-31588

COMMUNICATIONS SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Minnesota

41-0957999

(State or other jurisdiction
of incorporation or organization)

(Federal Employer
Identification No.)

10900 Red Circle Drive, Minnetonka, MN 55343
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: (952) 996-1674

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|-------------------------------|---|
| Common Stock, \$.05 par value | NASDAQ |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES NO

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Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. YES NO

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definition of "accelerated filer", "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Act.

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer Smaller Report Company

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant was approximately \$63,805,000 based upon the closing sale price of the Company's common stock on the NASDAQ on June 30, 2009.

As of March 15, 2010 there were outstanding 8,357,559 shares of the Registrant's common stock.

Documents Incorporated by Reference: Portions of the Company's Proxy Statement for its Annual Meeting of Shareholders to be held on May 18, 2010 are incorporated by reference into Part III of this Form 10-K.

PART I

ITEM 1. BUSINESS

(a) GENERAL DEVELOPMENT OF BUSINESS

Communications Systems, Inc. (herein collectively referred to as *CSI*, *our*, *we* or the *Company*) is a Minnesota corporation organized in 1969 which operates directly and through its subsidiaries located in the United States, Costa Rica, the United Kingdom and China. *CSI* is principally engaged through its *Suttle* and *Austin Taylor* business units in the manufacture and sale of modular connecting and wiring devices for voice and data communications, digital subscriber line filters, and structured wiring systems and through its *Transition Networks* business unit in the manufacture and sale of media and rate conversion products for telecommunications networks. *CSI* also provides IT solutions through its *JDL Technologies* business unit including network design, computer infrastructure installations, IT service management, change management, network security, and network operation services.

The Company maintains a website at www.commsystems.com. Our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our periodic reports on Form 8-K (and any amendments to these reports) are available free of charge by linking from our website to the Securities & Exchange Commission website.

(b) FINANCIAL INFORMATION ABOUT INDUSTRY SEGMENTS

The Company classifies its businesses into four segments: *Suttle*, which manufactures U.S. standard modular connecting and wiring devices for voice and data communications; *Transition Networks*, which designs and markets media conversion products, Ethernet switches, and other connectivity and data transmission products; *Austin Taylor*, which manufactures British standard line jacks, patch panels, metal boxes, distribution and central office frames; and *JDL Technologies, (JDL)*, which provides IT solutions. Non-allocated general and administrative expenses are separately accounted for as *Other* in the Company's segment reporting. There are no material intersegment revenues. Further information regarding the various segments is set forth in Note 9 of the Notes to Consolidated Financial Statements under Item 8, herein.

(c) NARRATIVE DESCRIPTION OF BUSINESS

(1) Information Regarding Business Segments

(i) Suttle

Suttle manufactures and markets connectors and wiring devices for voice, data and video communications under the *Suttle* brand name in the United States (U.S.) and internationally. *Suttle* also manufactures and markets a line of residential structured wiring products under the *SOHO* (Small Office Home Office) *Access* brand name. *Suttle* also markets a line of *DSL* (Digital Subscriber Line) filters for the telecommunications market. Approximately 54% of *Suttle*'s products are manufactured at its plants in *Hector, Minnesota (Suttle Apparatus Minnesota Division)*, and *San Jose, Costa Rica (Suttle Costa Rica, S.A.)*. The other 46% are purchased from offshore contract manufacturers. Segment sales were \$42,867,000 (39% of consolidated revenues) in 2009 and \$44,421,000 (36% of consolidated revenues) in 2008.

Products

Suttle's products are used in on-premise connection of voice, data, and video devices. The core product line consists primarily of modular connecting devices and includes numerous types of jacks, connecting blocks and assemblies, adapters, cords and related equipment, which are offered in a variety of colors, styles and wiring configurations. Many of the products are used in voice applications but *Suttle* continues to develop an expanding line of products for full communications and entertainment connectivity. A significant portion of *Suttle*'s revenue is derived from sales of a line of corrosion-resistant connectors, which utilize a water-resistant gel to offer superior performance in harsh environments. *Suttle* connectivity products generally range in price from \$0.30 to \$30.00 per unit. A majority of *Suttle*'s sales volume, both in units and revenues, is derived from products selling for under \$5.00 per unit.

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Suttle produces a full product line of residential structured wiring equipment used for customer premise applications for voice, data, video, and entertainment distribution. This line of products consists of structured wiring enclosures which are recessed or surface mounted in a residence or small business, and a series of plug-and-play modules which snap into the enclosures to complete the system. The modules selected determine the application of service and the number of ports or connections can be scaled up by adding more modules. These products are marketed under the SOHO Access™ line of products. Suttle's residential wiring systems range in price from \$5.42 to \$95.00.

Suttle also sells DSL filters for home and business applications that are procured from offshore sources. These filters permit the user to receive both analog and digital signals simultaneously and allow a single telephone line to support uninterrupted voice, fax and internet capabilities.

Markets and Marketing

Suttle competes in all major areas of the telecommunications connector market utilizing traditional modular jacks.

Suttle markets DSL filtering devices to telephone companies for use with their DSL home install kits. The products include both inline filters for deployment in the home and DSL splitters which are typically mounted outside the home near the telephone demarcation point.

Suttle markets residential structured cabling system products which are an increasingly important part of its product line. Service providers such as the telephone and cable companies have extended their traditional services to include comprehensive communications and entertainment offerings which require enhanced premise cabling. Suttle markets its products to service providers, residential builders, and low voltage installers through distributors, and through the Company's sales staff.

Suttle's customers include the major communication companies including both telephone and cable service provider companies. The Company's major telephone company customers include Verizon, ATT (formerly Bell South and SBC Communications), and Qwest. Major telephone companies are served directly by Suttle's sales staff and through a select group of distributors. As a group, sales to the major telephone companies (including DSL), both directly and through distribution, represented 58% of Suttle's sales in 2009 and 46% in 2008. The Company's cable company customers include Comcast, Time Warner, Cox Communications, and Charter, as well as other cable companies. Other customers include smaller telephone companies, electrical/low voltage contractors, home builders, original equipment manufacturers, and retailers. These customers are served primarily through distributors but are also served directly by Suttle's sales staff. Sales to cable customers and original equipment manufacturers (OEM) are made through a nationwide network of distributors and through the Suttle sales staff. Sales to cable television distributors represented 5% of Suttle's sales in 2009 and 8% in 2008. Sales to OEMs and other distributors were 18% of Suttle's sales in 2009 and 20% in 2008. Sales to international customers and other customers represented 19% of Suttle's sales in 2009 and 26% in 2008.

The Company's Suttle brand name is important to its business. Suttle regularly supports this name by trade advertising and believes it is well known in the marketplace.

Competition

Suttle encounters strong competition in all its product lines and competes primarily on the basis of the broad lines of products offered, product performance, quality, price and delivery. In addition, distributors of Suttle's products also market products for one or more of these competitors.

Order Book

Suttle manufactures its products on the basis of estimated customer requirements. Outstanding customer orders at March 1, 2010 were approximately \$3,373,000 compared to approximately \$3,333,000 at March 1, 2009. New orders are generally filled within 60 days. Suttle does not believe its order book is a significant indicator of future results.

Manufacturing and Sources of Supply

Suttle's products are manufactured using plastic parts, wire sub-assemblies, fasteners, brackets, electronic circuit boards and other components, most of which are fabricated by Suttle. There are multiple sources of supply for the materials and parts required and the Company is not dependent upon any single supplier, except that Suttle's corrosion-resistant products utilize a moisture-resistant gel-filled fig available only from Tyco Electronics. Suttle has not generally experienced significant problems in obtaining its required supplies, although from time to time spot shortages are experienced and additional order lead times are required from the offshore suppliers.

Research and Development: Patents

Suttle continually monitors industry requirements and creates new products to improve its existing product line. Historically, Suttle has generally not relied on patents to protect its competitive position in its market. However, duplication of its designs by foreign apparatus manufacturers has caused Suttle to apply for design patents on a number of products.

(ii) Transition Networks

Transition Networks, Inc. (Transition Networks) is based in Minnetonka, Minnesota and also maintains an engineering center and sales office in Shanghai, China. Transition designs, assembles and markets media converters, transceivers, network interface cards, Ethernet switches, Small Form factor Pluggable modules (SFP)s, and other connectivity products under the Transition Networks and MILAN brand names. Transition sells its product through distributors, resellers, integrators, and OEMs. These media converter and Ethernet Switch products permit voice and data networks to move information between copper-wired equipment and fiber-optic cable. Sales by Transition Networks were \$55,098,000 (50% of consolidated sales) in 2009 compared to 62,924,000 (51% of consolidated sales) in 2008. International sales accounted for 18% of Transition's sales, or \$9,886,000 in 2009, compared to \$17,061,000, or 27% of Transition's sales in 2008.

Products

Transition Networks designs, assembles and sells media converter devices, Ethernet switches and other connectivity products that make it possible to transmit telecommunications signals between systems using different types of media (for example, between copper and fiber optic networks). These products assist customers to integrate fiber optics into their existing network infrastructure as their networks grow, and extend data services to customers or remote locations. Protocols supported include Gigabit Ethernet, Fast Ethernet, Ethernet, T1/E1, DS3, RS232, RS485, OC3, OC12, and more. The company uses proprietary Application Specific Integrated Circuits (ASIC) for development of some products, as well as ASICs from integrated circuit manufacturers such as Marvell® and Broadcom® for the development of new products. Product hardware and software development is done internally and is expensed when incurred. The software that Transition Networks utilizes to manage its products is provided free with the product. Transition Networks product development is focused on hardware, with software developed to support hardware sales. The Company has been developing and marketing Ethernet based networking products for approximately 22 years. Transition Networks continues to develop products that address the enterprise, service provider, industrial, and security markets and, in addition, targets the specific vertical markets of government and education.

Manufacturing and Sources of Supply

Transition Networks outsources most of its manufacturing. In 2009, approximately 60% of its products were manufactured offshore, principally in Asia. Offshore sources of supply are subject to certain risks, including interference from political sources. The balance of its products are manufactured in the United States. The Company has alternate sources of supply for its products and to date has not had problems obtaining necessary product.

Markets and Marketing

Transition Networks' products are used in a broad array of markets, including enterprise networks, service providers' networks, security and industrial environments such as in manufacturing processes. Transition Networks has a broad customer base and its products are used in a variety of applications.

The media conversion product line addresses and is utilized in a variety of applications. The chassis based system, the Point System, is used primarily in telecommunications closets for high-density applications and when multiple protocols need to be supported. Stand alone media converters are used typically at a workstation or for lower density applications. The line of Ethernet switches is used in both the central closet and at the end user station.

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Marketing primarily consists of direct marketing utilizing a sales force, tradeshows, trade magazine advertising, on-line advertising, web site, social media and public relations activities. Transition Networks also provides and participates in advertising and cooperative marketing campaigns with distribution partners.

The Company's Transition Networks and MILAN brand names are important to its business. The Company regularly supports these names by trade advertising and believes them to be well known in the marketplace.

Research and Development

Transition Networks continues to develop products that address the enterprise, service provider, security and industrial markets. This includes developing converters for emerging protocols and existing protocols in new markets, as well as new industry standards. Some of these products include remote management devices built on the IEEE® 802.3AH standard, Metro Ethernet Forum (MEF)® standards and Power Over Ethernet based on the IEEE® 802.3AF standard. Some design efforts are paced by the development of critical components such as integrated circuits and optical transceivers.

Research and development consists primarily of testing, equipment and supplies associated with enhancing existing products and developing new products. Research and development costs are expensed when incurred and were \$1,707,000 in 2009 compared to \$1,792,000 in 2008.

Transition Network's research and development operations are conducted in the United States and China. Transition opened an engineering and sales office in China (Transition Networks Shanghai) in the third quarter of 2007. The China operation focuses primarily on engineering, including hardware and software development and testing. In the near future, additional operations will include marketing, purchasing, and potentially sales support.

Competition

Transition Networks faces strong competition across its entire product line. A large number of competitors exist for the highest volume products in the Fast Ethernet and Gigabit Ethernet family. Low cost competitors from China and Taiwan are strongest in the developing Asian markets, but have had limited success in the North American market for the media converter products. A deeper penetration of these competitors poses a potential threat to sales and profit margins. Competition also exists from substitutes such as lower cost fiber switches. The Fast Ethernet and Gigabit Ethernet switch market is filled with a large number of domestic and Asian competitors. Transition Networks also faces new competitors as it enters new markets for industrial products, security market, and higher performance devices for the service provider market.

Order Book

Outstanding customer orders for Transition Networks products were approximately \$8,190,000 at March 1, 2010 and \$2,000,000 at March 1, 2009. Transition Networks orders are fulfilled on a relatively short-term basis and therefore the order book is not considered a significant indicator of future results.

(iii) JDL Technologies, Inc.

JDL Technologies, Inc., located in Fort Lauderdale, FL (JDL), provides IT solutions including network design, network infrastructure installations, IT service management, change management, network security, desktop virtualization and network operation services. JDL's 2009 sales were \$8,765,000 (8% of consolidated sales) compared to 2008 sales of \$9,838,000 (8% of consolidated sales). Project revenue totaled \$7,357,000 in 2009 or 84% of JDL sales compared to \$4,482,000 in 2008 or 46% of JDL sales. Managed services revenues were \$1,408,000 and \$5,355,000 in 2009 and 2008, respectively.

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During the past several years JDL derived most of its revenues from two major customers, Broward County, Florida school district and the Virgin Islands Department of Education (VIDE). As discussed below, VIDE ceased being a customer after June 2008. While the Broward County school district is currently the primary source of JDL's revenues, JDL has embarked on a new strategic initiative to diversify its customer base and solution offerings to address the rapidly emerging needs of the IT market of the future.

Impairment of VIDE Assets

On January 17, 2008 the Company was notified that JDL was not selected as a vendor to provide services to VIDE for the 2008-2009 school year and ceased operations in the Virgin Islands July 1, 2008. As a result, the Company determined that assets, including goodwill, related to its VIDE operations were impaired. See Management's Discussion and Analysis in Item 7 herein for further information.

Order Book

Outstanding customer orders and contracts for JDL products and services were approximately \$18,564,000 at March 1, 2010 and \$4,400,000 at March 1, 2009. Approved amounts could vary from the original contracts.

(iv) Austin Taylor

Austin Taylor Communications, Ltd. is located in Bethesda, North Wales, United Kingdom. Austin Taylor is a provider of telephony and data networking products to telecommunications companies, distributors and installers throughout the U.K., Europe and the Middle East. Austin Taylor sales were \$3,062,000 (3% of consolidated revenues) in 2009 and \$5,516,000 (5% of consolidated revenues) in 2008.

At its plant in Bethesda the company designs and manufactures external metal cabinets and internal metal boxes to industry standards and to customer specifications and procures other products from offshore sources. All manufacturing and supply line products are supported to ISO: 9001:2000 approved standards to guarantee customer quality, consistency and reliability. Approximately 72% and 59% of Austin Taylor sales were to U.K. customers in 2009 and 2008.

Outstanding customer orders for Austin Taylor products were approximately \$265,000 at March 1, 2010 compared to \$193,000 at March 1, 2009. Because Austin Taylor fills new orders on a relatively short timetable, the Company does not believe its order book is a significant indicator of future results.

(2) Employment Levels

As of March 1, 2010 the Company employed 429 people. Of this number, 223 were employed by Suttle (including 92 in Hector, Minnesota and 131 in Costa Rica), 133 by Transition Networks, Inc. (116 in Minnetonka, MN and 17 in China), 21 by JDL Technologies, Inc., 33 by Austin Taylor Communications, Ltd and 19 corporate general and administrative positions. Nine of the Company's Austin Taylor employees are represented under collective and individual bargaining agreements. The Company considers its employee relations to be good.

(3) Executive Officers of Registrant

The executive officers of the Company and their ages at March 1, 2010 were as follows:

| <u>Name</u> | <u>Age</u> | <u>Position¹</u> |
|----------------------|------------|---|
| Jeffrey K. Berg | 67 | President and Chief Executive Officer [2007] ² |
| David T. McGraw | 58 | Vice President, Treasurer and Chief Financial Officer [2008] ³ |
| William G. Schultz | 41 | Vice President and General Manager, Transition Networks, Inc. [2007] ⁵ |
| Bruce Blackwood | 47 | Vice President and General Manager, Suttle [2007] ⁶ |
| Michael J. Skucius | 56 | Vice President, Information Technology [2010] ⁷ |
| Karen Nesburg Bleick | 45 | Vice President, Human Resources [2009] ⁸ |
| Vince Geraci | 63 | Managing Director, Austin Taylor Inc [2008] ⁹ |
| Melvyn J. Albiston | 64 | Vice President and General Manager JDL Technologies, Inc [2010] ¹⁰ |

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- 1 Dates in brackets indicate period during which officers began serving in such capacity. Executive officers serve at the pleasure of the Board of Directors and are elected annually for one-year terms.
 - 2 Mr. Berg was appointed Chief Executive Officer of the Company in June 2007. From November 2000 to June 2007 he served as the Company's Chief Operating Officer and was named President of the Company in March 2002. Prior to November 2000, Mr. Berg served as President of the Company's Suttle operations.
 - 3 Mr. McGraw was appointed Chief Financial Officer in January 2008. From September 2002 to December 2007 he served as President of Suttle. From May 2001 to August 2002, he served as Chief Operating Officer of JDL Technologies, Inc. Prior to May 2001, he was Vice President-General Manager of Precision Diversified Industries in Plymouth, MN.
 - 5 Mr. Schultz was appointed Vice President and General Manager of Transition Networks, Inc. in October 2007. From May 2000 to September 2007, he served as Transition Networks Vice President of Marketing. Prior to May 2000, he was Distribution Business Manager for AMP Division of Tyco International, Ltd.
 - 6 Mr. Blackwood was appointed Vice President and General Manager of Suttle in December 2007. From July 2001 to November 2007 he served as Suttle's Vice President of Sales. Prior to July 2001 he was Vice President of Sales for Americable.
 - 7 Mr. Skucius was appointed Vice President of Information Technology in January 2010. From July 2007 to December 2009 he served as Vice President and General Manager of JDL. From 1980 to 2007 he was the Company's Director of Management Information Services.
 - 8 Ms. Nesburg Bleick was appointed Vice President, Human Resources in January 2009. From October 2002 to December 2008, she served as Director of Human Resources.
 - 9 Mr. Geraci was appointed Managing Director of Austin Taylor in November 2008. From April 2005 to October 2008 he was Regional Sales Manager for Suttle. Prior to April 2005, he was an independent consultant.
 - 10 Mr. Albiston was appointed Vice President and General Manager of JDL Technologies in January 2010. For the preceding five years he was an independent consultant.

(d) FINANCIAL INFORMATION ABOUT FOREIGN AND DOMESTIC OPERATIONS AND EXPORT SALES

Financial information about domestic and foreign operations and export sales may be obtained by reference to Note 9 of the Notes to Consolidated Financial Statements under Item 8 herein.

ITEM 1A. RISK FACTORS

Forward Looking Statements

Certain statements contained in this Annual Report on Form 10-K are forward-looking statements within the meaning of and in reliance on the Private Securities Litigation Reform Act of 1995, which provides a safe harbor for forward-looking statements. Actual events and results may differ materially from those expressed or forecasted in forward-looking statements due to a number of factors. The principal important risk factors that could cause our actual performance and future events and actions to differ materially from such forward-looking statements include, but are not limited to, the risk factors discussed below.

Risks Related to Our Business

The primary markets we serve are highly competitive, and our ability to compete requires continual focus on delivering high quality, competitively priced products and the regular introduction of new products that meet evolving customer requirements.

Competition in the markets for voice and data communications products is intense. Our ability to compete with other manufacturers of these products depends primarily on our engineering, manufacturing and marketing skills; the price, quality and reliability of our products; our delivery and service capabilities; and our control of operating expenses. We have experienced, and anticipate continuing to experience, pricing pressures from our customers as well as our competitors. The markets we serve are characterized by rapid technological advances and evolving industry standards. These markets can be significantly affected by new product introductions and marketing activities of industry participants. Certain of our competitors and potential competitors may have greater financial, technological, manufacturing, marketing, and personnel resources than us. Present and future competitors may be able to identify new markets and develop products more quickly, which are superior to those developed by us. They may also adapt new technologies faster, devote greater resources to research and development, promote products more aggressively, and price products more competitively than us. There are no assurances that competition will not intensify or that we will be able to compete effectively in the markets in which we compete.

We face many challenges in maintaining acceptable margins, and our level of gross margin may not be sustainable.

Gross margins among our products vary and are subject to fluctuation from quarter to quarter. The factors that may impact our gross margins adversely are numerous and include:

- Changes in customer, geographic, or product mix;
- Our ability to reduce product costs;
- Increases in material or labor costs;
- Expediting costs incurred to meet customer delivery requirements;
- Excess inventory and inventory carrying charges;
- Obsolescence charges;
- Changes in shipment volume;
- Changes in component pricing;
- Increased price competition;
- Changes in distribution channels;
- Increased warranty cost; and
- Our ability to manage the impact of foreign currency exchange rate fluctuations.

Consolidation among our customers has occurred and further consolidation may occur and result in the loss of some customers and may reduce revenue during the pendency of business combinations and related integration activities.

We believe consolidation among our customers in the future may occur in order for them to increase market share and achieve greater economies of scale. Consolidation has impacted our business as our customers focus on completing business combinations and integrating their operations. In certain instances, customers integrating large-scale acquisitions have reduced their purchases of our products during the integration period.

The impact of significant mergers among our customers on our business is likely to be unclear until sometime after such transactions are completed. After a consolidation occurs, a customer may choose to reduce the number of vendors from which it purchases equipment and may choose one of our competitors as its preferred vendor. There can be no assurance that we will continue to supply equipment to the surviving communications service provider after a business combination is completed.

Our profitability could be impacted negatively if one or more of our key customers substantially reduces orders for our products and/or transitions their purchases towards lower gross margin products.

Our customer base is somewhat concentrated, with our top ten customers accounting for 72%, 60% and 54% of net sales for fiscal 2009, 2008 and 2007, respectively. One of our largest customers, Verizon, accounted for 9%, 5% and 5% of our net sales for the fiscal years 2009, 2008 and 2007. The merger of AT&T and BellSouth in our fiscal 2007 created another large customer for us. In fiscal 2009, 2008 and 2007, this combined company accounted for approximately 12%, 12% and 10% of our sales, respectively. If we lose a significant customer for any reason, our sales and gross profit will be impacted negatively.

Our market is subject to rapid technological change and, to compete effectively, we must continually introduce new products that achieve market acceptance.

The communications equipment industry is characterized by rapid technological changes, evolving industry standards, changing market conditions, short product life cycles and rapidly changing customer requirements and frequent new product and service introductions and enhancements. The introduction of products using new technologies or the adoption of new industry standards can make our existing products, or products under development, obsolete or unmarketable. Our future success will depend on our ability to enhance our existing products, to introduce new products to meet changing customer requirements and emerging technologies, and to demonstrate the performance advantages and cost-effectiveness of our products over competing products. Failure by us to modify our products to support new alternative technologies or failure to achieve widespread customer acceptance of such modified products could cause us to lose market share and cause our revenues to decline.

We may not predict technological trends or the success of new products in the communications equipment market accurately. New product development often requires forecasting of market trends, development and implementation of new technologies and processes and substantial capital commitments. We do not know whether other new products we develop will gain market acceptance or result in profitable sales.

Certain of our competitors have greater engineering and product development resources than we have. Although we expect to continue to invest significant resources in product development activities, our efforts to achieve and maintain profitability will require us to be selective and focused with our research and development expenditures. If we fail to anticipate or respond in a cost-effective and timely manner to technological developments, changes in industry standards or customer requirements, or if we experience any significant delays in product development or introduction, our business, operating results and financial condition could be affected adversely.

We may experience delays in developing and marketing product enhancements or new products that respond to technological change, evolving industry standards and changing customer requirements. There can be no assurance that we will not experience difficulties that could delay or prevent the successful development, introduction, and marketing of these products or product enhancements, or that our new products and product enhancements will adequately meet the requirements of the marketplace and achieve any significant or sustainable degree of market acceptance in existing or additional markets. In addition, the future introductions or announcements of products by us or one of our competitors embodying new technologies or changes in industry standards or customer requirements could render our then-existing products obsolete or unmarketable. There can be no assurance that the introduction or announcement of new product offerings by us or one or more of our competitors will not cause customers to defer their purchase of our existing products, which could cause our revenues to decline.

We evaluate and frequently pursue acquisitions, but we may not successfully close the acquisitions and, if these acquisitions are completed, we may have difficulty integrating the acquired businesses with our existing operations.

We regularly consider the acquisition of complementary companies and/or product lines. We cannot, however, provide assurances that we will be able to find appropriate candidates for acquisitions, reach agreement to acquire them, or obtain requisite shareholder or regulatory approvals needed to close strategic acquisitions, despite the effort and management attention invested.

The impact of future acquisitions on our business, operating results and financial condition is uncertain. In the case of businesses we may acquire in the future, we may have difficulty assimilating these businesses and their products, services, technologies and personnel into our operations. These difficulties could disrupt our ongoing business, distract our management and workforce, increase our expenses and materially adversely affect our operating results and financial condition. Also, we may not be able to retain key management and other critical employees after an acquisition. We may also acquire unanticipated liabilities. In addition to these risks, we may not realize all of the anticipated benefits of these acquisitions.

Our operating results fluctuate from quarter to quarter.

Our operating results are difficult to predict and may fluctuate significantly from quarter to quarter. Fluctuations in our quarterly operating results may be caused by many factors, including the following:

- the volume and timing of orders from shipments to our customers;
- the overall level of capital expenditures by our customers;
- work stoppages and other developments affecting the operations of our customers;
- the timing of and our ability to obtain new customer contracts and the timing of revenue recognition;
- the timing of new product and service announcements;
- the availability of products and services;
- market acceptance of new and enhanced versions of our products and services;
- variations in the mix of products and services we sell;
- the location and utilization of our production capacity and employees; and
- the availability and cost of key components of our products.

Our expense levels are based in part on expectations of future revenues. If revenue levels in a particular quarter are lower than expected, our operating results will be affected adversely.

We depend on manufacturing relationships and on limited-source suppliers and any disruptions in these relationships may cause damage to our customer relationships.

We procure all parts and certain services involved in the production of our products and subcontract much of our product manufacturing to outside firms that specialize in such services. Although most of the components of our products are available from multiple vendors, we have several single-source supplier relationships, either because alternative sources are not available or because the relationship is advantageous to us. There can be no assurance that our suppliers will be able to meet our future requirements for products and components in a timely fashion. In addition, the availability of many of these components to us is dependent in part on our ability to provide our suppliers with accurate forecasts of our future requirements. Delays or lost sales could be caused by other factors beyond our control, including defects in the quality of components or products supplied by others.

We are dependent upon our senior management and other critical employees.

Like all communications technology companies, our success is dependent on the efforts and abilities of our senior management personnel and other critical employees, including those in sales, marketing and product development functions. Our ability to attract, retain and motivate these employees is critical to our success. In addition, because we may acquire one or more businesses in the future, our success will depend, in part, upon our ability to retain and integrate our own personnel with personnel from acquired entities that are necessary to the continued success or the successful integration of the acquired businesses.

Managing our inventory is complex and may include write-downs of excess or obsolete inventory.

Managing our inventory of components and finished products is complicated by a number of factors, including the need to maintain a significant inventory of finished goods for orders we anticipate but may not be received. These issues may cause us to purchase and maintain significant amounts of inventory. If this inventory is not used as expected based on anticipated requirements, it may become excess or obsolete. The existence of excess or obsolete inventory can result in sales price reductions and/or inventory write-downs, which could adversely affect our business and results of operations.

We face risks associated with expanding our sales outside of the United States.

We believe that our future growth is dependent in part upon our ability to increase sales in international markets. These sales are subject to a variety of risks, including fluctuations in currency exchange rates, tariffs, import restrictions and other trade barriers, unexpected changes in regulatory requirements, longer accounts receivable payment cycles and potentially adverse tax consequences, and export license requirements. In addition, we are subject to the risks inherent in conducting business internationally, including political and economic instability and unexpected changes in diplomatic and trade relationships. There can be no assurance that one or more of these factors will not have a material adverse effect on our business strategy and financial condition.

Compliance with internal control requirements is expensive and poses certain risks.

We expect to incur significant continuing costs, including accounting fees and staffing costs, in order to maintain compliance with the internal control requirements of the Sarbanes-Oxley Act of 2002. Expansion of our business, particularly internationally, will necessitate ongoing changes to our internal control systems, processes and information systems. In addition, if we complete acquisitions in the future, our ability to integrate operations of the acquired company could impact our compliance with Section 404 of the Sarbanes-Oxley Act. We cannot be certain that as our business changes, our current design for internal control over financial reporting will be sufficient to enable management to determine that our internal controls are effective for any period, or on an ongoing basis.

In the future, if we fail to complete the annual Section 404 evaluation in a timely manner, we could be subject to regulatory scrutiny and a loss of public confidence in our internal controls. In addition, any failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations.

Product defects or the failure of our products to meet specifications could cause us to lose customers and revenue or to incur unexpected expenses.

If our products do not meet our customers' performance requirements, our customer relationships may suffer. Also, our products may contain defects or fail to meet product specifications. Any failure or poor performance of our products could result in:

delayed market acceptance of our products;

delayed product shipments;

unexpected expenses and diversion of resources to replace defective products or identify and correct the source of errors;

damage to our reputation and our customer relationships;

delayed recognition of sales or reduced sales; and

product liability claims or other claims for damages that may be caused by any product defects or performance failures.

Our sales and operations may continue to be impacted adversely by current global economic conditions.

For more than a year, financial markets globally have experienced extreme disruption. This includes, among other things, extreme volatility in security prices, severely diminished liquidity and credit availability, ratings downgrades of certain investments and declining valuations of others. The severity and length of the present disruptions in the financial markets and the global economy are unknown. There can be no assurance that there will not be a further deterioration in financial markets and in business conditions generally. These economic developments have adversely affected our business in a number of ways and will likely continue to adversely impact our business during the foreseeable future.

Risks Related to Our Common Stock

Our stock price has been volatile historically and the price of our common stock may fluctuate significantly in the future.

The trading price of our common stock has been and may continue to be subject to wide fluctuations. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results, announcements of technological innovations or new products by us or our competitors, the operating and stock price performance of other companies that investors may deem comparable to us, and new reports relating to trends in our markets or general economic conditions.

In addition, the stock market in general, and prices for companies in our industry in particular, have experienced extreme volatility that often has been unrelated to the operating performance of such companies. These broad market and industry fluctuations may adversely affect the price of our common stock, regardless of our operating performance.

Anti-takeover provisions in our charter documents, our shareholder rights agreement and Minnesota law could prevent or delay a change in control of our company.

Provisions of our articles of incorporation and bylaws, our shareholder rights agreement (also known as a "poison pill") and Minnesota law may discourage, delay or prevent a merger or acquisition that a shareholder may consider favorable, and could limit the price that investors are willing to pay for our common stock. These provisions include the following:

advance notice requirements for shareholder proposals;

authorization for our board of directors to issue preferred stock without shareholder approval;

authorization for our board of directors to issue preferred stock purchase rights upon a third party's acquisition of 16.5% or more of our outstanding shares of common stock; and

limitations on business combinations with interested shareholders

classification of Board of Directors that serve staggered, three year terms.

Some of these provisions may discourage a future acquisition of our company even though our shareholders would receive an attractive value for their shares, or a significant number of our shareholders believe such a proposed transaction would be in their best interest.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Administrative, manufacturing and engineering functions of CSI are conducted at the following facilities:

- In Minnetonka, Minnesota the Company owns a 105,000 square foot building where its executive and administrative offices are located. In addition, Transition Networks uses this facility for its warehouse, assembly, engineering and administrative operations, JDL Technologies, Inc. uses this facility for its executive and some administrative operations, and Suttle uses this facility for its sales, marketing and product development.
 - Suttle's manufacturing is conducted at two locations. At Hector, Minnesota, the Company owns three plants totaling 88,000 feet of manufacturing space. The Company leases 40,000 square feet of manufacturing space in San Jose, Costa Rica.
 - Austin Taylor Communications, Ltd. owns a 40,000 square foot facility in Bethesda, Wales, U.K.
 - Transition Networks leases 1,000 square feet of office space for engineering and sales activities in Shanghai, China.
- CSI believes these facilities will be adequate to accommodate its administrative, manufacturing and distribution needs for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

No material litigation or other material claim is presently pending against the Company.

ITEM 4. RESERVED

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASE OF EQUITY SECURITIES

(a) MARKET INFORMATION

The Company's common stock trades on the NASDAQ under the trading symbol JCS.

The table below presents the price range of high and low trades of the Company's common stock for each quarterly period indicated as reported by NASDAQ for 2009 and 2008.

| | 2009 | | 2008 | |
|--------|---------|---------|----------|---------|
| | High | Low | High | Low |
| First | \$ 9.54 | \$ 6.95 | \$ 12.15 | \$ 9.75 |
| Second | 11.96 | 7.52 | 11.75 | 10.02 |
| Third | 13.05 | 9.61 | 11.62 | 9.61 |
| Fourth | 13.70 | 10.47 | 11.00 | 6.93 |

(b) HOLDERS

At March 15, 2010 there were approximately 603 registered holders of record of Communications Systems, Inc. common stock.

(c) DIVIDENDS

Communications Systems, Inc. paid regular quarterly dividends to its shareholders on the dates and at the rates indicated below:

| <u>Payment Date</u> | <u>Dividend per Share</u> |
|---------------------|---------------------------|
| January 1, 2010 | \$.14 |
| October 1, 2009 | .14 |
| July 1, 2009 | .14 |
| April 1, 2009 | .12 |
| January 1, 2009 | .12 |
| October 1, 2008 | .12 |
| July 1, 2008 | .12 |
| April 1, 2008 | .12 |
| January 1, 2008 | .12 |

The payment of future dividends will be determined at the discretion of the Board of Directors.

(d) INFORMATION REGARDING EQUITY COMPENSATION PLANS

The following table presents information about the Company's equity compensation plans, under which equity securities of the Company are authorized for issuance, as of December 31, 2009:

Securities Authorized for Issuance Under Equity Compensation Plans

| <u>Plan Category (1)</u> | <u>Number of shares of common stock to be issued upon exercise of outstanding options, warrants and rights</u> | <u>Weighted-average exercise price of outstanding options warrants and rights</u> | <u>Number of shares of common stock remaining available for future issuance under equity compensation plans (excluding shares in column (a))</u> |
|--|--|---|--|
| <u>Equity compensation plans approved by security holders:</u> | | | |
| 1992 Stock Plan-Employee Plan | | \$ | 1,123,739 |
| 1992 Stock Plan-Nonemployee Director Plan | 189,000 | \$ 9.77 | 31,000 |
| 1990 Employee Stock Purchase Plan | 4,675 | \$ 11.81 | 87,828 |
| <u>Equity compensation plans not approved by security holders:</u> | | | |

None

(1) The Company does not have individual compensation arrangements involving the grant of options, warrants and rights.

(e) REGULATION S-K, ITEM 201 (e) INFORMATION

The following graph presents, at the end of each of the Company's last five fiscal years, the cumulative total return on the common stock of the Company as compared to the cumulative total return reported for the NASDAQ (U.S.), and the NASDAQ Telecommunications Index. Company information and each index assume the investment of \$100 on the last business day before January 1, 2004 and the reinvestment of all dividends.

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Comparison of Five-Year Cumulative Total Return

| <u>Company or Index</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> |
|------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Communications Systems, Inc. | \$ 100.000 | \$ 104.770 | \$ 89.450 | \$ 107.454 | \$ 75.039 | \$ 126.135 |
| NASDAQ US | 100.000 | 102.135 | 112.187 | 121.681 | 58.639 | 84.282 |
| NASDAQ TELCOM | 100.000 | 95.037 | 124.968 | 111.157 | 63.868 | 95.770 |

(f) RECENT SALES OF UNREGISTERED SECURITIES

Not applicable.

(g) PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

In 2009 the Company repurchased a total of 5,126 shares of common stock since January 1, 2009 pursuant to Rule 10b-18 under the Exchange Act. The following table presents the repurchases for the three months ending December 31, 2009:

ISSUER PURCHASES OF EQUITY SECURITIES (1)

| <u>Period</u> | <u>(a) Total Number of Shares (or Units) Purchased</u> | <u>(b) Average Price Paid per Share (or Unit)</u> | <u>(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs</u> | <u>(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs</u> |
|---------------|--|---|--|--|
| October 2009 | | | | 482,026 |
| November 2009 | | | | 482,026 |
| December 2009 | 88 | \$ 11.35 | 88 | 481,938 |
| Total | 88 | | 88 | |

- (1) Shares repurchased in 2009 were repurchased pursuant to a Board approved program to repurchase a total of 500,000 shares that was publicly announced in November 2008. All of the shares repurchased were repurchased pursuant to this authorization and in compliance with Rule 10b-18.

ITEM 6. SELECTED FINANCIAL DATA
COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
SELECTED FINANCIAL INFORMATION
(in thousands except per share amounts)

| | Year Ended December 31 | | | | |
|---|------------------------|-----------------|-----------------|-----------------|-----------------|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| Selected Income Statement Data | | | | | |
| Sales from Continuing Operations | \$ 109,792 | \$ 122,700 | \$ 121,243 | \$ 115,440 | \$ 115,382 |
| Costs and Expenses: | | | | | |
| Cost of Sales | 67,944 | 76,008 | 78,357 | 76,853 | 77,861 |
| Selling, General and Administrative Expenses | 31,433 | 33,109 | 32,623 | 33,562 | 31,651 |
| Impairment Loss | 196 | 2,999 | | | |
| Total Costs and Expenses | 99,573 | 112,116 | 110,980 | 110,415 | 109,512 |
| Operating Income from Continuing Operations | 10,219 | 10,584 | 10,263 | 5,025 | 5,870 |
| Other income (expense), Net | 581 | 597 | 1,760 | 698 | 448 |
| Income from Continuing Operations Before Income Taxes | 10,800 | 11,181 | 12,023 | 5,723 | 6,318 |
| Income Tax Expense | 4,756 | 4,570 | 4,512 | 1,228 | 1,728 |
| Income from Continuing Operations | 6,044 | 6,611 | 7,511 | 4,495 | 4,590 |
| Net Loss from Discontinued Operations | | | | | (120) |
| Net Income | \$ 6,044 | \$ 6,611 | \$ 7,511 | \$ 4,495 | \$ 4,470 |
| Basic Net Income (loss) Per Share | | | | | |
| Continuing Operations | \$.72 | \$.77 | \$.86 | \$.52 | \$.53 |
| Discontinued Operations | | | | | (.01) |
| | \$.72 | \$.77 | \$.86 | \$.52 | \$.52 |
| Diluted Net Income (loss) Per Share | | | | | |
| Continuing Operations | \$.72 | \$.77 | \$.85 | \$.51 | \$.52 |
| Discontinued Operations | | | | | (.01) |
| | \$.72 | \$.77 | \$.85 | \$.51 | \$.51 |
| Cash Dividends Per Share | \$.52 | \$.48 | \$.42 | \$.34 | \$.27 |
| Average Dilutive Shares Outstanding | 8,352 | 8,563 | 8,831 | 8,807 | 8,716 |
| Selected Balance Sheet Data | | | | | |
| Total Assets | \$ 102,914 | \$ 98,738 | \$ 100,760 | \$ 92,723 | \$ 92,883 |
| Property, Plant and Equipment, Net | 13,322 | 12,015 | 13,945 | 8,580 | 8,300 |

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| | | | | | |
|-----------------------|--------|--------|--------|--------|--------|
| Long-term liabilities | 4,220 | 4,919 | 4,045 | 724 | 1,332 |
| Stockholders' Equity | 85,939 | 83,728 | 84,931 | 82,545 | 79,851 |

(1) During the first and third quarters of fiscal 2008, the Company recognized approximately \$2.0 million of revenue related to services that were invoiced and expensed in fiscal 2007

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Communications Systems, Inc. is a global company with sales in over 90 countries and facilities supporting design, manufacturing and distribution in the United States, Costa Rica, China and the United Kingdom. We sell a growing family of physical and electronic connectivity products and infrastructure, as well as IT services for voice, video and data communications. Our product families encompass a broad range of passive and active products, including copper-based and fiber optic connection devices, digital subscriber line filters and connection devices, structured wiring systems that support Local Area Networks, media conversion devices and switches.

The voice, video and data markets in which our products are sold provide services that are vital to the modern world. Therefore, we expect the size of these markets will, generally, continue to expand, although the pace of growth will be affected by economic conditions in the United States and around the world. This growth, along with inevitable technological change, will generate innumerable opportunities for the type of products we sell.

From the perspective of our customers, our goal is to be a leading company in the markets we serve by providing high quality products and services that are competitively priced. From the perspective of our shareholders, our goal is to steadily and consistently increase our revenues and profits. Achieving these goals will require success in the following areas. We must apply our financial resources to support increased sales, maintain brand loyalty, improve product quality and develop new products. At the same time, we must maintain price levels and control expenses to provide adequate margins and superior bottom line results. Finally, to accelerate our growth we must expand our sales outside of the US and prudently acquire complementary businesses and product lines.

While we face many challenges and risks that are presented earlier in this report, the intense competition we face in the markets we serve and successfully introducing new products are, perhaps, our greatest challenges. Some of our competitors are larger and better capitalized, and some are based outside the US. These firms often have greater capacity to absorb lower margins that are inconsistent with our financial goals and are able support a higher level of new product development using their greater resources or lower cost structure. In order to achieve profitable growth in the face of these challenges, we must constantly validate the value of our products to existing and new customers and select and pursue new product development opportunities and product line acquisitions that best fit our capabilities, resources and competitive position.

We are currently pursuing these objectives through the following four business units:

Austin Taylor

Located in Bethesda, Wales, United Kingdom, Austin Taylor manufactures cabling installation and connection products for copper and fiber optic media. Austin Taylor serves the government and commercial markets throughout Europe and the Middle East with British standard products. Austin Taylor's broad catalog of products ranges from telephony linejacks to structured cabling and from plastic connection boxes to metal cabinets.

JDL Technologies

JDL Technologies is an IT services company that provides outsourced technical services in the education and business market segments. JDL provides studies and analysis, design, installation, maintenance and operational support for network based, server centered systems. JDL's largest customer is the School Board of Broward County, Florida (SBBC). JDL runs SBBC's Network Operation Center which monitors all network elements (servers, switches, routers) and over 60,000 computers in 265 buildings for the nation's 6th largest school district.

Suttle

Founded in 1910, Suttle is one of the world's largest suppliers of high-volume copper connection products used by North America's largest telcos. Suttle also designs, manufactures and markets a full line of structured wiring components for small office, home office (SOHO) for voice, video and high-speed data communications convergent solutions. Suttle's products are used throughout the telco, multi-service cable operators (MSOs), and installer/contractor markets.

Transition Networks

Transition Networks offers a full suite of networking connectivity solutions including media converters, network interface cards, switches, and coarse-wave division multiplexing (CWDM). Utilizing engineering resources in the U.S. and its Product Design and Development Facility in Shanghai, China, Transition Networks designs and markets products for a broad spectrum of protocols including Ethernet, Fast Ethernet, Gigabit Ethernet, T1/E1, DS3, and serial. Transition Networks distributes these hardware-based connectivity solutions through a network of resellers in 90 countries and is the preferred choice among industry IT professionals for high-end media conversion devices.

Forward Looking Statements

In this report and from time to time, in reports filed with the Securities and Exchange Commission, in press releases, and in other communications to shareholders or the investing public, there may be forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The Company may make forward looking statements concerning possible or anticipated future financial performance, business activities, plans, pending claims, investigations or litigation which are typically preceded by the words believes, expects, anticipates, intends or similar expressions. For such forward-looking statements, the Company claims the protection of the safe harbor for forward-looking statements contained in federal securities laws. Shareholders and the investing public should understand that such forward looking statements are subject to risks and uncertainties which could cause actual performance, activities, anticipated results, outcomes or plans to differ significantly from those indicated in the forward-looking statements. For a detailed discussion of a number of such risk factors, please see Item 1A above.

Critical Accounting Policies

Sales Returns and Allowances: An allowance is established for possible return of products, rebates and advertising allowances. The amount of the allowance is an estimate, which is based on historical ratios of returns to sales, the historical average length of time between the sale and the return and other factors. Though management considers these allowances adequate and proper, changes in customers' behavior versus historical experience or changes in the Company's return policies are among the factors that could affect the adequacy of this allowance.

Inventory Valuation: The Company's inventories are valued at the lower of cost or market. Reserves for overstock and obsolescence are estimated and recorded to reduce the carrying value to estimated net realizable value. The amount of the reserve is determined based on projected sales information, plans for discontinued products and other factors. Though management considers these reserves adequate and proper, changes in sales volumes due to unexpected economic or competitive conditions are among the factors that could materially affect the adequacy of this reserve.

Income Taxes: In the preparation of the Company's consolidated financial statements, management calculates income taxes. This includes estimating the Company's current tax liability as well as assessing temporary differences resulting from different treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. These assets and liabilities are analyzed regularly and management assesses the likelihood that deferred tax assets will be realized from future taxable income. The valuation allowance for deferred income tax benefits is determined based upon the expectation of whether the benefits are more likely than not to be realized. The Company records interest and penalties related to income taxes as income tax expense in the Consolidated Statements of Income.

Warranty: The Company's warranty programs vary by business groups and by product lines. Reserves for the estimated cost of product warranties are established at the time revenue is recognized. The costs of our warranty obligations are estimated based on warranty policy and the applicable contractual warranty, our historical experience of known product failure rates, our vendors' experience and material and service delivery costs incurred in correcting product failures. Management reviews the estimated warranty liability on a quarterly basis to determine its adequacy. Though management considers these balances adequate and proper, changes in the Company's warranty policy or a significant change in product defects versus historical experience are among the factors that could affect the adequacy of this reserve.

Asset Impairment: We are required to test for asset impairment relating to property and equipment whenever events or changes in circumstances indicate that the carrying value of an asset might not be recoverable. An impairment analysis is performed when indicators of impairment are present. If such indicators are present and if the sum of the future expected cash flows from a company's asset, undiscounted and without interest charges, is less than the carrying value, an asset impairment must be recognized in the financial statements. The amount of the impairment is the difference between the fair value of the asset and the carrying value of the asset.

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We believe the accounting estimates related to potential asset impairments are critical as they require management to make assumptions about future cash flows and the impact of recognizing an impairment could have a significant effect on operations.

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

The Company believes that accounting estimates related to goodwill impairment are critical because the underlying assumptions used for the discounted cash flow can change from period to period and could potentially cause a material impact to the income statement. Management's assumptions about inflation rates and other internal and external economic conditions, such as earnings growth rate, require significant judgment based on fluctuating rates and expected revenues.

Revenue Recognition: The Company recognizes revenue when the earnings process is complete, evidenced by persuasive evidence of an agreement, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectability is reasonably assured. In the Suttle, Transition Networks and Austin Taylor segments, the earning process completion is evidenced through the shipment of goods, based on the sales terms of these segments, the risk of loss is transferred upon shipment or delivery to customers and there are no significant obligations subsequent to that point. Other than the sales returns as discussed above, there are not significant estimates related to revenue recognition for these segments.

JDL Technologies records revenue on hardware, software and related equipment sales and installation contracts when the revenue recognition criteria are met and the products are installed and accepted by the customer.

JDL records revenue on service contracts on a straight-line basis over the contract period, unless evidence suggests that the revenue is earned in a different pattern. Each contract is individually reviewed to determine when the earnings process is complete. Contracts in effect through June 30, 2008 with the United States Virgin Islands Department of Education (VIDE) required funding under the federal government's E-RATE program and approval by the Schools and Libraries Division (SLD) of the Universal Service Administration Company before payment was made. For the periods covered by this report, we did not recognize E-RATE revenue on our VIDE contracts until approval was received from the SLD.

Foreign Currency Translation: Assets and liabilities of the foreign subsidiary are translated to U.S. dollars at year-end rates, and the statements of operations are translated at average exchange rates during the year. Translation adjustments arising from the translation of the foreign affiliates' net assets into U.S. dollars are recorded in other comprehensive income.

Results of Operations

2009 Compared to 2008

Sales were \$109,792,000 in 2009, an 11% decrease from sales of \$122,700,000 in 2008. Operating income decreased 3% to \$10,219,000 in 2009 as compared to \$10,584,000 in 2008. Income before income taxes decreased 3% to \$10,799,000 from \$11,181,000 in 2008. Net income decreased 9% to \$6,044,000 in 2009 compared to \$6,611,000 in 2008.

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Suttle

Suttle sales decreased 3% to \$42,867,000 in 2009 compared to \$44,421,000 in 2008. Sales by product groups in 2009 and 2008 were:

| | Suttle Sales by Product Group | |
|-----------------------------|-------------------------------|---------------|
| | 2009 | 2008 |
| Modular connecting products | \$ 16,120,000 | \$ 18,834,000 |
| DSL products | 13,310,000 | 10,270,000 |
| Structured cabling products | 12,821,000 | 14,445,000 |
| Other products | 616,000 | 872,000 |
| | \$ 42,867,000 | \$ 44,421,000 |

Suttle s sales by customer groups in 2009 and 2008 were:

| | Suttle Sales by Customer Group | |
|---------------------------|--------------------------------|---------------|
| | 2009 | 2008 |
| Major telephone companies | \$ 24,829,000 | \$ 20,624,000 |
| Distributors/OEM | 9,861,000 | 12,459,000 |
| International | 4,802,000 | 6,382,000 |
| Other | 3,375,000 | 4,956,000 |
| | \$ 42,867,000 | \$ 44,421,000 |

The decrease in sales was due primarily to the erosion in the number of land-line customers served by the major telephone customers and the severe downturn in the domestic housing market. Sales to the major telephone companies increased 20% to \$24,829,000 in 2009 compared to \$20,624,000 in 2008 due to increased sales of DSL products. Sales to these customers accounted for 58% of Suttle s sales in 2009 compared to 46% of sales in 2008. The land-line loss experienced by the major telephone companies caused a faster than expected decline in the traditional and Corroshield product lines. However, sales of DSL products and structured cabling products to these same customers increased as investment remained strong into FTTP networks. Sales to distributors, original equipment manufacturers (OEMs), and electrical contractors decreased 21% and accounted for 23% of sales in 2009 compared to 28% in 2008. The decline in this segment is a direct result of reduced opportunities in the domestic market for new single-family unit (SFU) construction and multi-dwelling unit (MDU) construction. International sales accounted for 11% of Suttle s 2009 sales but declined 25% compared to 2008. International telephone customers also faced land-line loss causing decreased sales of voice products. DSL product sales into this segment did increase as customers increased investments in broadband.

Suttle s gross margins decreased 9% to \$9,771,000 in 2009 compared to \$10,778,000 in 2008. The gross margin percentage was 23% in 2009 compared to 24% in 2008. This decrease in gross margin was due to a change in product mix as sales of higher margin products, such as the traditional and Corroshield product lines declined as compared to lower margin DSL sales.

Selling, general and administrative expenses remained stable at \$6,054,000 in 2009 compared to \$6,045,000 in 2008.

Suttle s operating income declined 21% to \$3,717,000 in 2009 from \$4,733,000 in 2008 due to the decreased revenues and margins noted above.

Transition Networks

Transition Networks is a provider of active networking hardware devices. Characteristics of the business include a rapid pace of change in technologies and alternative solutions to our products. Transition Networks derives revenues from one time product sales and non-recurring revenue streams from service contracts. The majority of the business is derived from one time network projects that do not repeat. The core markets for the products are enterprise, service providers, and industrial users. Roughly 82% of Transition Networks revenue comes from North America, but we continue to see opportunity for long term growth outside of North America and we will invest resources in sales, marketing, and infrastructure to grow that business.

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Transition Networks sales decreased 12% to \$55,098,000 compared to \$62,924,000 in 2008. Transition Networks organizes its sales force and segments its customers geographically. Sales by customer groups in 2009 and 2008 were:

| Transition Networks Sales by Region | | | |
|--|---------------|----|-------------|
| | 2009 | | 2008 |
| North America | \$ 45,213,000 | \$ | 45,863,000 |
| Europe, Middle East, Asia (EMEA) | 4,818,000 | | 8,352,000 |
| Rest of world | 5,067,000 | | 8,709,000 |
| | \$ 55,098,000 | \$ | 62,924,000 |

Sales in North America decreased 1% compared to 2008. Overall sales have either remained flat or declined in most markets in the US, but declines have not been as significant as in international markets. International sales decreased \$7,176,000, or 42%, due to the impact of the severe global recession and currency fluctuations. Customers have either delayed or canceled projects, but the Company is continuing to invest in international sales and marketing because long term projects are promising.

The following table summarizes Transition Networks 2009 and 2008 sales by product group:

| Transition Networks Sales by Product Group | | | |
|---|---------------|----|-------------|
| | 2009 | | 2008 |
| Media converters | \$ 39,251,000 | \$ | 47,196,000 |
| Ethernet switches | 3,786,000 | | 5,809,000 |
| Ethernet adapters | 8,903,000 | | 7,220,000 |
| Other products | 3,158,000 | | 2,699,000 |
| | \$ 55,098,000 | \$ | 62,924,000 |

Gross margin decreased 5% to \$29,329,000 in 2009 compared to \$30,972,000 in 2008 due to decreases in revenues, but represented a lower percentage decline compared to revenues due to gross margin improvements. Gross margin as a percentage of sales increased to 53% in 2009 compared to 49% in 2008 due to new lower cost designs and outsourcing of production to lower cost offshore suppliers and fewer sales of lower margin products. The increase in sales of Ethernet adapters and decrease in sales of media converters is one of the contributors to the increased margins. The decline in sales of media converters is due to the slowing economy around the world. The increase in sales of Ethernet adapters is due to ongoing projects in North America.

Selling, general and administrative expenses decreased 6% to \$19,371,000 in 2009 from \$20,673,000 in 2008 due to the decline in revenue which resulted in lower commission expense and cost containment efforts some of which were offset by increases in research and development costs related to the creation of new products. Operating income decreased 3% to \$9,958,000 in 2009 compared to \$10,299,000 in 2008.

Transition Networks will continue to develop product based on market needs as well as following industry standards set by such organizations as the Institute of Electrical and Electronics Engineers (IEEE) and the Metro Ethernet Forum (MEF). We will also continue to invest in sales and marketing to grow revenues in our target markets and expand sales outside of North America.

JDL Technologies, Inc.

Sales by JDL Technologies, Inc. (the Company's IT services business unit) decreased 11% to \$8,765,000 in 2009 compared to \$9,838,000 in 2008. The following table summarizes JDL's revenues by customer group in 2009 and 2008:

| JDL Revenue by Customer Group | |
|--------------------------------------|-------------|
| 2009 | 2008 |

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| | | | | |
|---|----|-----------|----|-----------|
| Broward County FL schools | \$ | 8,594,000 | \$ | 5,186,000 |
| U.S. Virgin Islands Dept. of Education (VIDE) | | | | 4,649,000 |
| All other | | 171,000 | | 3,000 |
| | \$ | 8,765,000 | \$ | 9,838,000 |

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Revenues earned in Broward County FL increased \$3,408,000 or 66% in 2009. Part of the increase was the result of network refresh work originally scheduled for 2008 that was performed in the first quarter of 2009 due to customer budget limitations in the fourth quarter of 2008. Overall, in 2009 the Company booked installation business above 2008 levels. The decrease in VIDE revenue in 2009 was due to losing VIDE as a customer as of June 30, 2008.

JDL gross margin was \$2,753,000 in 2009 compared to \$4,212,000 in 2008. Gross margin in 2008 was significantly impacted by the timing of the recognition of revenues from JDL's VIDE contracts as costs of \$1.4 million were recorded in 2007, when VIDE services were provided, while the \$2.0 million revenue received for such services was recognized in the first nine months of 2008 when the E-Rate funding was approved.

Selling, general and administrative expenses increased 18% in 2009 to \$1,299,000 compared to \$1,105,000 in 2008 due to an increase in compensation expenses and sales activities. Operating income increased to \$1,455,000 in 2009 compared to \$108,000 in 2008. Operating income in 2008 was impacted by a \$2,999,000 impairment charge related to goodwill and network infrastructure assets due to the loss of VIDE as a customer.

Austin Taylor

Austin Taylor's revenues decreased 45% to \$3,061,000 in 2009, compared to \$5,516,000 in 2008. This decrease is primarily due to difficulties in securing connector products from Far East contract manufacturers and the general market and economy slowdown, primarily outside of the U.K.. Gross margin decreased 101% to a loss of \$6,000 in 2009 from income of \$730,000 in 2008. Gross margin as a percentage of sales was 0% in 2009 compared to 13% in 2008. This decrease was due to greatly increased material costs compounded by an unfavorable currency exchange rate during 2009. Additionally, Austin Taylor was burdened with the impact of product quality issues from two of its major vendors. Austin Taylor reported an operating loss in 2009 of \$1,214,000 compared to \$85,000 in 2008. Included in the 2009 operating loss is a \$196,000 impairment charge related to Austin Taylor's machinery and equipment assets. Management is currently implementing measures to improve Austin Taylor's performance. Consideration is also being given to various strategic alternatives, but no decision to implement any particular strategic alternative has been made.

Other

Net investment and other income decreased slightly to \$581,000 in 2009 compared to \$597,000 in 2008. Income before income taxes decreased to \$10,799,000 in 2009 compared to \$11,181,000 in 2008. The Company's effective income tax rate was 44% in 2009 compared to 41% in 2008. This effective rate was higher than the standard rate of 35% due to state income taxes, foreign losses not deductible for U.S. income tax purposes, income tax return to provision adjustments, and provisions for interest charges as explained in Note 8 to the condensed consolidated financial statements.

2008 Compared to 2007

Sales were \$122,700,000 in 2008, a 1% increase from sales of \$121,243,000 in 2007. Operating income increased 3% to \$10,584,000 in 2008 as compared to \$10,263,000 in 2007. Income before income taxes decreased 7% to \$11,181,000 from \$12,023,000 in 2007. Net income decreased 12% to \$6,611,000 in 2008 compared to \$7,511,000 in 2007.

Suttle

Suttle sales decreased 8% to \$44,421,000 in 2008 compared to \$48,135,000 in 2007. Sales by product groups in 2008 and 2007 were:

| Suttle Sales by Product Group | | |
|--------------------------------------|---------------|---------------|
| | 2008 | 2007 |
| Modular connecting products | \$ 18,834,000 | \$ 24,146,000 |
| DSL products | 10,270,000 | 12,278,000 |
| Structured cabling products | 14,445,000 | 10,866,000 |
| Other products | 872,000 | 845,000 |
| | \$ 44,421,000 | \$ 48,135,000 |

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Suttle's sales by customer groups in 2008 and 2007 were:

| Suttle Sales by Customer Group | | |
|---------------------------------------|---------------|---------------|
| | 2008 | 2007 |
| Major telephone companies | \$ 20,624,000 | \$ 20,581,000 |
| Distributors/OEM | 16,367,000 | 18,482,000 |
| International | 2,474,000 | 3,940,000 |
| Other | 4,956,000 | 5,132,000 |
| | \$ 44,421,000 | \$ 48,135,000 |

The decrease in sales was due primarily to the accelerated land-line loss by the major telephone customers, the severe downturn in the domestic housing market, and the loss of the Bellsouth DSL contract during the course of the acquisition by ATT. Sales to the major telephone companies remained stable at \$20,624,000 in 2008 compared to \$20,581,000 in 2007. Sales to these customers accounted for 46% of Suttle's sales in 2008 compared to 43% of sales in 2007. The land-line loss in the major telephone companies forced a faster than expected decline in the traditional and Corroshield product lines. Additionally, the lost DSL contract at Bellsouth was valued at \$2.9 million in 2007. However, sales of structured cabling products to these same customers increased as investment remained strong into FTTP networks. Sales to distributors, original equipment manufacturers (OEMs), and electrical contractors decreased 28% and accounted for 37% of sales in 2008 compared to 38% in 2007. The decline in this segment is a direct result of reduced opportunities in the domestic market for new single-family unit (SFU) construction and multi-dwelling unit (MDU) construction. International sales decreased 37% and accounted for 6% of Suttle's 2008 sales. International telephone customers also faced land-line loss causing decreased sales of voice products. DSL product sales into this segment did increase as customers increased investment into broadband.

Suttle's gross margins decreased 17% to \$10,778,000 in 2008 compared to \$13,030,000 in 2007. The gross margin percentage was 24% in 2008 compared to 27% in 2007. This decrease in gross margin was due to a change in product mix attributed to declining sales in higher margin product, such as the traditional and Corroshield product lines.

Selling, general and administrative expenses decreased 16% to \$6,045,000 in 2008 from \$7,202,000 in 2007. This decrease was due to reduction in staff, lower commissions and bonus expense.

Suttle's operating income declined 19% to \$4,733,000 in 2008 from \$5,828,000 in 2007 due to the decreased revenues and margins noted above.

Transition Networks

Transition Networks sales increased 19% to \$62,924,000 compared to \$53,063,000 in 2007. Transition Networks organizes its sales force and segments its customers geographically. Sales by customer groups in 2008 and 2007 were:

| Transition Networks Sales by Region | | |
|--|---------------|---------------|
| | 2008 | 2007 |
| North America | \$ 45,863,000 | \$ 38,126,000 |
| Europe, Middle East, Asia (EMEA) | 8,352,000 | 6,890,000 |
| Rest of world | 8,709,000 | 8,047,000 |
| | \$ 62,924,000 | \$ 53,063,000 |

Sales in North America increased 20% compared to 2007. Sales in Europe, Middle East and Asia grew approximately 21% and all other sales increased 8% compared to 2007. A large portion of the growth in North America sales came from the U.S. Federal Government which accounted for the majority of the increase in our Ethernet adapter sales. Transition also experienced good growth in sales to the service provider space and traditional enterprise also grew. There is inherent risk in the federal government of projects reaching completion and thereby no longer requiring our product, funding can be cut, or the technology platform can change eliminating the need for our products.

Growth outside the North America region came mostly from the service provider space which is traditionally a larger portion of sales outside of North America.

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The following table summarizes Transition Networks' 2008 and 2007 sales by product group:

| Transition Networks Sales by Product Group | | |
|---|----------------------|----------------------|
| | 2008 | 2007 |
| Media converters | \$ 47,196,000 | \$ 44,500,000 |
| Ethernet switches | 5,809,000 | 5,720,000 |
| Ethernet adapters | 7,220,000 | 2,516,000 |
| Other products | 2,699,000 | 327,000 |
| | \$ 62,924,000 | \$ 53,063,000 |

Gross margin increased 28% to \$30,972,000 in 2008 compared to \$24,211,000 in 2007 due to increase in revenues and lower cost of goods sold. Gross margin as a percentage of sales increased to 49% in 2008 compared to 46% in 2007 due to additional outsourcing of production to lower cost offshore suppliers through an inventory cost reduction plan of \$1.2 million in 2008 and an increase in sales of higher margin products (such as converters and adapters). Selling, general and administrative expenses increased 11% to \$20,673,000 in 2008 from \$18,608,000 in 2007 due to increases in the sales force headcount and marketing program incentives and expenses. While overall SG&A costs increased over 2007, there was a decrease as a percentage of sales down to 33% in 2008 versus 35% in 2007. Operating income for the combined units increased 84% to \$10,299,000 in 2008 compared to \$5,603,000 in 2007.

Transition Networks will continue to develop product based on market needs as well as following industry standards set by such organizations as the Institute of Electrical and Electronics Engineers (IEEE) and the Metro Ethernet Forum (MEF). We will also continue to invest in sales and marketing to grow revenues in our target markets and expand sales outside of North America.

JDL Technologies, Inc.

Sales by JDL Technologies, Inc. (the Company's IT services business unit) decreased 26% to \$9,838,000 in 2008 compared to \$13,219,000 in 2007. The following table summarizes JDL's revenues by customer group in 2008 and 2007:

| JDL Revenue by Customer Group | | |
|---|---------------------|----------------------|
| | 2008 | 2007 |
| Broward County FL schools | \$ 5,186,000 | \$ 5,716,000 |
| U.S. Virgin Islands Dept. of Education (VIDE) | 4,649,000 | 6,223,000 |
| All other | 3,000 | 1,280,000 |
| | \$ 9,838,000 | \$ 13,219,000 |

In 2007, funding commitments for several contracts were received for work performed in earlier periods. As a result, the Company recognized \$2,555,000 of revenue for services performed in 2006. Revenue in 2008 includes \$2.0 million for contracts of services provided to the VIDE in 2007 that were not approved until 2008. JDL does not expect any material revenue from the VIDE after December 31, 2008.

Revenues earned in Broward County FL declined \$530,000 or 9% in 2008. The decline was the result of a delay in network refresh work due to customer budget limitations. The revenue decline does not represent a loss of business as the work was merely delayed into 2009. The decrease in other revenues from 2007 to 2008 was due to the sale of certain lines of business to a former officer in 2007.

Gross margins earned by JDL in 2008 increased to \$4,212,000 compared to \$4,033,000 in 2007. Gross margins in 2008 and 2007 were significantly impacted by the timing of the recognition of E-RATE revenues from JDL's VIDE contracts. Costs of \$1.4 million were recorded in 2007, when the services were provided, however, the \$2.0 million revenue related to these costs was recognized in 2008 when the E-Rate funding was approved. Similarly, the Company's 2007 margins include \$2,555,000 for services provided to the VIDE in 2006. The impact on 2007 gross margins due to timing of revenue recognition was partially offset by increased depreciation charges due to higher levels of plant investments in the U.S. Virgin Islands and reduced volumes of equipment sales to Broward County. VIDE's decision to select another vendor for the 2008-2009 contract year (discussed below) resulted in reduced selling, general and administrative expenses. These costs decreased 55% in 2008 to \$1,105,000 from \$2,466,000 in 2007. The decrease was due to lower legal and professional fees, staff reductions and cuts in marketing

and administrative costs.

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JDL had operating income of \$108,000 in 2008 compared to \$1,567,000 in 2007. The sharp decline in operating income for JDL stems from the decision of the VIDE, to select another vendor to provide wireless network services for the contract year beginning July 1, 2008. JDL had supplied network services to VIDE under one year contracts since 2002. Notification of this decision by VIDE, which was totally unexpected by the Company, was given to JDL on January 17, 2008, and after unsuccessful attempts to reverse VIDE's decision, the Company decided to terminate its operations in the Virgin Islands effective July 1, 2008. In accordance with generally accepted accounting principles, the Company conducted an evaluation of this event for impairment, and identified an impairment of goodwill of \$704,000 and impairment of the network infrastructure with a total net book value of \$2,295,000. The process of winding up JDL's Virgin Islands operations is complete.

Austin Taylor

Austin Taylor's revenues decreased 19% in 2008 to \$5,516,000 from \$6,826,000 in 2007, due to decreased order activity from its two major customers. Gross margin decreased to \$730,000 in 2008 from \$1,611,000 in 2007. Gross margin as a percentage of sales decreased to 13% in 2008 from 24% in 2007. This decrease was due to greatly increased material costs during 2008 and certain quality issues with two of its major vendors. Austin Taylor reported an operating loss in 2008 of \$85,000 compared to operating income of \$479,000 in 2007.

Other

Net investment and other income decreased to \$597,000 in 2008 compared to \$1,760,000 in 2007 due to an increase in interest expense on the Company's mortgage and a decrease in earnings on cash investments. The Company paid a full year in interest expense on the mortgage in 2008 while only a few months in 2007. The Company generally invested its excess cash in money market funds and certificates of deposit in 2008, which had lower rates than in the prior year. The combination of the state and foreign income taxes increased the Company's 2008 tax rate to 41% compared to a normal U.S. rate of 35%.

Acquisitions and Dispositions

The Company is a growth-oriented manufacturer of telecommunications connecting and networking devices. The Company continually searches for acquisition candidates with products that will enable the Company to better serve its target markets.

Effects of Inflation

Inflation has not had a significant effect on operations. The Company does not have long-term production or procurement contracts and has historically been able to adjust pricing and purchasing decisions to respond to inflationary pressures.

Liquidity and Capital Resources

As of December 31, 2009, the Company had approximately \$40,069,000 in cash, cash equivalents and investments. Of this amount, \$12,972,000 was invested in short-term money market funds that are not considered to be bank deposits and are not insured or guaranteed by the federal deposit insurance company (FDIC) or other government agency. These money market funds seek to preserve the value of the investment at \$1.00 per share; however, it is possible to lose money investing in these funds. The remainder in cash and cash equivalents is operating cash and certificates of deposit, which are fully insured through the FDIC. The Company has not experienced any losses on its deposits of cash and cash equivalents. The Company also had \$18,776,000 in investments which consist of certificates of deposit that are traded on the open market and are classified as available-for-sale at December 31, 2009.

The Company had current assets of approximately \$76,967,000 and current liabilities of \$12,754,000 at December 31, 2009 compared to current assets of \$80,819,000 and current liabilities of \$10,091,000 at the end of 2008.

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Cash flow provided by operating activities was approximately \$17,637,000 in 2009 compared to \$10,223,000 provided by operations in 2008. Significant working capital changes from 2008 to 2009 included decreased inventory of \$4,909,000 and a decrease in accounts receivable of \$2,287,000 related to increased collections and lower revenues during the year.

Investing activities used \$21,873,000 of cash in 2009 compared to using \$2,065,000 of cash in 2008 due to the purchase of certificates of deposit with original maturities of greater than 90 days, offset by the sale of such investments. Additionally, capital expenditures during 2009 were \$3,238,000 compared to \$2,462,000 in 2008. In 2008, there were additional purchases equipping the Company's new building in Minnetonka, Minnesota. In 2009, the Company spent approximately \$2,258,000 on new machinery at the Suttle facility in Hector, Minnesota.

Net cash used by financing activities was \$4,563,000 in 2009 compared to \$7,262,000 in 2008. Cash dividends paid on common stock increased to \$4,333,000 in 2009 (\$0.52 per common share) from \$4,133,000 in 2008 (\$0.48 per common share). Proceeds from common stock issuances, principally shares sold to the Company's Employee Stock Ownership Plan and pursuant to options issued under the Company's Employee Stock Purchase Plan, totaled approximately \$171,000 in 2009 and \$376,000 in 2008. The Company purchased and retired 5,126 shares for \$53,000 in 2009 and 343,899 shares for \$3,222,000 in 2008. At December 31, 2009, Board of Director authority to purchase approximately 481,938 additional shares remained in effect. As part of the acquisition of the new Minnetonka headquarters building in July 2007, the Company assumed an outstanding mortgage of \$4,380,000. The mortgage is payable in monthly installments and carries an interest rate of 6.83%. The mortgage matures on March 1, 2016. Remaining mortgage payments on principal totaled \$348,000 during 2009. The outstanding balance on the mortgage was \$2,774,000 at December 31, 2009.

The Company expects that the effective income tax rate for fiscal 2010 will be approximately 45%.

The Company had no outstanding obligations under its line of credit at December 31, 2009 and 2008, and the Company's entire credit line (\$10,000,000 at March 1, 2010) is available for use. The current line of credit expires September 30, 2010. Management believes that we will be able to renew the line on terms acceptable to the Company; however this can not be assured. In the opinion of management, based on the Company's current financial and operating position and projected future expenditures, sufficient funds are available to meet the Company's anticipated operating and capital expenditure needs.

Contractual Obligation Summary

The following table summarizes our contractual obligations at December 31, 2009 and the effect these obligations are expected to have on our liquidity and cash flow in future periods:

| | <u>Less than One Year</u> | <u>1 - 3 Years</u> | <u>3 - 5 Years</u> | <u>More Than 5 Years</u> |
|----------------------------|-------------------------------|---------------------|---------------------|------------------------------|
| Long-term debt | \$ 373,000 | \$ 827,000 | \$ 947,000 | \$ 628,000 |
| Interest on long-term debt | 178,000 | 275,000 | 155,000 | 28,000 |
| Pensions | 247,000 | 385,000 | 648,000 | 1,814,000 |
| Operating leases | 142,000 | 144,000 | | |
| Compensation plans | 1,257,000 | 887,000 | | |
| Total | \$ 2,197,000 | \$ 2,518,000 | \$ 1,750,000 | \$ 2,470,000 |

As of December 31, 2009, the Company had no other material commitments (either cancelable or non-cancelable) for capital expenditures, short or long term debt, capital leases or other purchase commitments related to ongoing operations.

Recently Issued Accounting Pronouncements

We do not believe there are any recently issued accounting standards that have not yet been adopted that will have a material impact on the Company's financial statements.

Off Balance Sheet Arrangements

None.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

The vast majority of our transactions are denominated in U.S. dollars; as such, fluctuations in foreign currency exchange rates have historically not been material to the Company. At December 31, 2009 our bank line of credit carried a variable interest rate based on our bank's average certificate of deposit rate plus 1.5%. The Company's investments are money market and certificates of deposit types of investments that earn interest at prevailing market rates and as such do not have material risk exposure.

Based on the Company's operations, in the opinion of management, the Company is not exposed to material future losses due to market risk.

At December 31, 2009 approximately \$279,000 of assets were invested in the Company's assembly plant subsidiary in Costa Rica. The Company expects to maintain assets in Costa Rica as needed to support the continued operation of the Suttle subsidiary. The Company uses the U.S. dollar as its functional currency in Costa Rica. Accordingly, the Company believes its risk of material loss due to fluctuations in foreign currency markets to be small.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
(a) FINANCIAL STATEMENTS

REPORT OF MANAGEMENT

The management of Communications Systems, Inc. and its subsidiary companies is responsible for the integrity and objectivity of the financial statements and other financial information contained in the annual report. The financial statements and related information were prepared in accordance with accounting principles generally accepted in the United States of America and include amounts that are based on management's informed judgments and estimates.

In fulfilling its responsibilities for the integrity of financial information, management maintains accounting systems and related controls. These controls provide reasonable assurance, at appropriate costs, that assets are safeguarded against losses and that financial records are reliable for use in preparing financial statements. Management recognizes its responsibility for conducting the Company's affairs according to the highest standards of personal and corporate conduct.

The Audit Committee of the Board of Directors, comprised solely of outside directors, meets with the independent auditors and management periodically to review accounting, auditing, financial reporting and internal control matters. The independent auditors have free access to this committee, without management present, to discuss the results of their audit work and their opinion on the adequacy of internal financial controls and the quality of financial reporting.

/s/ Jeffrey K. Berg

Jeffrey K. Berg
Chief Executive Officer

/s/ David T. McGraw

David T. McGraw
Chief Financial Officer

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors of
Communications Systems, Inc.:

We have audited the accompanying consolidated balance sheets of Communications Systems, Inc. and subsidiaries (the Company) as of December 31, 2009 and 2008, and the related consolidated statements of income and comprehensive income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2009. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ Deloitte & Touche LLP

Minneapolis, Minnesota
March 18, 2010

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| | <u>December 31 2009</u> | <u>December 31 2008</u> |
|--|-----------------------------|-----------------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 21,293,448 | \$ 29,951,561 |
| Investments | 11,236,940 | |
| Trade accounts receivable, less allowance for doubtful accounts of \$505,000 and \$219,000, respectively | 15,042,411 | 17,243,788 |
| Inventories | 24,598,317 | 29,398,443 |
| Prepaid income taxes | 337,274 | |
| Other current assets | 884,555 | 861,039 |
| Deferred income taxes | 3,574,501 | 3,364,297 |
| TOTAL CURRENT ASSETS | 76,967,446 | 80,819,128 |
| PROPERTY, PLANT AND EQUIPMENT, net | 13,321,825 | 12,014,541 |
| OTHER ASSETS: | | |
| Investments | 7,538,903 | |
| Goodwill | 4,560,217 | 4,560,217 |
| Deferred income taxes | | 643,667 |
| Funded pension assets | 399,743 | 566,137 |
| Other assets | 125,560 | 134,101 |
| TOTAL OTHER ASSETS | 12,624,423 | 5,904,122 |
| TOTAL ASSETS | \$ 102,913,694 | \$ 98,737,791 |

LIABILITIES AND STOCKHOLDERS EQUITY

| | | |
|------------------------------------|-------------------|-------------------|
| CURRENT LIABILITIES: | | |
| Current portion of long-term debt | \$ 372,926 | \$ 348,373 |
| Accounts payable | 4,986,028 | 4,126,756 |
| Accrued compensation and benefits | 4,855,899 | 2,985,233 |
| Other accrued liabilities | 1,370,105 | 1,624,971 |
| Income taxes payable | | 11,430 |
| Dividends payable | 1,169,040 | 994,169 |
| TOTAL CURRENT LIABILITIES | 12,753,998 | 10,090,932 |
| LONG TERM LIABILITIES: | | |
| Long-term compensation plans | 887,210 | 1,410,559 |
| Income taxes payable | 723,534 | 733,683 |
| Deferred income taxes | 208,111 | |
| Long term debt - mortgage payable | 2,401,548 | 2,774,474 |
| TOTAL LONG-TERM LIABILITIES | 4,220,403 | 4,918,716 |

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS EQUITY

Preferred stock, par value \$1.00 per share; 3,000,000 shares authorized; none issued

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| | | |
|--|-----------------------|----------------------|
| Common stock, par value \$.05 per share; 30,000,000 shares authorized; 8,352,883 and 8,282,348 shares issued and outstanding, respectively | 417,644 | 414,117 |
| Additional paid-in capital | 33,641,510 | 33,019,154 |
| Retained earnings | 52,007,261 | 50,503,410 |
| Accumulated other comprehensive income | (127,122) | (208,538) |
| TOTAL STOCKHOLDERS EQUITY | <u>85,939,293</u> | <u>83,728,143</u> |
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | <u>\$ 102,913,694</u> | <u>\$ 98,737,791</u> |

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

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

| | Year Ended December 31 | | |
|---|------------------------|----------------|----------------|
| | 2009 | 2008 | 2007 |
| Sales | \$ 109,792,207 | \$ 122,699,678 | \$ 121,243,248 |
| Costs and expenses: | | | |
| Cost of sales | 67,943,557 | 76,008,162 | 78,357,538 |
| Selling, general and administrative expenses | 31,434,097 | 33,108,488 | 32,623,142 |
| Impairment loss | 196,020 | 2,999,441 | |
| Total costs and expenses | 99,573,674 | 112,116,091 | 110,980,680 |
| Operating income | 10,218,533 | 10,583,587 | 10,262,568 |
| Other income and (expenses): | | | |
| Investment and other income | 810,039 | 706,202 | 954,011 |
| Gain on sale of assets | 39,919 | 84,513 | 834,165 |
| Interest and other expense | (269,151) | (193,010) | (27,978) |
| Other income, net | 580,807 | 597,705 | 1,760,198 |
| Income from operations before income taxes | 10,799,340 | 11,181,292 | 12,022,766 |
| Income tax expense | 4,755,695 | 4,569,875 | 4,512,000 |
| Net income | 6,043,645 | 6,611,417 | 7,510,766 |
| Other comprehensive income (loss): | | | |
| Additional minimum pension liability adjustments | 285,000 | (60,226) | 571,226 |
| Unrealized gains on available-for-sale securities | 33,802 | | |
| Foreign currency translation adjustment | (237,386) | (1,345,278) | 209,129 |
| Total other comprehensive income (loss) | 81,416 | (1,405,504) | 780,355 |
| Comprehensive income | \$ 6,125,061 | \$ 5,205,913 | \$ 8,291,121 |
| Basic net income per share: | \$.72 | \$.77 | \$.86 |
| Diluted net income per share: | \$.72 | \$.77 | \$.85 |
| Average Basic Shares Outstanding | 8,339,566 | 8,539,396 | 8,761,300 |
| Average Dilutive Shares Outstanding | 8,352,084 | 8,562,533 | 8,830,713 |
| Dividends per share | \$.52 | \$.48 | \$.42 |

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

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

| | Common Stock | | Additional Paid-in Capital | Retained Earnings | Cumulative Other Comprehensive Income (Loss) | Total |
|--|------------------|-------------------|----------------------------------|----------------------|---|----------------------|
| | Shares | Amount | | | | |
| BALANCE AT DECEMBER 31, 2006 | 8,732,429 | 436,621 | 33,488,345 | 48,203,511 | 416,611 | 82,545,088 |
| Adjustment to initially apply tax guidance | | | | 427,302 | | 427,302 |
| Net income | | | | 7,510,766 | | 7,510,766 |
| Issuance of common stock under Employee Stock Purchase Plan | 9,851 | 493 | 98,489 | | | 98,982 |
| Issuance of common stock to Employee Stock Ownership Plan | 41,745 | 2,087 | 421,207 | | | 423,294 |
| Issuance of common stock under Employee Stock Option Plan | 128,415 | 6,421 | 890,161 | | | 896,582 |
| Tax benefit from non-qualified employee stock options | | | 82,862 | | | 82,862 |
| Share based compensation | | | 49,205 | | | 49,205 |
| Purchase of common stock | (371,235) | (18,562) | (1,508,306) | (2,514,851) | | (4,041,719) |
| Shareholder dividends | | | | (3,842,135) | | (3,842,135) |
| Other comprehensive income | | | | | 780,355 | 780,355 |
| BALANCE AT DECEMBER 31, 2007 | 8,541,205 | \$ 427,060 | \$ 33,521,963 | \$ 49,784,593 | \$ 1,196,966 | \$ 84,930,582 |
| Net income | | | | 6,611,417 | | 6,611,417 |
| Issuance of common stock to Employee Stock Purchase Plan | 7,947 | 397 | 85,674 | | | 86,071 |
| Issuance of common stock under Employee Stock Ownership Plan | 38,296 | 1,915 | 452,659 | | | 454,574 |
| Issuance of common stock under Employee Stock Option Plan | 38,800 | 1,940 | 288,205 | | | 290,145 |
| Tax benefit from non-qualified employee stock options | | | 39,384 | | | 39,384 |
| Share based compensation | | | 41,824 | | | 41,824 |
| Purchase of common stock | (343,899) | (17,195) | (1,410,555) | (1,794,746) | | (3,222,496) |
| Shareholder dividends | | | | (4,097,854) | | (4,097,854) |
| Other comprehensive loss | | | | | (1,405,504) | (1,405,504) |
| BALANCE AT DECEMBER 31, 2008 | 8,282,349 | \$ 414,117 | \$ 33,019,154 | \$ 50,503,410 | \$ (208,538) | \$ 83,728,143 |
| Net income | | | | 6,043,645 | | 6,043,645 |
| Issuance of common stock under Employee Stock Purchase Plan | 12,327 | 616 | 101,450 | | | 102,066 |
| Issuance of common stock to Employee Stock Ownership Plan | 56,933 | 2,847 | 441,231 | | | 444,078 |
| Issuance of common stock under Employee Stock Option Plan | 6,400 | 320 | 68,240 | | | 68,560 |
| Tax benefit from non-qualified employee stock options | | | 467 | | | 467 |
| Share based compensation | | | 31,571 | | | 31,571 |
| Purchase of common stock | (5,126) | (256) | (20,603) | (32,258) | | (53,117) |
| Shareholder dividends | | | | (4,507,536) | | (4,507,536) |
| Other comprehensive income | | | | | 81,416 | 81,416 |
| BALANCE AT DECEMBER 31, 2009 | 8,352,883 | \$ 417,644 | \$ 33,641,510 | \$ 52,007,261 | \$ (127,122) | \$ 85,939,293 |

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

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Year Ended December 31 | | |
|---|------------------------|---------------|---------------|
| | 2009 | 2008 | 2007 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income | \$ 6,043,645 | \$ 6,611,417 | \$ 7,510,766 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 1,698,321 | 1,865,111 | 2,159,184 |
| Share based compensation | 31,571 | 41,824 | 49,205 |
| Deferred taxes | 641,574 | (484,944) | 837,263 |
| Impairment loss | 196,020 | 2,999,441 | |
| Gain on sale of assets | (39,919) | (84,513) | (650,852) |
| Excess tax benefit from stock based payments | (467) | (39,384) | (82,862) |
| Changes in assets and liabilities net of effects from acquisitions: | | | |
| Trade receivables | 2,287,237 | (112,150) | 2,249,347 |
| Inventories | 4,908,760 | (1,912,971) | (2,740,228) |
| Prepaid income taxes | (337,274) | 1,418,576 | 780,205 |
| Other current assets | (10,116) | 116,415 | (237,824) |
| Accounts payable | 827,562 | 305,782 | 741,144 |
| Accrued compensation and benefits | 1,791,395 | 33,524 | 821,362 |
| Other accrued expenses | (263,369) | 249,802 | 96,193 |
| Income taxes payable | (21,112) | (428,399) | (694,370) |
| Other | (116,707) | (356,814) | (246,480) |
| Net cash provided by operating activities | 17,637,121 | 10,222,717 | 10,592,053 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Capital expenditures | (3,237,558) | (2,462,145) | (4,680,694) |
| Purchases of investments | (34,841,042) | | |
| Proceeds from the sale of fixed assets | 106,672 | 396,857 | 2,196,337 |
| Proceeds from the sale of investments | 16,099,000 | | |
| Net cash used in investing activities | (21,872,928) | (2,065,288) | (2,484,357) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Cash dividends paid | (4,332,666) | (4,132,815) | (3,685,673) |
| Mortgage principal payments | (348,373) | (322,309) | (935,113) |
| Proceeds from issuance of common stock | 170,626 | 376,218 | 995,565 |
| Excess tax benefit from stock based payments | 467 | 39,384 | 82,862 |
| Purchase of common stock | (53,117) | (3,222,497) | (4,041,719) |
| Net cash used in financing activities | (4,563,063) | (7,262,019) | (7,584,079) |
| EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH | 140,757 | (371,728) | 153,090 |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS | (8,658,113) | 523,682 | 676,707 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | 29,951,561 | 29,427,879 | 28,751,172 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR | \$ 21,293,448 | \$ 29,951,561 | \$ 29,427,879 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | | |
| Income taxes paid | \$ 4,472,507 | \$ 4,031,223 | \$ 3,588,852 |
| Interest paid | 225,883 | 211,723 | 267,176 |
| Dividends declared not paid | 1,169,040 | 994,169 | 1,029,130 |

NON-CASH INVESTING AND FINANCING INFORMATION:

| | |
|--|-----------|
| Mortgage assumed for acquisition of building | 4,380,269 |
|--|-----------|

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

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years Ended December 31, 2009, 2008 and 2007

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of business: Communications Systems, Inc. (herein collectively called *CSI*, *our* or the *Company*) is a Minnesota corporation organized in 1969 which operates directly and through its subsidiaries located in the United States, Costa Rica, the United Kingdom and China. *CSI* is principally engaged through its *Suttle* and *Austin Taylor* business units in the manufacture and sale of modular connecting and wiring devices for voice and data communications, digital subscriber line filters, and structured wiring systems and through its *Transition Networks* business unit in the manufacture of media and rate conversion products for telecommunications networks. *CSI* also provides through its *JDL Technologies* business unit IT solutions including network design, computer infrastructure installations, IT service management, change management, network security and network operations services.

The Company classifies its businesses into four segments: *Suttle*, which manufactures U.S. standard modular connecting and wiring devices for voice and data communications; *Transition Networks* subsidiary that designs and markets media conversion products, Ethernet switches, and other connectivity and data transmission products; *Austin Taylor*, which manufactures British standard line jacks, patch panels, metal boxes, distribution and central office frames; and *JDL Technologies, (JDL)*, which provides IT services; Non-allocated general and administrative expenses are separately accounted for as *Other* in the Company's segment reporting. There are no material intersegment revenues.

Principles of consolidation: The consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany transactions and accounts have been eliminated.

Use of estimates: The presentation 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 reported amounts of assets and liabilities and 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. The Company uses estimates based on the best information available in recording transactions and balances resulting from operations. Actual results could differ from those estimates. The Company's estimates consist principally of reserves for doubtful accounts, sales returns, warranty costs, asset impairment evaluations, accruals for compensation plans, self insured medical and dental accruals, pension liabilities, lower of cost or market inventory adjustments, provisions for income taxes and deferred taxes and depreciable lives of fixed assets.

Cash equivalents: For purposes of the consolidated statements of cash flows, the Company considers all highly liquid investments with a maturity of three months or less at the time of purchase to be cash equivalents. As of December 31, 2009, the Company had \$21.3 million in cash and cash equivalents. Of this amount, \$13.0 million was invested in short-term money market funds that are not considered to be bank deposits and are not insured or guaranteed by the federal deposit insurance company (FDIC) or other government agency. These money market funds seek to preserve the value of the investment at \$1.00 per share; however, it is possible to lose money investing in these funds. The remainder is operating cash and certificates of deposit which are fully insured through the FDIC.

Investments: Investments consist of certificates of deposit that are traded on the open market and are classified as available-for-sale at December 31, 2009. Available-for-sale investments are reported at fair value with unrealized gains and losses excluded from operations and reported as a separate component of stockholders' equity, net of tax (See Accumulated Comprehensive income below).

Inventories: Inventories are stated at the lower of cost or market. Cost is determined by the first-in, first-out method. Provision to reduce inventories to the lower of cost or market is made based on a review of excess and obsolete inventories, estimates of future sales, examination of historical consumption rates and the related value of component parts.

Property, plant and equipment: Property, plant and equipment are recorded at cost. Depreciation is computed using the straight-line method. Depreciation included in cost of sales and selling, general and administrative expenses for continuing operations was \$1,698,000, \$1,865,000 and \$2,150,000 for 2009, 2008 and 2007, respectively. Maintenance and repairs are charged to operations and additions or improvements are capitalized. Items of property sold, retired or otherwise disposed of are removed from the asset and accumulated depreciation accounts and any gains or losses on disposal are reflected in operations.

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Goodwill: Goodwill represents the amount by which the purchase prices (including liabilities assumed) of acquired businesses exceed the estimated fair value of the net tangible assets and separately identifiable assets of these businesses. Goodwill and intangible assets with indefinite useful lives are not amortized, but are tested at least annually for impairment. The Company reassesses the value of our reporting units and related goodwill balances at the end of each fiscal year and at other times if events have occurred or circumstances exist that indicate the carrying amount of goodwill may not be recoverable.

Recoverability of long-lived assets: The Company reviews its long-lived assets periodically to determine potential impairment by comparing the carrying value of the assets with expected net cash flows expected to be provided by operating activities of the business or related products. If the sum of the expected future net cash flows is less than the carrying value, an impairment loss would be measured by comparing the amount by which the carrying value exceeds the fair value of the asset.

Warranty: The Company reserves for the estimated cost of product warranties at the time revenue is recognized. We estimate the costs of our warranty obligations based on our warranty policy or applicable contractual warranty, historical experience of known product failure rates, and use of materials and service delivery costs incurred in correcting product failures. Management reviews the estimated warranty liability on a quarterly basis to determine its adequacy.

The following table presents the changes in the Company's warranty liability for the years ended December 31, 2009 and 2008, which relate to normal product warranties and a five year obligation to provide for potential future liabilities for certain network equipment sales:

| | Year Ended December 31 | |
|---|------------------------|------------|
| | 2009 | 2008 |
| Beginning balance | \$ 593,000 | \$ 518,000 |
| Amounts charged to (recovered from) expense | 407,000 | 467,000 |
| Actual warranty costs paid | (352,000) | (392,000) |
| | \$ 648,000 | \$ 593,000 |

Accumulated Comprehensive income: The components of accumulated other comprehensive income are as follows:

| | December 31 | |
|---|----------------|--------------|
| | 2009 | 2008 |
| Foreign currency translation | \$ (1,089,760) | \$ (852,374) |
| Unrealized gain on available-for-sale investments | 33,802 | |
| Minimum pension liability | 928,836 | 643,836 |
| | \$ (127,122) | \$ (208,538) |

The functional currency of Austin Taylor is the British pound. Assets and liabilities denominated in this foreign currency were translated into U.S. dollars at year-end exchange rates. Revenue and expense transactions were translated using average exchange rates. Suttle Costa Rica and Transition China use the U.S. dollar as its functional currency.

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

JDL Technologies generally records revenue on hardware, software and related equipment sales and installation contracts when the revenue recognition criteria are met and products are installed and accepted by the customer.

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JDL records revenue on service contracts on a straight-line basis over the contract period, unless evidence suggests the revenue is earned in a different pattern. Each contract is individually reviewed to determine when the earnings process is complete. Contracts with the Virgin Islands Department of Education (VIDE) are funded by the federal government's E-RATE program and must be approved by the Schools and Libraries Division (SLD) of the Universal Service Administration Company (USAC) before payment can be received. Our policy is not to recognize E-RATE revenue on our VIDE contracts until they are approved by the SLD.

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Research and development: Research and development costs consist of outside testing services, equipment and supplies associated with enhancing existing products and developing new products. Research and development costs are expensed when incurred and totaled \$1,707,000 in 2009, \$1,792,000 in 2008 and \$592,000 in 2007.

Net income per share: Basic net income per common share is based on the weighted average number of common shares outstanding during each year. Diluted net income per common share adjusts for the dilutive effect of potential common shares outstanding. The Company's only potential common shares outstanding are stock options, which resulted in a dilutive effect of 12,519 shares, 23,137 shares and 69,413 shares in 2009, 2008 and 2007, respectively. The Company calculates the dilutive effect of outstanding options using the treasury stock method. The number of shares not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of common stock during the year for 2009, 2008, and 2007 was 81,000, 155,900 and 116,900, respectively.

Stock compensation: The Company accounts for stock-based compensation awards on a fair value basis. The estimated grant date fair value of each stock-based award is recognized in income over the requisite service period (generally the vesting period). The estimated fair value of each option is calculated using the Black-Scholes option-pricing model.

NOTE 2 - INVENTORIES

Inventories consist of:

| | December 31 | |
|-----------------------------|---------------|---------------|
| | 2009 | 2008 |
| Finished goods | \$ 15,195,132 | \$ 17,924,907 |
| Raw and processed materials | 9,403,185 | 11,473,536 |
| | \$ 24,598,317 | \$ 29,398,443 |

NOTE 3 - PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment and the estimated useful lives are as follows:

| | Estimated useful life | December 31 | |
|-------------------------------|--------------------------|---------------|---------------|
| | | 2009 | 2008 |
| Land | | \$ 3,104,569 | \$ 3,051,600 |
| Buildings and improvements | 7-40 years | 8,335,344 | 8,107,132 |
| Machinery and equipment | 3-15 years | 21,482,373 | 22,355,113 |
| Furniture and fixtures | 5-10 years | 3,518,607 | 3,351,143 |
| Construction in progress | | | 44,715 |
| | | 36,440,893 | 36,909,703 |
| Less accumulated depreciation | | (23,119,068) | (24,895,162) |
| | | \$ 13,321,825 | \$ 12,014,541 |

During 2009, Austin Taylor suffered operating losses which represented an event that required the related fixed assets to be tested for impairment. The Company completed an evaluation at the end of 2009 and identified an impairment charge on machinery and equipment assets totaling \$196,000.

On January 17, 2008 the Company was notified by VIDE, a customer of JDL Technologies under successive one year contracts since 1998, that the Company was not selected as VIDE's vendor effective July 1, 2008. The decision of VIDE to select another vendor for the next contract year represented an event that required the related asset group to be tested for impairment. The Company completed this evaluation in the first quarter of fiscal 2008 and identified an impairment of the network infrastructure supporting services provided to VIDE to the extent of its total net book

value of \$2,295,000.

NOTE 4 - EMPLOYEE RETIREMENT BENEFITS

The Company has an Employee Savings Plan (401(k)) and matches a percentage of employee contributions up to six percent of compensation. Contributions to the plan in 2009, 2008 and 2007 were \$420,000, \$410,000, and \$407,000, respectively.

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The Company's U.K. based subsidiary Austin Taylor maintains defined benefit pension plans that cover approximately 10 active employees. The Company does not provide any other post-retirement benefits to its employees. The following table summarizes the balance sheet impact, including benefit obligations, assets and funded status of Austin Taylor's pension plans at December 31, 2009 and 2008:

| | <u>2009</u> | <u>2008</u> |
|---|-------------------|-------------------|
| Change in benefit obligation: | | |
| Benefit obligation at the beginning of the year | \$ 3,891,000 | \$ 5,685,000 |
| Service cost | 37,000 | 35,000 |
| Interest cost | 261,000 | 243,000 |
| Participant contributions | 16,000 | 9,000 |
| Actuarial (gains)/losses | (199,000) | (223,000) |
| Benefits paid | (169,000) | (294,000) |
| Foreign currency (gains)/losses | 388,000 | (1,564,000) |
| | <u>4,623,000</u> | <u>3,891,000</u> |
| Change in plan assets: | | |
| Fair value of plan assets at beginning of year | 4,457,000 | 6,080,000 |
| Actual return on plan assets | 83,000 | 174,000 |
| Employer contributions | 191,000 | 161,000 |
| Participant contributions | 16,000 | 9,000 |
| Benefits paid | (169,000) | (294,000) |
| Foreign currency gains (losses) | 445,000 | (1,673,000) |
| | <u>5,023,000</u> | <u>4,457,000</u> |
| Funded status at end of year net asset /(liability) | <u>\$ 400,000</u> | <u>\$ 566,000</u> |

Weighted average assumptions used to determine net periodic pension costs:

| | | |
|---------------------------|------|------|
| Discount rate | 5.8% | 6.3% |
| Expected return on assets | 5.0% | 5.4% |

The plans are funded through UK government gilts and an insurance contract both recorded in the financial statements at fair value. The related amounts for each of these investments were \$2,711,000 and \$2,312,000 as of December 31, 2009 and were determined to be level 2 and level 3 investments, respectively. Level 2 investments are valued based on observable inputs such as quoted prices for similar instruments and quoted prices in markets that are not active. Level 3 investments are valued based on significant unobservable inputs.

The Company does not expect any plan assets to be returned to the Company during the twelve months subsequent to December 31, 2009.

The Company expects to make contributions of \$57,000 to the plan in 2010.

The Company estimates its future pension benefit payments will be as follows:

| | |
|----------------|------------|
| 2010 | \$ 247,000 |
| 2011 | 180,000 |
| 2012 | 205,000 |
| 2013 | 274,000 |
| 2014 | 374,000 |
| 2015 thru 2019 | 1,814,000 |

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Components of the Company's net periodic pension costs are:

| | <u>2009</u> | <u>2008</u> | <u>2007</u> |
|--|------------------|------------------|------------------|
| Service cost | \$ 37,000 | \$ 35,000 | \$ 52,000 |
| Interest cost | 261,000 | 243,000 | 314,000 |
| Expected return on assets | (226,000) | (237,000) | (312,000) |
| Amortization of unrecognized (gain)/loss | | | |
| Net periodic pension cost | <u>\$ 72,000</u> | <u>\$ 41,000</u> | <u>\$ 54,000</u> |

NOTE 5 COMMITMENTS AND CONTINGENCIES

Operating leases: The Company leases land, buildings and equipment under operating leases with original terms from 1 to 5 years. Total rent expense was \$440,000, \$789,000 and \$1,328,000 in 2009, 2008 and 2007 respectively. Sublease income received was \$12,000, \$12,000 and \$28,000 in 2009, 2008 and 2007 respectively. At December 31, 2009, the Company was obligated under noncancelable operating leases to make minimum annual future lease payments as follows:

Year Ending December 31:

| | |
|------------|------------|
| 2010 | \$ 142,000 |
| 2011 | 77,000 |
| 2012 | 67,000 |
| Thereafter | |
| | \$ 286,000 |

Long-term debt: As part of the purchase of the new Minnetonka headquarters building in July 2007, the Company assumed an outstanding mortgage of \$4,380,000. The mortgage is payable in monthly installments and carries an interest rate of 6.83%. The mortgage matures on March 1, 2016. The outstanding balance on the mortgage was \$2,774,000 at December 31, 2009. The mortgage is secured by the building.

The annual requirements for principal payments on the mortgage are as follows:

| | |
|------------|------------|
| 2010 | \$ 373,000 |
| 2011 | 399,000 |
| 2012 | 427,000 |
| 2013 | 457,000 |
| 2014 | 490,000 |
| Thereafter | 628,000 |

Line of credit: The Company has a \$10,000,000 line of credit from U.S. Bank. The Company had no outstanding borrowings against the line of credit at December 31, 2009 and 2008. Interest on borrowings on the credit line is at the LIBOR rate plus 1.5% (1.8% at December 31, 2009). The credit agreement expires September 30, 2010 and is secured by assets of the Company.

As of December 31, 2009, the Company had no other material commitments (either cancelable or non-cancelable) for capital expenditures or other purchase commitments related to ongoing operations. The Company had no outstanding obligations under its line of credit at December 31, 2009 and 2008, and the entire credit line is available for use.

Long-term compensation plans: The Company has a performance unit incentive plan (PUP). The plan provides long term competitive compensation to enable the Company to attract and retain qualified executive talent and to reward employees for achieving goals and improving company performance. The plan provides grants of performance units made at the beginning of four year performance periods and paid at the end of the period if return on asset goals are met. Awards are made every other year and are given in the form of cash at the end of the cycle with annual vesting. Payment in the case of retirement, disability or death will be on a pro rata basis. Every other year a new four-year cycle begins to create a potential pay out every other year. The Company accrued PUP expense of \$734,000, \$775,000 and \$421,000 in 2009, 2008 and 2007, respectively. Accrual balances for long-term compensation plans at December 31, 2009 and 2008 was \$2,144,000 and \$1,410,000, respectively. PUP awards paid were \$0 in 2009, \$679,000 in 2008 and \$0 in 2007. Remaining PUP awards will be paid out in 2010 and 2012.

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

NOTE 6 STOCK COMPENSATION

Stock-based compensation expense is recognized based on the fair value of awards granted over the vesting period of the award. Stock-based compensation expense recognized under for 2009, 2008 and 2007 was \$32,000, \$42,000 and \$49,000 before income taxes and \$20,000, \$27,000 and \$32,000 after income taxes, respectively. At December 31, 2009 all outstanding options were vested.

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The fair value of awards issued under the Company's stock option plan and Employee Stock Purchase Plan transactions is estimated at grant date using the Black-Scholes option-pricing model. The following table displays the assumptions used in the model.

| | Year Ended December 31 | | |
|-------------------------|------------------------|---------|---------|
| | 2009 | 2008 | 2007 |
| Expected volatility | 28.3% | 26.6% | 31.4% |
| Risk free interest rate | 3.4% | 3.8% | 5.2% |
| Expected holding period | 7 years | 7 years | 7 years |
| Dividend yield | 4.9% | 4.0% | 3.9% |

Fair value of all options granted was approximately \$32,000, \$42,000 and \$49,000 in 2009, 2008 and 2007, respectively

Common shares are reserved for issuance in connection with a nonqualified stock option plan under which up to 300,000 shares may be issued to nonemployee directors. The plan provides for the automatic grant of nonqualified options for 3,000 shares of common stock annually to each nonemployee director concurrent with the annual stockholders' meeting. Exercise price is the fair market value of the stock at the date of grant. Options granted under this plan vest when issued and expire 10 years from date of grant. 31,000 shares are available to be issued under the plan at December 31, 2009. Stock options were granted to non-employee directors for 18,000 shares in 2009, 2008 and 2007.

Common shares are also reserved in connection with the Company's 1992 stock plan under which 2,500,000 shares of common stock may be issued pursuant to stock options, stock appreciation rights, restricted stock or deferred stock granted to officers and key employees. Exercise prices of stock options under the plan cannot be less than fair market value of the stock on the date of grant. Rules and conditions governing awards of stock options, stock appreciation rights and restricted or deferred stock are determined by the Compensation Committee of the Board of Directors, subject to certain limitations incorporated into the plan. 1,123,739 shares are available to be issued under the plan at December 31, 2009. Options granted to officers and key employees expire five years from date of grant with one-third of the options vesting after six months and the remaining two-thirds vesting equally over the next two years. The Company did not issue any options under this plan in 2009, 2008 or 2007.

Changes in outstanding employee and director stock options during the three years ended December 31, 2009 were as follows:

| | Number of shares | Weighted average exercise price per share |
|----------------------------------|---------------------|--|
| Outstanding at December 31, 2006 | 570,280 | 9.53 |
| Granted | 18,000 | 10.22 |
| Exercised | (175,930) | 8.15 |
| Canceled | (14,900) | 13.90 |
| | 397,450 | 10.01 |
| Outstanding at December 31, 2007 | 397,450 | 10.01 |
| Granted | 18,000 | 11.41 |
| Exercised | (38,800) | 7.48 |
| Canceled | (25,300) | 15.04 |
| | 351,350 | 9.99 |
| Outstanding at December 31, 2008 | 351,350 | 9.99 |
| Granted | 18,000 | 9.73 |
| Exercised | (6,400) | 10.71 |
| Canceled | (173,950) | 10.18 |
| | 189,000 | 9.77 |
| Outstanding at December 31, 2009 | 189,000 | 9.77 |

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All outstanding options were fully vested and currently exercisable at December 31, 2009. The aggregate intrinsic value of all outstanding in-the-money options was \$545,000 based on the Company's stock price at December 31, 2009. The intrinsic value of options exercised during the year was \$30,000, \$142,000 and \$521,000 in 2009, 2008 and 2007, respectively. The following table summarizes the status of stock options outstanding at December 31, 2009:

| Range of Exercise Prices | Shares | Weighted Average Remaining Option Life | Weighted Average Exercise Price |
|--------------------------|--------|--|---------------------------------------|
| \$7.13 to \$8.64 | 72,000 | 2.9 years | \$ 7.72 |
| \$8.65 to \$9.99 | 36,000 | 7.9 years | 9.67 |
| \$10.00 to \$12.00 | 57,000 | 7.0 years | 10.59 |
| \$12.01 to \$15.00 | 24,000 | 0.4 years | 14.13 |

The Company receives an income tax benefit related to the gains received by officers and key employees who make disqualifying dispositions of stock received on exercise of qualified incentive stock options and on non-qualified options. The amount of tax benefit received by the Company was \$0, \$108,000 and \$83,000 in 2009, 2008 and 2007 respectively. The tax benefit amounts have been credited to additional paid-in capital.

EMPLOYEE STOCK PURCHASE PLAN

The Company maintains an Employee Stock Purchase Plan for which 500,000 common shares have been reserved. Employees are able to acquire shares through payroll deductions at 95% of the price at the end of each semi-annual plan. 87,828 shares remain available under the Plan for purchase as of December 31, 2009.

EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)

All eligible employees of the Company participate in the ESOP after completing one year of service. Contributions are allocated to each participant based on compensation and vest 30% after three years of service and incrementally thereafter, with full vesting after seven years. At December 31, 2009, the ESOP held 526,240 shares of the Company's common stock, all of which have been allocated to the accounts of eligible employees. Contributions to the plan are determined by the Board of Directors and can be made in cash or shares of the Company's stock. The 2009 ESOP contribution was \$471,563 for which the Company issued 37,907 shares in March 2010. The 2008 ESOP contribution was \$444,077 for which the Company issued 56,933 shares in 2009. The Company's 2007 ESOP contribution was \$454,754 for which the Company issued 38,296 shares of common stock to the ESOP in March 2008.

NOTE 7 COMMON STOCK

PURCHASES OF COMMUNICATIONS SYSTEMS, INC. COMMON STOCK

In September 2006 and October 2008, the Company's Board of Directors authorized the repurchase of shares of the Company's stock pursuant to Exchange Act Rule 106-18 on the open market, in block trades or in private transactions. At December 31, 2009, 481,938 additional shares could be repurchased under outstanding Board authorizations.

SHAREHOLDER RIGHTS PLAN

On December 23, 2009 the Board of Directors adopted a shareholders' rights plan. Under this plan, the Board of Directors declared a distribution of one right per share of common stock. Each right entitles the holder to purchase 1/100th of a share of a new series of Junior Participating Preferred Stock of the Company at an initial exercise price of \$41. The rights expire on December 23, 2019. The rights will become exercisable only following the acquisition by a person or group, without the prior consent of the Board of Directors, of 16.5% or more of the Company's voting stock, or following the announcement of a tender offer or exchange offer to acquire an interest of 16.5% or more. If the rights become exercisable, each rightholder will be entitled to purchase, at the exercise price, common stock with a market value equal to twice the exercise price. Should the Company be acquired, each right would entitle the holder to purchase, at the exercise price, common stock of the acquiring company with a market value equal to twice the exercise price. Any rights owned by the acquiring person or group would become void.

NOTE 8 - INCOME TAXES

Income tax expense from continuing operations consists of the following:

| | Year Ended December 31 | | |
|---------------------------------|------------------------|---------------------|---------------------|
| | 2009 | 2008 | 2007 |
| Currently payable income taxes: | | | |
| Federal | \$ 3,766,000 | \$ 3,765,000 | \$ 3,082,000 |
| State | 362,000 | 492,000 | 385,000 |
| Foreign | (14,000) | 798,000 | 208,000 |
| | <u>4,114,000</u> | <u>5,055,000</u> | <u>3,675,000</u> |
| Deferred income taxes (benefit) | 642,000 | (485,000) | 837,000 |
| | <u>\$ 4,756,000</u> | <u>\$ 4,570,000</u> | <u>\$ 4,512,000</u> |

Austin Taylor Communications, Ltd. operates in the United Kingdom (U.K.) and is subject to U.K. rather than U.S. income taxes. Austin Taylor had pretax losses of \$1,252,000 and \$64,000 in 2009 and 2008, respectively and pretax income of \$495,000 in 2007. As of December 31, 2009, Austin Taylor's net operating loss carry-forward was \$4,416,000. The Company is uncertain that it will be able to generate the future income needed to realize the tax benefit of the carry-forward. Accordingly, the Company has a reserve against the potential carry-forward benefit.

In 2007 Transition Networks China began operations in China and is subject to Chinese taxes rather than U.S. income taxes. Shanghai Ling had pretax losses of \$190,000, \$1,252,000, and \$196,000 in 2009, 2008, and 2007 respectively. At the end of 2009, Shanghai Ling's net operating loss carry-forward was \$1,638,000. Due to the history of losses in China the Company remains uncertain that it will be able to generate the future income needed to realize the tax benefit of the carry-forward. Accordingly, the Company has continued to a valuation allowance against the full amount of the potential carry-forward benefit.

Suttle Costa Rica, S.A. operates in Costa Rica and is subject to Costa Rica income taxes. It is the Company's intention to maintain the remaining undistributed earnings in its Costa Rica subsidiary to support continued operations there. No deferred taxes have been provided for the undistributed earnings.

The provision for income taxes for continuing operations varied from the federal statutory tax rate as follows:

| | Year Ended December 31 | | |
|---|------------------------|--------------|--------------|
| | 2009 | 2008 | 2007 |
| Tax at U.S. statutory rate | 35.0% | 35.0% | 35.0% |
| Surtax exemption | (0.9) | (0.9) | (0.9) |
| State income taxes, net of federal benefit | 2.5 | 2.1 | 2.2 |
| Foreign income taxes, net of operating loss valuation reserve | 4.9 | 2.3 | 2.0 |
| Tax exempt interest income | | | (2.1) |
| Impairment of goodwill | | 2.2 | |
| Other | 2.5 | 0.2 | 1.3 |
| | <u>44.0%</u> | <u>40.9%</u> | <u>37.5%</u> |

Deferred tax assets and liabilities as of December 31 related to the following:

| 2009 | 2008 |
|------|------|
|------|------|

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| | | |
|---|-----------------------------|-----------------------------|
| Deferred tax assets: | | |
| Allowance for doubtful accounts | \$ 186,000 | \$ 81,000 |
| Inventory | 2,706,000 | 2,435,000 |
| Accrued and prepaid expenses | 683,000 | 848,000 |
| Domestic net operating loss carry-forward | 345,000 | 425,000 |
| Long-term compensation plans | 331,000 | 331,000 |
| Nonemployee director stock compensation | 63,000 | 52,000 |
| State income taxes | 54,000 | 49,000 |
| Foreign net operating loss carry-forwards and credits | 2,228,000 | 1,676,000 |
| | <u> </u> | <u> </u> |
| Gross deferred tax assets | 6,596,000 | 5,897,000 |
| Valuation allowance | (1,771,000) | (1,382,000) |
| | <u> </u> | <u> </u> |
| Net deferred tax assets | 4,825,000 | 4,515,000 |
| | <u> </u> | <u> </u> |
| Deferred tax liabilities | | |
| Depreciation | (1,195,000) | (361,000) |
| Intangible assets | (264,000) | (146,000) |
| | <u> </u> | <u> </u> |
| Gross deferred tax liability | (1,459,000) | (507,000) |
| | <u> </u> | <u> </u> |
| Total net deferred tax asset/(liability) | \$ 3,366,000 | \$ 4,008,000 |
| | <u> </u> | <u> </u> |

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As part of a previous acquisition, the Company purchased net operating loss carry-forwards in the amount of \$3,790,000. At December 31, 2009, the Company has \$986,000 remaining net operating loss carry-forwards for income tax purposes which expire in 2014. Utilization of net operating loss carry-forwards is limited to \$228,000 per year in future years.

The Company assesses uncertain tax positions in accordance with current accounting guidance. Under this guidance, the Company must recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such uncertain tax positions are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate resolution. The Company's practice is to recognize interest and penalties related to income tax matters in income tax expense.

Changes in the Company's unrecognized tax benefits are summarized as follows:

| | 2009 | 2008 | 2007 |
|---|------------|------------|--------------|
| Unrecognized tax benefits January 1 | \$ 380,000 | \$ 656,000 | \$ 1,076,000 |
| Gross increases - tax positions in prior period | | 118,000 | 4,000 |
| Gross decreases - tax positions in prior period | | | (430,000) |
| Gross increases - current period tax positions | 66,000 | 81,000 | 6,000 |
| Settlements | | | (430,000) |
| Expiration of statute of limitations | (97,000) | (45,000) | |
| Unrecognized tax benefits December 31, 2009 | \$ 349,000 | \$ 380,000 | \$ 656,000 |

The Company's income tax liability accounts included accruals for interest and penalties of \$374,000 at December 31, 2009. Included in the balance of unrecognized tax benefits at December 31, 2009 are \$583,000 of tax benefits that if recognized would affect the tax rate. The Company's unrecognized tax benefits could be reduced by \$86,000 in the next twelve months due to statute of limitations expirations.

The Company's federal and state tax returns and tax returns it has filed in Costa Rica and the United Kingdom are open for review going back to the 2006 tax year. Puerto Rico has no statute of limitations on tax returns.

NOTE 9- INFORMATION CONCERNING INDUSTRY SEGMENTS AND MAJOR CUSTOMERS

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

Suttle products are sold principally to United States (U.S.) customers. Suttle operates manufacturing facilities in the U.S. and Costa Rica. Net long-lived assets held in Costa Rica were approximately \$279,000 at December 31, 2009. Transition Networks manufactures its products in the United States and makes sales in both the U.S. and international markets. JDL Technologies operates in the U.S. and makes sales in the U.S. and the U.S. Virgin Islands. Austin Taylor operates a manufacturing facility in the United Kingdom (U.K.) and makes sales in the U.K. and internationally. Consolidated sales to U.S. customers were approximately 82%, 71% and 81% of sales from continuing operations in 2009, 2008 and 2007 respectively. In 2009, sales to one of Transition Networks' customers accounted for 16.7% and one of Suttle's customers accounted for 12.2% of sales. In 2008, sales to one of Transition Networks' customers accounted for 11.7% and one of Suttle's customers accounted for 12.4% of sales. No customer accounted for more than 10% of sales in 2007.

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Information concerning the Company's continuing operations in the various segments for the twelve-month periods ended December 31, 2009, 2008 and 2007 is as follows:

| | Suttle | Transition Networks | JDL Technologies | Austin Taylor | Other | Total |
|--|---------------|------------------------|---------------------|------------------|----------------|----------------|
| 2009 | | | | | | |
| Sales | \$ 42,866,947 | \$ 55,098,346 | \$ 8,765,415 | \$ 3,061,499 | \$ | \$ 109,792,207 |
| Cost of sales | 33,095,673 | 25,768,865 | 6,011,918 | 3,067,101 | | 67,943,557 |
| Gross profit | 9,771,274 | 29,329,481 | 2,753,497 | (5,602) | | 41,848,650 |
| Selling, general and administrative expenses | 6,054,170 | 19,371,120 | 1,298,790 | 1,012,194 | 3,697,823 | 31,630,117 |
| Impairment | | | | 196,020 | | |
| Operating income (loss) | \$ 3,717,104 | \$ 9,958,361 | \$ 1,454,707 | \$ (1,213,816) | \$ (3,697,823) | \$ 10,218,533 |
| Depreciation and amortization | \$ 651,407 | \$ 579,816 | \$ 155,744 | \$ 76,495 | \$ 234,859 | \$ 1,698,321 |
| Capital expenditures | \$ 2,667,916 | \$ 355,129 | \$ 37,026 | \$ 114,153 | \$ 63,334 | \$ 3,237,558 |
| Assets | \$ 21,110,624 | \$ 29,640,360 | \$ 1,548,930 | \$ 4,044,746 | \$ 46,569,034 | \$ 102,913,694 |
| 2008 | | | | | | |
| Sales | \$ 44,421,377 | \$ 62,924,469 | \$ 9,837,526 | \$ 5,516,306 | \$ | \$ 122,699,678 |
| Cost of sales | 33,643,844 | 31,952,354 | 5,625,666 | 4,786,298 | | 76,008,162 |
| Gross profit | 10,777,533 | 30,972,115 | 4,211,860 | 730,008 | | 46,691,516 |
| Selling, general and administrative expenses | 6,044,718 | 20,672,700 | 1,104,732 | 815,461 | 4,470,877 | 33,108,488 |
| Impairment | | | 2,999,441 | | | 2,999,441 |
| Operating income (loss) | \$ 4,732,815 | \$ 10,299,415 | \$ 107,687 | \$ (85,453) | \$ (4,470,877) | \$ 10,583,587 |
| Depreciation and amortization | \$ 646,969 | \$ 586,236 | \$ 308,936 | \$ 105,127 | \$ 217,843 | \$ 1,865,111 |
| Capital expenditures | \$ 482,399 | \$ 474,656 | \$ 12,262 | \$ 92,233 | \$ 1,400,595 | \$ 2,462,145 |
| Assets | \$ 22,722,488 | \$ 30,291,569 | \$ 3,853,243 | \$ 4,323,044 | \$ 37,547,447 | \$ 98,737,791 |
| 2007 | | | | | | |
| Sales from continuing operations | \$ 48,135,180 | \$ 53,062,681 | \$ 13,219,376 | \$ 6,826,011 | \$ | \$ 121,243,248 |
| Cost of sales | 35,104,903 | 28,851,469 | 9,186,070 | 5,215,096 | | 78,357,538 |
| Gross Profit | 13,030,277 | 24,211,212 | 4,033,306 | 1,610,915 | | 42,885,710 |
| Selling, general and administrative expenses | 7,201,835 | 18,608,291 | 2,466,044 | 1,132,015 | 3,214,957 | 32,623,142 |

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| | | | | | | |
|-------------------------------|---------------|---------------|--------------|--------------|----------------|----------------|
| Operating income (loss) | \$ 5,828,442 | \$ 5,602,921 | \$ 1,567,262 | \$ 478,900 | \$ (3,214,957) | \$ 10,262,568 |
| Depreciation and amortization | \$ 746,474 | \$ 491,481 | \$ 704,660 | \$ 145,319 | \$ 71,250 | \$ 2,159,184 |
| Capital expenditures | \$ 643,029 | \$ 1,484,977 | \$ 103,808 | \$ 135,967 | \$ 2,302,474 | \$ 4,670,255 |
| Assets | \$ 27,102,439 | \$ 26,149,088 | \$ 7,336,651 | \$ 5,273,183 | \$ 34,898,952 | \$ 100,760,313 |

NOTE 10 FAIR VALUE MEASUREMENTS

On January 1, 2008, we adopted new accounting guidance on fair value measurements. The new guidance defines fair value, established a framework for measuring fair value under U.S. generally accepted accounting principles, and expands disclosures about fair value measurements. The new guidance was effective for us beginning January 1, 2008 for certain financial assets and liabilities. The new guidance is effective for non-financial assets and liabilities recognized or disclosed at fair value on a nonrecurring basis beginning January 1, 2009. The accounting guidance establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1 Observable inputs that reflect unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access at the measurement date.

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

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

The Company's assets and liabilities that are measured at fair value on a recurring basis as of December 31, 2009 include money market funds within cash equivalents of \$12,972,000 classified as level one within the hierarchy and certificate of deposits within investments of \$18,776,000 classified as level two. The Company does not have any assets or liabilities classified as level three within the hierarchy.

NOTE 11 GOODWILL

The changes in the carrying amount of goodwill for the years ended December 31, 2009 and 2008 by segment are as follows:

| | JDL Technologies | Suttle | Transition Networks | Total |
|-------------------------------|-----------------------------|---------------|--------------------------------|--------------|
| January 1 2008 | \$ 703,878 | \$ 1,271,986 | \$ 3,288,231 | \$ 5,264,095 |
| Impairment | (703,878) | | | (703,878) |
| December 31, 2008 | | 1,271,986 | 3,288,231 | 4,560,217 |
| December 31, 2009 | \$ | \$ 1,271,986 | \$ 3,288,231 | \$ 4,560,217 |
| Gross goodwill | \$ 703,878 | \$ 1,271,986 | \$ 3,288,231 | \$ 5,264,095 |
| Accumulated impairment losses | (703,878) | | | (703,878) |
| Balance at December 31, 2009 | \$ | \$ 1,271,986 | \$ 3,288,231 | \$ 4,560,217 |

On January 17, 2008, VIDE, at that time a major customer of the JDL Technologies segment under successive one year contracts since 1998, notified the company that JDL was not selected as a vendor to provide services to VIDE effective July 1, 2008. The loss of the VIDE contract represented an event that required goodwill to be tested for impairment. The Company completed the evaluation at March 31, 2008 and recorded a goodwill impairment for the JDL Technologies segment of \$704,000. The Company has determined that there were no additional impairments as of December 31, 2008 and 2009.

NOTE 12 SUBSEQUENT EVENTS

The Company has evaluated subsequent events through the date of this filing. We do not believe there are any material subsequent events which would require further disclosure.

(b) SUPPLEMENTAL FINANCIAL INFORMATION

Quarterly Operating Results
(in thousands except per share amounts)

| | Quarter Ended | | | |
|------------------------------|---------------|-----------|-----------|-----------|
| | March 31 | June 30 | Sept 30 | Dec 31 |
| 2009 | | | | |
| Sales | \$ 26,765 | \$ 28,584 | \$ 28,107 | \$ 26,336 |
| Gross margins | 9,779 | 10,650 | 10,868 | 10,552 |
| Operating income | 1,777 | 2,768 | 3,349 | 2,325 |
| Net income | 1,223 | 1,748 | 1,861 | 1,212 |
| Basic net income per share | \$.15 | \$.21 | \$.22 | \$.15 |
| Diluted net income per share | \$.15 | \$.21 | \$.22 | \$.14 |
| 2008 | | | | |
| Sales | \$ 30,321 | \$ 31,291 | \$ 32,683 | \$ 28,405 |
| Gross margins | 11,451 | 11,262 | 13,527 | 10,452 |
| Operating income | 199 | 2,930 | 5,236 | 2,219 |
| Net income | 186 | 2,261 | 2,794 | 1,370 |
| Basic net income per share | \$.02 | \$.26 | \$.33 | \$.17 |
| Diluted net income per share | \$.02 | \$.26 | \$.32 | \$.17 |

During the first and third quarters of fiscal 2008, the Company recognized approximately \$2.0 million of revenue related to services that were invoiced and expensed in fiscal 2007. See further discussion in Note 1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A (T): CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)).

Our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the applicable rule and forms.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Operating Effectiveness of Accounting and Control Procedures. We concluded that, in the aggregate, no material weakness existed as of December 31, 2009 related to documentation and review of significant accounting judgments and estimates, balance sheet account reconciliations, financial closing processes and financial reporting processes at period ends.

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

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

ITEM 9B. OTHER INFORMATION

Not applicable.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE Information Incorporated by Reference

The information required by Item 401 under Regulation S-K, to the extent applicable to the Company's directors, will be set forth under the caption "Election of Directors" in the Company's definitive proxy material for its May 18, 2010 Annual Meeting of Shareholders (2010 Proxy Materials), which information is expressly incorporated by reference herein. The information called for with respect to the Company's officers by paragraph [b] of Item 401 is set forth under Item 1(c) (3) herein. The information called for by Item 405 under Regulation S-K regarding Exchange Act, Section 16 (a) compliance, to the extent applicable, will be set forth under the caption "Certain Transactions" in the Company's 2010 Proxy Materials.

Code of Ethics

The Company has adopted a code of Ethics applicable to all officers of the Company as well as certain other key accounting personnel. A copy of the Code of Ethics can be obtained free of charge upon written request directed to the Company's Assistant Secretary at the executive offices of the Company.

Information required pursuant to Item 407 under Regulation S-K will be presented in the Company's 2010 Proxy Materials.

ITEM 11. EXECUTIVE COMPENSATION

The information called for by Item 402 under Regulation S-K to the extent applicable, will be set forth under the caption "Executive Compensation" in the Company's 2010 Proxy Materials, which information is expressly incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information called for by Item 403 under Regulation S-K will be set forth under the captions "Security Ownership of Certain Beneficial Owners and Management" and "Election of Directors" in the Company's 2010 Proxy Materials, which information is expressly incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by Items 404 and 407(a) under Regulation S-K will be provided in the Company's 2010 Proxy Materials to the extent applicable, and such information, if any, is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information called for by Item 14 of Form 10K and 9(e) of Schedule 14A will be set forth under the caption "Principal Accountant Fees and Services" in the Company's 2010 Proxy Materials, which information is expressly incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) (1) **Consolidated Financial Statements**

The following Consolidated Financial Statements of Communications Systems, Inc. and subsidiaries appear at pages 28 to 45 herein:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2009 and 2008

Consolidated Statements of Income and Comprehensive Income for the years ended December 31, 2009, 2008 and 2007

Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2009, 2008 and 2007

Consolidated Statements of Cash Flows for the years ended December 31, 2009, 2008 and 2007

Notes to Consolidated Financial Statements

(a) (2) **Consolidated Financial Statement Schedule**

The following financial statement schedule is being filed as part of this Form 10-K Report:

Schedule II - Valuation and Qualifying Accounts and Reserves

All other schedules are omitted as the required information is inapplicable or the information is presented in the consolidated financial statements or related notes.

(a) (3) **Exhibits**

The exhibits which accompany or are incorporated by reference in this report, including all exhibits required to be filed with this report pursuant to Item 601 of Regulation S-K, including each management or compensatory plan or arrangement are described on the Exhibit Index, which is at pages 52 and 53 of this report.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

COMMUNICATIONS SYSTEMS, INC.

Dated: March 18, 2010

/s/ Jeffrey K. Berg

Jeffrey K. Berg, President, Chief Executive
Office and Director

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant in the capacities and on the dates indicated:

Each person whose signature appears below constitutes and appoints JEFFREY K. BERG and DAVID T. MCGRAW as his true and lawful attorneys-in-fact and agents, each acting alone, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any or all amendments to this Annual Report on Form 10-K and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, each acting alone, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all said attorneys-in-fact and agents, each acting alone, or his substitute or substitutes, may lawfully do or cause to be done by virtue thereof.

| <u>Signature</u> | <u>Title</u> | <u>Date</u> |
|---|---|----------------|
| <u>/s/Jeffrey K. Berg</u> Jeffrey K. Berg | President, Chief Executive Officer and Director | March 18, 2010 |
| <u>/s/David T. McGraw</u> David T. McGraw | Vice President, Treasurer and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) | March 18, 2010 |
| <u>/s/Curtis A. Sampson</u> Curtis A. Sampson | Chairman of the Board of Directors, and Director | March 18, 2010 |
| <u>/s/Randall D. Sampson</u> Randall D. Sampson | Director | March 18, 2010 |
| <u>/s/Edwin C. Freeman</u> Edwin C. Freeman | Director | March 18, 2010 |
| <u>/s/Luella G. Goldberg</u> Luella Gross Goldberg | Director | March 18, 2010 |
| <u>/s/Gerald D. Pint</u> Gerald D. Pint | Director | March 18, 2010 |
| <u>/s/Roger H.D. Lacey</u> Roger H.D. Lacey | Director | March 18, 2010 |

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

OF

COMMUNICATIONS SYSTEMS, INC.

FOR

YEAR ENDED DECEMBER 31, 2009

FINANCIAL STATEMENT SCHEDULE

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
 Schedule II - Valuation and Qualifying Accounts and Reserves

| Description | Balance at Beginning of Period | Additions Charged to Cost and Expenses | Deductions from Reserves | Other Changes Add (Deduct) | Balance at End of Period |
|----------------------------------|--------------------------------|--|--------------------------|----------------------------|--------------------------|
| Allowance for doubtful accounts: | | | | | |
| Year ended: | | | | | |
| December 31, 2009 | \$ 219,000 | \$ 310,000 | \$ (24,000) (A) | | \$ 505,000 |
| December 31, 2008 | \$ 198,000 | \$ 79,000 | \$ (58,000) (A) | | \$ 219,000 |
| December 31, 2007 | \$ 585,000 | \$ 22,000 | \$ (409,000) (A) | | \$ 198,000 |

(A) Accounts determined to be uncollectible and charged off against reserve.

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

OF

COMMUNICATIONS SYSTEMS, INC.

FOR

YEAR ENDED DECEMBER 31, 2009

EXHIBITS

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES Exhibit Index To Form 10-K for the Year Ended December 31, 2009

| Regulation S-K Exhibit Table Reference | Title of Document | Location in Consecutive Numbering System as Filed With the Securities and Exchange Commission |
|--|---|---|
| 3.1 | Articles of Incorporation, as amended | Filed as Exhibit 3.1 to the Form 10-K Report of the Company for its year ended December 31, 1989 (the 1989 Form 10-K) and incorporated herein by reference. |
| 3.2 | Bylaws, as amended | Filed as Exhibit 3.2 to the 1989 Form 10-K and incorporated herein by reference. |
| 10.1 | 1987 Stock Plan | Filed as Exhibit 10.1 to the Form 10-K Report of the Company for its year ended December 31, 1993 (the 1993 Form 10-K) and incorporated herein by reference. |
| 10.2 | Employee Savings Plan | Filed as Exhibit 10.2 to the 1993 Form 10-K and incorporated herein by reference. |
| 10.3 | Employee Stock Ownership Plan | Filed as Exhibit 10.3 to the 1993 Form 10-K and incorporated herein by reference. |
| 10.4 | Employee Stock Purchase Plan, as amended to December 2008 | Filed as Exhibit 10.4 to the 2008 Form 10-K and incorporated herein by reference. |
| 10.5 | Stock Option Plan for Nonemployee Directors | Filed as Exhibit 10.5 to the 1993 Form 10-K and incorporated herein by reference. |
| 10.6 | 1992 Stock Plan | Filed as Exhibit 10.6 to the 1993 Form 10-K and incorporated herein by reference. |
| 10.7 | Flexible Benefit Plan | Filed as Exhibit 10.7 to the 1993 Form 10-K and incorporated herein by reference. |
| 10.8 | Supplemental Executive Retirement Plan | Filed as Exhibit 10.8 to the 1993 Form 10-K and incorporated herein by reference. |
| 10.9 | Form of Rights Agreement, dated as of October 26, 1999 between the Company and Wells Fargo Bank Minnesota, National Association | Filed as Exhibit 1 to the Company s Form 8-A on November 8, 1999 and incorporated herein by reference. |

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
Exhibit Index To
Form 10-K for the Year Ended December 31, 2009

| Regulation S-K Exhibit Table Reference | Title of Document | Location in Consecutive Numbering System as Filed With the Securities and Exchange Commission |
|---|--|--|
| 21 | Subsidiaries of the Registrant | Filed herewith. |
| 23 | Independent Auditors Report | Filed herewith. |
| 24 | Power of Attorney | Included in signatures at page 48. |
| 31.1 | Certification of Chief Executive Officer | Filed herewith. |
| 31.2 | Certification of Chief Financial Officer | Filed herewith. |
| 32 | Certification under USC § 1350 | § 1350 Filed herewith. |

The exhibits referred to in this Exhibit Index will be supplied to a shareholder at a charge of \$.25 per page upon written request directed to CSI's Assistant Secretary at the executive offices of the Company.