

ELECTRO SENSORS INC  
Form 10KSB  
March 29, 2007  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**Form 10-KSB**

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

**For the fiscal year ended December 31, 2006**

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

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

**Commission file number 0-9587**

**ELECTRO-SENSORS, INC.**

(Name of small business issuer in its charter)

**Minnesota**

(State or other jurisdiction of incorporation or organization)

**41-0943459**

(IRS Employer Identification No.)

**6111 Blue Circle Drive**  
**Minnetonka, Minnesota 55343-9108**

(Address of principal executive offices, including zip code)

**(952) 930-0100**

(Issuer's telephone number)

Securities registered under Section 12(b) of the Exchange Act:  
**Common Stock, \$0.10 par value, registered on the NASDAQ (Capital) Market**  
Securities registered under Section 12(g) of the Exchange Act: **None**

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Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B is contained in this form, and no disclosure will 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-KSB or any amendment to this Form 10-KSB.

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

The issuer's revenues for the fiscal year ended December 31, 2006 were \$5,756,305.

The aggregate market value of the voting stock held by non-affiliates (persons other than officers, directors, or holders of more than 5% of the outstanding stock) of the registrant was approximately \$10,376,000 based upon the closing price of the Common Stock as reported on The Nasdaq Stock Market® on March 5, 2007.

The number of shares outstanding of the registrant's Common Stock, \$0.10 par value, on March 5, 2007 was 3,361,392.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's Proxy Statement for its Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-KSB.

Transitional Small Business Disclosure Format (check one): Yes  No

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**

**Form 10-KSB for the Year Ended December 31, 2006**

**TABLE OF CONTENTS**

<b>PART I</b>	<b>PAGE</b>
Item 1 <u>Description of Business</u>	3
Item 2 <u>Description of Property</u>	8
Item 3 <u>Legal Proceedings</u>	8
Item 4 <u>Submission of Matters to a Vote of Security Holders</u>	8
 <b>PART II</b>	
Item 5 <u>Market for Common Equity and Related Stockholder Matters</u>	9
Item 6 <u>Management's Discussion and Analysis or Plan of Operation</u>	9
Item 7 <u>Financial Statements</u>	12
Item 8 <u>Changes In and Disagreements with Accountants on Accounting and Financial Disclosure</u>	32
Item 8A <u>Controls and Procedures</u>	32
Item 8B <u>Other Information</u>	32
 <b>PART III</b>	
Item 9 <u>Directors and Executive Officers of the Registrant; Compliance with Section 16 of the Exchange Act</u>	33
Item 10 <u>Executive Compensation</u>	33
Item 11 <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	33
Item 12 <u>Certain Relationships and Related Transactions</u>	33
Item 13 <u>Exhibits</u>	33
Item 14 <u>Principal Accountant Fees and Services</u>	33
 <b><u>SIGNATURES</u></b>	 34

2

---

Table of Contents

**PART I**

**Item 1 Description of Business**

*Introduction*

Electro-Sensors, Inc. ( we , us , our , the Company or ESI ) is engaged in two distinct operating segments: (1) the manufacture and distribution of industrial production monitoring and process control systems through its Controls Division, and (2) the development and distribution of PC-based software for both automated survey processing and hand printed character recognition through its AutoData Systems Division. The operating segments are based on the markets that we serve and the products that we provide to those markets.

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In addition, through its subsidiary ESI Investment Company, we periodically make strategic investments in other businesses and companies, primarily when we believe that such investments will facilitate development of technology complementary to our existing products. Although ESI, through its subsidiary ESI Investment Company, invests in other businesses or companies, ESI does not intend to become an investment company and intends to remain primarily an operating company. The Company's primary investments are 343,267 shares of Rudolph Technologies, Inc. and 551,759 shares of PPT Vision, Inc. The PPT Vision investment is accounted for under the equity method of accounting.

Unless indicated otherwise, the terms "Company" and "ESI" when used herein, includes Electro-Sensors, Inc. and its consolidated subsidiaries. As of December 31, 2006, ESI had two consolidated subsidiaries: ESI Investment Company and Senstar Corporation. Senstar Corporation does not have any business transactions.

ESI, incorporated in Minnesota in July 1968, has executive offices located at 6111 Blue Circle Drive, Minnetonka, Minnesota, 55343 and telephone number (952) 930-0100.

### *Operating Segments/Principal Products/Markets*

#### *Production Monitoring Systems - Controls Division*

Our Controls Division manufactures and sells several different types of monitoring systems that measure actual machine production and operation rates, as well as systems that regulate the speed of related machines in production processes.

*Speed Monitoring Systems.* Our original products, speed monitoring systems, compare machine revolutions per minute or speed against acceptable rates as determined by the customer. The monitors generally have the same relative operating principle and use a non-contacting sensing head that translates the speed of a rotating shaft into analog readouts. The systems include a signal-generating pulser disc or wrap that attaches to a rotating shaft, the sensing device, and a control unit. The systems vary in complexity, from a simple system that detects slow-downs or stoppages, to more sophisticated systems that warn of deviations from precise tolerances and that permit various subsidiary operations to be determined through monitoring the shaft speed.

The speed monitoring systems include a line of digital products that translate sensor impulses from its production monitoring systems into digital readouts indicating production counts or rates, such as parts, gallons, or board feet. The speed monitoring systems also include alarm systems, tachometers, and other devices that translate impulses from the sensors into alarm signals, computer inputs, or digital displays that are usable by the customer.

Three production monitoring devices that do not operate by measuring shaft speeds are also in the speed monitoring systems product line. These devices are the tilt switch, vibration monitor, and slide gate position monitor. A tilt switch is designed to alert the operator when a storage bin or production system reaches a certain capacity (e.g., when grain fills a silo). A vibration monitor will alert an operator when the vibration of a machine in a production system exceeds or is below a specified level. The slide gate position monitor is used in plant operations to provide feedback of the position of a slide gate.

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*Drive Control Systems.* In 1987, we expanded its speed monitoring systems product line to include products that regulate and synchronize machine speeds. Drive control system products not only monitor machine operation levels, but also regulate the speed of motors on related machines in a production sequence to ensure that the performances of various operations are coordinated. In the past, these distinct features allowed the Company to market these products under the Drive Control Systems name. The product line consists of a line of digital control products for motors that require a complete closed loop PID (Proportional Integral Derivative) control. The closed loop controllers coordinate production speed among process motors and reduce waste.

In 1988, we entered into a sales agreement with MKS Maschinen Kontroll Systeme GmbH ( MKS ), the West German manufacturer of a Synchronous Drive Controller ( SDC ) product line, giving the Company exclusive rights to distribute in the United States the drive control products manufactured by MKS. The SDC product line manufactured by MKS coordinates motors in a production

3

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### Table of Contents

machine with other parts of the machine process. The SDC products were designed for use as a precision speed reference for use with variable speed drives and enable manufacturers to match speed/velocity and phase/position of independently driven machines so they operate together. Applications include synchronizing overhead and floor conveyors and load sharing of multiple motors.

We believe that significant savings in both time and materials can be achieved by manufacturing companies by adding drive control technology to existing manufacturing processes to coordinate operation of related machines. We intend to continue to market its products in this retro-fit market and also to companies building new manufacturing machinery or processing systems.

We expect to continue to expend resources in development and marketing of its various Production Monitoring Systems throughout 2007.

### *Character Recognition Systems AutoData Systems Division*

We initially began development of its AutoData Systems as a development project chartered to create opportunities using proprietary pattern recognition technology. The outcome of the project was a Microsoft® Windows<sup>®</sup> based software system that reads hand printed characters, checkmarks, and barcodes from scanned forms.

Our system offers an alternative to manual data entry, by automatically extracting information from paper forms and converting it into a format compatible with most computer databases. This intelligent data entry alternative saves time, strain, and money compared to the method of manual data entry. The basis of the handprint reading capability is Associative Pattern Memory (APM), a patented pattern recognition algorithm. APM is a trainable, neural network-based memory that was incorporated in a Dynamic Link Library (DLL) and used in the products currently sold by AutoData Systems Division.

AutoData Systems became an operating segment in January 1993. The first software package, AutoData® PRO , was released in May 1993. This software package was designed for the end user. AutoData® PRO, served as a utility software package designed to process only checkmark and

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handprint information from scanned forms. The software allowed the user to export the data in an ASCII file format.

In September 1993, AutoData® PRO II was released as an upgrade, along with AutoData® SDK . AutoData® SDK allowed Windows developers to embed the AutoData® DLL into their application in order to provide automated data collection from scanned or faxed forms.

In 1996, AutoData® Survey was released. AutoData® Survey was the Company's first software package to include an analysis and report generation feature, greatly enhancing the salability of AutoData technology. This product was directed at the Healthcare market, where it gained a foothold in patient satisfaction measurement. AutoData has released two upgrades to the original Survey software, the latest being AutoData® Survey Plus 2000 .

AutoData Systems released AutoData® Scannable Office software in March 2000. This product provided an upgrade path for PRO II customers, and offered a key enhancement: integration with the Microsoft® Office suite. Scannable Office allows the user to utilize Microsoft® Word to create scannable forms. The software reads data from completed forms and automatically places extracted data directly into Microsoft® Excel, Access or any ODBC-compliant database, setting data up for analysis. Scannable Office has the widest recognition capabilities of the AutoData end-user products; it contains handprint (ICR), Optical Character (OCR), Optical Mark (OMR), and barcode recognition capabilities.

In December 2002, the company released AutoData® ExpertScan software to its customer base. ExpertScan has handprint (ICR), Optical Mark (OMR) and barcode recognition capabilities. Like Survey Plus 2000, ExpertScan automates survey and form processing, as well as tabulation of results. The product offers several form design and reporting enhancements. It can also be sold as an upgrade to Survey Plus 2000. ExpertScan provides a mid-range option for AutoData prospects, rounding out the company's product offering.

### ***Marketing and Distribution***

*Controls Division.* The Controls Division sells its products primarily through home office sales people who deal directly with customers and a number of manufacturer's representatives with exclusive territories and non-exclusive distributors located throughout the United States, Mexico, China, Korea, Canada, Peru, Chile, Bolivia, and Thailand. The sensing and control units are sold under the Electro-Sensors, Inc. brand as a range of products from simple sensors to complex motor speed controllers. These products are sold to businesses in all major standard industrial classifications, including grain, feed, biofuels, food processing, chemicals, agricultural, mining, utility, forest products, steel, tire, glass and electronics. Any business that uses machinery with a rotating shaft is a potential customer.

For marketing, we advertise in national industrial periodicals that cover a wide range of industrial products and attends several tradeshow designated for the industry throughout the year. A corporate website and other related industry websites are also used for advertising and marketing purposes. We expect to continue to market its products in this and related markets.

4

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Table of Contents

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*AutoData Systems Division.* The AutoData Systems Division markets its products primarily through home office sales personnel who deal directly with end-users and a limited number of Value-Added Resellers (VARs). This division primarily sells in the United States, Canada and Western Europe, and currently actively markets only in the U.S. We are currently developing the ability to process surveys electronically using e-mail for our ExpertScan software.

### ***Competition***

*Controls Division.* Competition for the Company's monitoring products arises from a broad range of industrial and commercial businesses. Design, quality and multiplicity of application, rather than price, are the focus of competition in selling these products. The Company has substantial competition for its production monitoring systems. Many of these competitors are well established and larger in terms of total sales volume. Among the larger competitors are: Danaher Controls, Red Lion Controls, Control Concepts, 4B Elevator Components Ltd., Durant Corporation, and Contrex, Inc. The Company believes its competitive advantages include that its products are sold as ready-to-install units and that its products have a wide range of applications. The Company's major disadvantages include the fact that its major competitors are much larger, have a broader variety of sensing instruments, and have larger sales forces and established names.

*AutoData Systems.* Competition for the market segment primarily ranges from substitute products such as Data Entry suppliers, to directly competitive software suppliers, and more recently, suppliers of web-based survey software and services. We believe that few direct competitors have as sophisticated recognition capabilities as our AutoData Systems products. However, our AutoData products face direct competition from both ends of the spectrum: larger competitors offering a broader array of software products and services, and firms similar in size to our AutoData Systems Division that offer a low-price, more limited product.

The market is segmented based primarily on price and capabilities, with the larger firms, notably Cardiff Software and Captiva Software, offering enterprise-wide systems with broad information capture capabilities. Our AutoData products are focused on desktop, rather than enterprise-wide, solutions, positioning the Company as most appropriate to small offices and departments of larger organizations.

Because price is a primary competitive factor, the Company is subject to increasing pressures to make price adjustments to remain competitive. Such downward price adjustments, if any, may have an adverse impact on the Company's results of operations if not offset by an increase in revenues and/or a reduction in expenses.

### ***Suppliers***

*Controls Division.* The Controls Division purchases parts and materials for its production monitoring systems from various manufacturers and distributors. In some instances, these materials are manufactured in accordance with proprietary designs. Multiple sources of these supplies and materials are readily available, and the Controls Division is not dependent on any single source for these supplies and materials. This Division has not experienced any problem of short supply or delays from its suppliers.

*AutoData Systems.* The AutoData Systems Division purchases a variety of supplies and materials from various vendors and is not dependent upon any one source.

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The Company purchases a variety of parts, components, and other supplies from a variety of vendors for both of its operating divisions. While the Company usually has more than a single source of supply for those various parts, components and supplies, it is possible occasionally that there will be only one supplier for any single part, component or supply. Should a supplier be unwilling or unable to supply such an item in a timely manner, the Company's business could be materially adversely affected.

### *Customers*

The Company is not dependent upon a single or a few customers for a material (10% or more) portion of its sales in any of its operating divisions.

### *Patents, Trademarks and Licenses*

The names Electro-Sensors and AutoData are trademarks registered with the U.S. Patent and Trademark Office, respectively as Reg. No. 1,142,310 and Reg. No. 1,874,543. The Company believes its trademarks have been and will continue to be useful in developing and protecting market recognition for its products.

The Company holds two patents relating to its Production Monitoring Systems, and has obtained six patents related to its Character Recognition technology. The Company has also entered into a license agreement with MKS Maschinen Kontroll Systeme GmbH (MKS), a manufacturer of a Synchronous Drive Controller (SDC) product line, which grants the Company rights to distribute in the United States the drive control products manufactured by MKS.

5

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### Table of Contents

PPT Vision, Inc. has granted the Company an exclusive license that allows the Company to incorporate a patented neural network algorithm in its products. The initial use of this algorithm has been in the Company's AutoData Systems Division.

### *Governmental Approvals*

The Company is not required to obtain governmental approval of its products.

### *Effect of Governmental Regulations*



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The Company does not believe that any existing or proposed governmental regulations will have a material effect on its business.

### *Research and Development*

The Company invests in research and development programs to develop new products in related markets and to integrate state of the art technology into existing products.

Research and development expense (by division) during the past two fiscal years was:

#### *Controls Division:*

2006: \$348,000

2005: \$410,000

The Company's development projects for this division are undertaken based upon the identified specific needs of the Company's customer base.

#### *AutoData Systems:*

2006: \$219,000

2005: \$338,000

The Company has continued to fund the AutoData Systems Division's development activities. The goal is to create low-cost software based systems that enable accurate reading of hand-printed characters and other survey elements used on paper forms and also be able to send and complete the surveys via email.

The Company's future success is dependent in part upon its ability to develop new products in its varying segments. Difficulties or delays in the Company's ability to develop, produce, test and market new products could have a material adverse effect on future sales growth.

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Table of Contents

***Compliance with Environmental Laws***

Compliance with federal, state and local environmental provisions has only a nominal effect on current or anticipated capital expenditures and has had no material effect on earnings or on the competitive position of the Company.

***Employees***

As of February 20, 2007, the Company had 29 employees, of which 27 are full-time and 2 are part-time. The Company believes that its relations with its employees are good.

The Company's ability to maintain a competitive position and to continue to develop and market new products depends, in part, on its ability to retain key employees and qualified personnel. If the Company is unable to retain and/or recruit key employees, product development, marketing and sales could be negatively impacted.

***Fluctuations in Operating Results.*** ESI has experienced fluctuations in its operating results in the past, and may experience fluctuations in the future, which may affect the market price of its Common Stock. Sales can fluctuate as a result of a variety of factors, many of which are beyond the Company's control. Some of these factors are: product competition and acceptance, timing of customer orders, cancellation of orders, the mix of products sold, downturns in the market and economic disruptions. Because fluctuations can happen, the Company cautions investors that results of its operations for preceding periods may not be indicative of how the Company will perform in the future. There can be no assurance that the Company will experience continued earnings growth.

Further, investments held by the Company's subsidiary, ESI Investment Company, are subject to significant positive and negative changes in value. In particular, significant investments in PPT Vision, Inc. and Rudolph Technologies, Inc. have experienced substantial value fluctuations, both negative and positive, which are expected to continue. The Company's current intention is to continue to gradually liquidate its investment securities to finance the Company's working capital needs as needed.

***Expending Funds for Changes in Industry Standards, Customer Preferences or Technology.*** The Company's business depends upon periodically introducing new and enhanced products and solutions for customer needs. The development of products requires the Company to commit financial resources, personnel and time, usually in advance of significant market development for such products. In order to compete, the Company must anticipate both future demand and the technology available to meet that demand. There can be no assurance that the Company's research and development efforts will lead to new products or product innovations that can be made available to or will be accepted by the market.

*Cautionary Statements*

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements made by us or on our behalf. We have made, and may continue to make, forward-looking statements with respect to its business and financial matters, including statements contained in this document, other filings with the Securities and Exchange Commission, and reports to shareholders. Forward-looking statements generally include discussion of current expectations or forecasts of future events and can be identified by the use of terminology such as believe, estimate, expect, intend, may, could, will, and similar words or expressions. Any statement that does not relate solely to historical fact should be considered forward-looking. Electro-Sensors forward-looking statements generally relate to its growth strategy, future financial results, product development and sales efforts. Forward-looking statements are made throughout this Annual Report, but primarily in this Item 1 and Item 6 - *Management's Discussion and Analysis or Plan of Operation*, and include statements relating to management's intentions that the Company not become an investment company, our expectations and intentions with respect to growth, marketing and product development, our intention with respect to gradually liquidating its investment securities to finance working capital needs, the adequacy of our facilities, expansion of the number of our manufacturers' representatives and exclusive distributors, our intention to develop new products, and our expectations with respect to our cash requirements and use of cash. Forward-looking statements cannot be guaranteed and actual results may vary materially due to the uncertainties and risks, known and unknown, associated with such statements, including the Company's ability to successfully develop new products and manage the Company's cash requirements. The Company undertakes no obligations to update any forward-looking statements. The Company wishes to caution investors that the following important factors, among others, in some cases have affected and in the future could affect the Company's actual results of operations and cause such results to differ materially from those anticipated in forward-looking statements made in this document and elsewhere by or on behalf of the Company. It is not possible to foresee or identify all factors that could cause actual results to differ from expected or historical results. As such, investors should not consider any list of such factors to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions. These factors include:

our ability to successfully develop new products

our ability to quickly and successfully adapt to changing industry technological standards

our ability to comply with existing and changing industry regulations

7

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Table of Contents

our ability to manage cash requirements

our ability to attract and retain new manufacturers' representatives and exclusive distributors

our ability to attract and retain key personnel, including senior management

our ability to adapt to changing economic conditions and manage downturns in the economy in general

our ability to keep pace with competitors, some of whom are much larger and have substantially greater resources than us

**Item 2 Description of Property**

We own and occupy a 25,400 square foot facility at 6111 Blue Circle Drive, Minnetonka, Minnesota 55343. All operating entities are located within this facility. The facility is anticipated to be adequate for our needs in 2007.

**Item 3 Legal Proceedings**

We were not the subject of any legal proceedings as of the date of this filing. We are not aware of any threatened litigation.

**Item 4 Submission of Matters to a Vote of Security Holders**

There were no matters submitted to a vote of security holders during the last quarter of the fiscal year ended December 31, 2006.

8

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Table of Contents

**PART II**

**Item 5 Market for Common Equity and Related Stockholder Matters**

The Company's Common Stock trades on the Nasdaq Capital Market of The Nasdaq Stock Market® under the symbol ELSE. The following table sets forth the quarterly high and low reported last sales prices for the Company's Common Stock for each period indicated as reported on the Nasdaq system.

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	Period	High	Low
<b>2006</b>	First Quarter	\$5.19	\$4.04
	Second Quarter	\$11.55	\$3.90
	Third Quarter	\$4.87	\$3.67
	Fourth Quarter	\$6.25	\$3.97
<b>2005</b>	First Quarter	\$4.54	\$3.90
	Second Quarter	\$5.05	\$4.15
	Third Quarter	\$4.98	\$4.03
	Fourth Quarter	\$4.48	\$3.86

Based on data provided by the Company's transfer agent, management believes that as of February 22, 2007, the number of share owner accounts of record was approximately 131.

The Company paid cash dividends on its common stock of \$1.16 per share in 2006 and \$0.16 per share in 2005. During 2006 \$0.04 dividends were declared quarterly in addition to a one-time dividend of \$1.00.

From time to time, the Company may have an obligation to repurchase some of its securities as a result of obligations described in note 8 to the Company's 2006 consolidated financial statements. The Company did not repurchase any equity securities during the quarter ended December 31, 2006.

### **Item 6 Management's Discussion and Analysis or Plan of Operation**

The preparation of the Company's financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make decisions based upon estimates, assumptions, and factors it considers relevant to the circumstances. Such decisions include the selection of applicable accounting principles and the use of judgment in their application, the results of which impact reported amounts and disclosures. Changes in economic conditions or other business circumstances may affect the outcomes of management's estimates and assumptions.

### **RESULTS OF OPERATIONS**

#### **Comparison of Fiscal Year 2006 vs. Fiscal Year 2005**

##### ***Net Revenues***

Net revenues for fiscal year 2006 increased \$853,361 to \$5,756,000, or 17.4% when compared to net revenues for fiscal year 2005.

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Of this increase, the Controls division contributed an increase in net revenues of \$893,000, or 20.6% when comparing fiscal year 2006 to fiscal year 2005. Sales continued to grow to end user plant applications, manufacturers, and OEM equipment builders. In 2006, three new exclusive distributors were added internationally, and one new manufacturer's representative was added domestically to continue to develop our sales and marketing channel. We have continued to expand the joint sales calls and training with all of our partners in order to increase their knowledge and effectiveness. Throughout 2007, we expect to continue to expand the number of manufacturer's representatives and exclusive distributors. The corporate web sites provide significant information and product application knowledge to prospects and customers and also direct knowledge to our sales partners. New products developed and added to the product line in 2006 include a new speed signal convertor that communicates with a control system via DeviceNet, an additional product to monitor the position of rotary distributors, and a speed switch specifically designed for OEM's and international sales.

We will continue to develop new products that broaden the line and provide complete monitoring solutions to our customers. The customers for our Controls division have diverse applications for our products in the grain, feed, ethanol and biofuels, power generation, mining, chemical, and other processing areas.

9

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### Table of Contents

The AutoData Systems division had a decrease in net revenues of \$39,706 or 7.0% when comparing fiscal year 2006 to fiscal year 2005. This decrease is primarily due to decreased sales of the ExpertScan and Scannable Office software products. Product enhancements and upgrades were done to the existing products. We are also in the final product development phase of adding web survey capability via email to our ExpertScan product.

### *Cost of Sales*

The Company's cost of sales increased from \$1,913,000 to \$2,059,000, a difference of \$146,000 or 7.6% when comparing fiscal year 2006 to fiscal year 2005. Cost of sales increased in line with the sales increase. The Company continues efforts to maintain or reduce production costs.

### *Gross Margins*

Gross margins for the fiscal year 2006 were 64.2% versus 61.0% for the prior fiscal year. This increase in margins is due to larger sales volume of higher margin products and the building of products in greater quantities using outside assembly firms.

### *Operating Expenses*

Total operating expenses increased by \$28,000, or 0.9% when comparing fiscal year 2006 to fiscal year 2005. Of this increase, the Controls Division contributed an increase in operating expenses of \$236,000 or 10.1% when comparing fiscal year 2006 to fiscal year 2005. The AutoData Systems Division had a decrease in operating expenses of \$208,000 or 30.9% when comparing fiscal year 2006 to fiscal year 2005.

Selling and marketing costs increased by \$18,000, or 1.5% when comparing fiscal year 2006 to fiscal year 2005. Of this increase, the Controls Division had an increase of \$98,000 or 9.7%. The AutoData Systems Division had a decrease of \$80,000 or 36.0%. The increase from the Controls Division is due to increased efforts in marketing their product through manufacturer's representatives, additional advertising in trade publications and web sites, and trade shows and related marketing. The decrease from the AutoData Systems Division is due to reduced personnel in both marketing and research and development areas and lower contract development expenses.

General and administrative costs increased by \$190,000, or 18.8% in fiscal year 2006 compared to fiscal year 2005. Of this increase, the Controls Division had an increase of \$199,000, or 22.2%. This increase is primarily due to wage and benefits increases, the increasing legal and accounting professional fees and internal audit and accounting expenses associated with being a publicly traded company, and a one-time \$100,000 officer's bonus paid in 2006. The AutoData Systems Division had a decrease of \$9,000. The decrease for the AutoData Systems Division is due to reduced costs of repairs and maintenance, less equipment rental, and a lower percentage share of the costs of being a publicly-held company.

Research and development costs decreased \$180,000 or 24.1% in fiscal year 2006 when compared with fiscal year 2005. The Controls Division decreased \$62,000, or 15.1%, AutoData® Systems Division also had a decrease of \$118,000. The decrease in research and development costs in the Controls Division is due to reduced product testing costs at UL, lower depreciation expenses, and reduced legal expenses for patent applications. The decrease in the AutoData Systems Division is due to fewer personnel and focusing on core product development. This was offset by an increase in contract engineering.

#### ***Operating Income (Loss)***

The operating income for fiscal year 2006 was \$682,000, compared to last year's operating income of \$3,000, an increase of \$679,000 or 24,235%.

The Controls division had an operating income of \$729,000 compared to the income of \$252,000 in 2005, an increase of \$477,000. This increase in operating income is a result of increased sales, higher gross margins, and reduced research and development expenses.

The AutoData Systems Division had a 2006 operating loss of \$47,000 compared to a loss of \$249,000 for 2005, an increase of \$202,000 or 81.0%. This reduction in loss is the result of lowered marketing and research and development expenses.

#### ***Non-Operating Income***

ESI Investment Company continues to provide an alternative source of earnings for the Company through investments in available for sale securities; however, the Company's intent is to remain an operations-based Company. The Company's investments in available for sale securities are subject to significant positive and negative changes in value. In addition to income from the sale of investments, the Company also realizes interest income from its short-term holdings.

Table of Contents

Investment income for the fiscal year 2006 increased by \$887,000 to \$2,073,000. This increase was primarily due to the purchase of August Technology, Inc. on February 15, 2006 by Rudolph Technologies, Inc. From this sale, the Company received \$1,015,891 in cash and 347,224 shares of Rudolph Technologies, Inc. common stock. In November, the Company also received \$481,379 in proceeds for its shares of Encore Medical Corporation in the going private acquisition by Blackstone Capital Partners. The increase of 46.0% or \$92,000 in interest income earned on temporary cash investments is a result of increased Treasury Bill rates.

Equity in losses of equity method investee shows a loss of \$140,000 for fiscal year 2005, this loss represents the write off of our investment in a la mode, LLC (ALA). The Company wrote off the a la mode investment in 2005 as ALA has ceased business operations.

Available-for-sale securities are stated at fair value, and unrealized holding gains and losses, net of the related deferred tax effect, are reported as a separate component of stockholders' equity. Dividends on marketable equity securities are recognized in income when declared. Investments in unregistered securities are reported at original cost.

Realized gains and losses, including losses from declines in value of specific securities determined by management to be other-than-temporary, are included in income. Realized gains and losses are determined on the basis of the specific securities sold.

*Net Income After Tax*

We reported net income after tax for fiscal year 2006 of \$1,724,000 compared to net income of \$761,000 in 2005, an increase of \$963,000 or 126.5%. Income per share was \$0.52 in 2006 compared to earnings per share of \$0.24 in 2005.

**OFF-BALANCE SHEET ARRANGEMENTS**

We are not a party to any off-balance sheet transactions, arrangements or obligations that have, or are reasonably likely to have, a material effect on the Company's financial condition, changes in the financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

**LIQUIDITY AND CAPITAL RESOURCES**

The net change in our cash and cash equivalents was \$1,609,000 as of December 31, 2006 compared to December 31, 2005. Cash from operating activities of \$178,000 for the twelve months ended December 31, 2006 was primarily a result of our net income adjusted for non-cash charges.



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Cash provided by investing activities was \$1,816,000 for the twelve-month period ended December 31, 2006 compared to \$1,165,000 for the year ended December 31, 2005. Cash used for capital expenditures was \$6,000 and \$40,000 for the twelve months ended December 31, 2006 and 2005, respectively. Proceeds from the sale of investments for the twelve months ended December 31, 2006 increased to \$1,822,000 from \$1,205,000 when compared to the same period in 2005.

Cash used in financing activities was \$3,603,000 and \$426,000 for the twelve months ended December 31, 2006 and 2005, respectively. During the twelve months ended December 31, 2006 and 2005, the Company paid aggregate dividends of \$3,874,000 and \$517,000, respectively.

Our ongoing cash requirements will be primarily for capital expenditures, research and development and working capital. Management believes that cash on hand and any cash provided by operations will be sufficient to meet our cash requirements through at least the next 12 months. We anticipate that the quarterly dividends will be paid in 2007 at the same rate as in 2006.

The Company's primary investments are 343,267 shares of Rudolph Technologies, Inc. and 551,759 shares of PPT Vision, Inc. The PPT Vision investment is accounted for under the equity method of accounting. These stocks are subject to fluctuations in price and could have a negative effect on the liquidity of the Company. Liquid securities are periodically sold as deemed appropriate by management. The market value of PPT Vision stock as of January 31, 2007 is \$265,000.

### CRITICAL ACCOUNTING ESTIMATES

Management uses estimates and assumptions in preparing our financial statements in accordance with generally accepted accounting principles. These estimates affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported revenues and expenses. There are no significant accounting estimates described in the notes to the financial statements which are critical at this time.

11

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### Table of Contents

#### **Item 7 Financial Statements**

### INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

<u>Report of Registered Independent Public Accounting Firm</u>	13-14
<u>Financial Statements</u>	
<u>Consolidated Balance Sheet</u>	15
<u>Consolidated Statements of Operations</u>	16
<u>Consolidated Statements of Changes in Stockholders' Equity</u>	17
<u>Consolidated Statements of Cash Flows</u>	18
<u>Notes to Consolidated Financial Statements</u>	19

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Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders, Audit Committee and Board of Directors

Electro-Sensors, Inc. and Subsidiaries

Minnetonka, Minnesota

We have audited the accompanying consolidated balance sheet of Electro-Sensors, Inc. and Subsidiaries as of December 31, 2006, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for the year ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Electro-Sensors, Inc. and Subsidiaries as of December 31, 2006, and the results of their operations and their cash flows for the year ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

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/s/ Boulay, Heutmaker, Zibell & Co. P.L.L.P.  
Certified Public Accountants

Minneapolis, Minnesota

March 23, 2007

13

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Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders, Audit Committee and Board of Directors

Electro-Sensors, Inc. and Subsidiaries

Minnetonka, MN

We have audited the consolidated balance sheet of Electro-Sensors, Inc. and Subsidiaries as of December 31, 2005, and the related consolidated statements of operations, stockholders' equity and cash flows for the year then ended. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit 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 consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall consolidated financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Electro-Sensors, Inc. and Subsidiaries as of December 31, 2005 and the results of their operations and their cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

/s/ Virchow, Krause & Company, LLP

Minneapolis, Minnesota

January 27, 2006

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Table of Contents

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**December  
31,  
2006**