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

FORM 10-Q

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

For the quarterly period ended MARCH 31, 1999

OR

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

For the transition period from .................... to ........................

Commission File Number: 0-10355

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.) |
| 213 South Main Street, Hector, MN | 55342 |
| (Address of principal executive offices) | (Zip Code) |

(320) 848-6231
Registrant's telephone number, including area code

(Former name, address, and former fiscal year, if changed since last report)

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

APPLICABLE ONLY TO CORPORATE ISSUERS:
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| CLASS | Outstanding at April 30, 1999 |
|---|---|
| Common Stock, par value $.05 per share | 8,608,294 |

Total Pages (11) Exhibit Index at (NO EXHIBITS)

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

INDEX

PART I. FINANCIAL INFORMATION

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

Item 1. Financial Statements

CONSOLIDATED BALANCE SHEETS
(unaudited)

<TABLE>
<CAPTION>

| Assets: | March 31 1999 | December 31 1998 |
|---|---|---|
| Current assets: | | |
| Cash | $ 21,832,810 | $ 20,405,363 |
| Receivables, net | 19,125,141 | 14,624,123 |
| Inventories - Note 2 | 17,705,069 | 20,837,508 |
| Deferred income taxes | 1,348,000 | 1,348,000 |
| Other current assets | 477,065 | 499,549 |
| Total current assets | 60,488,085 | 57,714,543 |
| Property, plant and equipment | 30,994,518 | 30,654,182 |
| less accumulated depreciation | (19,903,318) | (19,275,422) |
| Net property, plant and equipment | 11,091,200 | 11,378,760 |
| Other assets: | | |
| Excess of cost over net assets acquired | 7,987,588 | 8,392,261 |
| Investments in mortgage backed and other securities | 1,240,830 | 1,316,912 |
| Deferred income taxes | 548,047 | 548,047 |
| Notes receivable from sale of assets of discontinued operations | 3,765,390 | 3,765,390 |
| Other assets | 834,053 | 783,799 |
| Total other assets | 14,375,908 | 14,806,409 |
| Total Assets | $ 85,955,193 | $ 83,899,712 |
| Liabilities and Stockholders' Equity: | | |
| Current liabilities: | | |
| Notes payable | $ 9,069,305 | $ 9,077,598 |
| Accounts payable | 4,568,389 | 4,589,078 |
| Accrued expenses | 3,964,848 | 3,823,596 |
| Dividends payable | 881,114 | 879,130 |
| Income taxes payable | 2,656,803 | 2,076,658 |
| Total current liabilities | 21,140,459 | 20,446,060 |
| Stockholders' Equity | 64,814,734 | 63,453,652 |
| Total Liabilities and Stockholders' Equity | $ 85,955,193 | $ 83,899,712 |

See notes to consolidated financial statements.

</TABLE>



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

<TABLE>
<CAPTION>

| | Three Months Ended March 31 | |
|---|---|---|
| | 1999 | 1998 |
| Sales | $ 26,596,892 | $ 17,486,063 |
| Costs and expenses: | | |
| Cost of sales | 17,561,114 | 12,242,094 |
| Selling, general and administrative expenses | 5,774,611 | 2,958,377 |

| | | |
|---|---|---|
| Total costs and expenses | 23,335,725 | 15,200,471 |
| Operating income | 3,261,167 | 2,285,592 |
| Other income and (expenses): | | |
| Investment income | 203,635 | 459,892 |
| Interest expense | (152,343) | (1,261) |
| Other income, net | 51,292 | 458,631 |
| Income before income taxes | 3,312,459 | 2,744,223 |
| Income taxes (Note 3) | 840,000 | 550,000 |
| Net income | 2,472,459 | 2,194,223 |
| Other comprehensive income - Foreign currency translation adjustment | (231,503) | 83,260 |
| Comprehensive income | $ 2,240,956 | $ 2,277,483 |
| Basic net income per share | $ .28 | $ .24 |
| Diluted net income per share | $ .28 | $ .23 |
| Average Basic Shares Outstanding | 8,802,972 | 9,321,576 |
| Average Dilutive Shares Outstanding | 8,832,458 | 9,418,637 |

See notes to consolidated financial statements.

</TABLE>



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<CAPTION>

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

| | Common Stock | | Additional | | Stock Option | Cumulative | |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | Paid-in Capital | Retaine Earnings | Notes Receivable | Translation Adjustment | Total |
| <S> | <C> | <C> | <C> | <C> | <C> | <C> | <C> |
| BALANCE AT DECEMBER 31, 1997 | 9,326,652 | $ 466,333 | $ 24,132,771 | $ 44,552,855 | $ - | $ 111,737 | $ 69,263,696 |
| Net income | | | | 7,867,425 | | | 7,867,425 |
| Issuance of stock to acquire JDL Technologies, Inc. | 158,005 | 7,900 | 2,204,170 | | | | 2,212,070 |
| Issuance of common stock under Employee Stock Purchase Plan | 12,210 | 610 | 112,259 | | | | 112,869 |
| Issuance of stock under Employee Stock Option Plan | 84,834 | 4,242 | 938,102 | | | | 942,344 |
| Tax benefit from non qualified employee stock options | | | 37,017 | | | | 37,017 |
| Issuance of notes receivable for stock options, net | | | | | (288,225) | | (288,225) |
| Purchase of stock | (790,400) | (39,520) | (2,173,405) | (11,052,325) | | | (13,265,250) |
| Shareholder dividends | | | | (3,505,492) | | | (3,505,492) |
| Foreign currency translation adjustment | | | | | | 77,198 | 77,198 |
| BALANCE AT DECEMBER 31, 1998 | 8,791,301 | 439,565 | 25,250,914 | 37,862,463 | (288,225) | 188,935 | 63,453,652 |
| Net income | | | | 2,472,459 | | | 2,472,459 |
| Issuance of common stock to Employee Stock Ownership Plan | 19,893 | 995 | 234,005 | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | | | | 235,000 |
| Purchase of stock | (23,400) | (1,170) | (67,679) | (164,911) | | | (233,760) |
| Shareholder dividends | | | | (881,114) | | | (881,114) |
| Foreign currency translation adjustment | | | | | | (231,503) | (231,503) |
| BALANCE AT MARCH 31, 1999 | 8,787,794 | $ 439,390 | $ 25,417,240 | $ 39,288,897 | $ (288,225) | $ (42,568) | $ 64,814,734 |

See notes to consolidated financial statements.

</TABLE>



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

| <S> | Three Months Ended March 31 <C> 1999 | <C> 1998 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $ 2,472,459 | $ 2,194,223 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,112,287 | 677,812 |
| Changes in assets and liabilities: | | |
| Decrease (increase) in accounts receivable | (4,553,860) | 1,621,219 |
| Decrease (increase) in inventory | 3,076,917 | (1,285,723) |
| Decrease in other current assets | 20,315 | 313,256 |
| Increase in accounts payable | 23,607 | 282,969 |
| Increase in accrued expenses | 300,733 | 936,080 |
| Increase (decrease) in income taxes payable | 584,509 | (85,423) |
| Net cash provided by operating activities | 3,036,967 | 4,654,413 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Capital expenditures | (478,221) | (1,005,875) |
| Maturities of mortgage-backed and other investment securities | 76,082 | 433,874 |
| Increase in other assets | (56,950) | (466,727) |
| Proceeds from maturities of U.S. Treasury securities | | 5,249,314 |
| Net cash provided by (used in) investing activities | (459,089) | 4,210,586 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Repayment of notes payable | (8,293) | |
| Dividends paid | (879,130) | (839,399) |
| Proceeds from issuance of common stock | | 325,787 |
| Purchase of stock | (233,760) | (2,101,131) |
| Net cash used in financing activities | (1,121,183) | (2,614,743) |

| | | |
|---|---|---|
| EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH | (29,248) | 45,008 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 1,427,447 | 6,295,264 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 20,405,363 | 17,942,315 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | $ 21,832,810 | $ 24,237,579 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Income taxes paid | $ 259,855 | $ 633,340 |
| Interest paid | 46,427 | 1,261 |

See notes to consolidated financial statements.

</TABLE>



COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - CONSOLIDATED FINANCIAL STATEMENTS

The balance sheet and statement of stockholders' equity as of March 31, 1999, the statements of income and comprehensive income and the statements of cash flows for the three-month periods ended March 31, 1999 and 1998 have been prepared by the Company without audit. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations, and cash flows at March 31, 1999 and 1998 have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. It is suggested these condensed financial statements be read in conjunction with the financial statements and notes thereto included in the Company's December 31, 1998 Annual Report to Shareholders. The results of operations for the periods ended March 31 are not necessarily indicative of the operating results for the entire year.

Effective December 1, 1998, the Company acquired all the capital stock of Transition Networks, Inc. for $8,507,000 (cash payments net of cash acquired). The transaction is being accounted for as a purchase, and the operations of Transition Networks, Inc. are included in consolidated operations as of the effective date. Excess cost over net assets acquired in the transaction was $4,047,000, which is being amortized on a straight-line basis over 5 years.

Effective August 7, 1998, in a noncash transaction, the Company acquired JDL Technologies, Inc. in exchange for 158,005 shares of its common stock. The acquisition was accounted for as a purchase. The excess of cost over net assets acquired in the transaction was $2,223,000 which is being amortized on a straight-line basis over 5 years. The results of operations of JDL Technologies, Inc. have been included in the Company's operations effective August 7, 1998.

Unaudited consolidated results of operations on a pro forma basis as though the acquisitions were effective January 1, 1998 are as follows:

| | Three Months Ended March 31, 1998 |
|---|---|
| Revenues | $ 23,861,817 |
| Net income | 1,685,968 |
| Basic net income per share | $ .18 |
| Diluted net income per share | $ .18 |

In February, 1999 the Company issued 19,893 shares of the Company's common stock to the Employee Stock Ownership Plan in payment of its 1998 obligation. In a noncash transaction, the Company recorded additional stockholders' equity of $235,000 (reflecting the market value of the stock at the time of the contribution) and reduced accrued expenses by the same amount.

NOTE 2 - INVENTORIES

Inventories summarized below are priced at the lower of first-in, first-out cost or market:

| | March 31 1999 | December 31 1998 |
|---|---|---|
| Finished Goods | $ 6,484,389 | $ 8,450,447 |
| Raw Materials | 11,220,680 | 12,387,061 |
| Total | $ 17,705,069 | $ 20,837,508 |

NOTE 3 - INCOME TAXES

Income taxes are computed based upon the estimated effective rate applicable to operating results for the full fiscal year. For the periods ended March 31, 1999 and 1998 income taxes do not bear a normal relationship to income before income taxes, primarily because income from Puerto Rico operations is taxed at rates lower than the U.S. rate.

NOTE 4 - 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 takes into effect 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 29,486 shares and 97,061 shares in 1999 and 1998, respectively. The Company calculates the dilutive effect of outstanding options using the treasury stock method.

NOTE 5 - SUBSEQUENT EVENT

On March 12, 1999, the Company signed an agreement to purchase LANart Corporation, a manufacturer of application specific integrated circuits located in Needham, Massachusetts, for approximately $6,000,000. LANart Corporation had sales of approximately $10,687,000 and a net loss of $1,151,000 for its most recent fiscal year ended December 31, 1998. The Company completed this acquisition in April 1999.

NOTE 6 - SEGMENT INFORMATION

The Company classifies its businesses into three segments: Suttle, which manufactures U.S. standard modular connecting and wiring devices for voice and data communications; Austin Taylor, which manufactures British standard line jacks, patch panels, wiring harness assemblies, metal boxes, distribution cabinets and distribution and central office frames; Transition Networks, which designs and markets data transmission and computer network products; and other operations. Information concerning the Company's continuing operations in the various segments is as follows:



<TABLE>
<CAPTION>

| | Suttle | Austin Taylor | Transition Networks | Other | Consolidated |
|---|---|---|---|---|---|
| Three Months Ended March 31, 1999: | | | | | |
| <S> | <C> | <C> | <C> | <C> | <C> |
| Revenues | $ 15,970,208 | $ 2,807,495 | $ 6,765,382 | $ 1,053,807 | $ 26,596,892 |
| Cost of sales | 10,245,881 | 2,251,862 | 4,342,829 | 720,542 | 17,561,114 |
| Gross profit | 5,724,327 | 555,633 | 2,422,553 | 333,265 | 9,035,778 |
| Selling, general and administrative expenses | 1,947,844 | 339,808 | 2,514,964 | 971,995 | 5,774,611 |
| Operating income (loss) | $ 3,776,483 | $ 215,825 | $ (92,411) | $ (638,730) | $ 3,261,167 |
| Depreciation and amortization | $ 529,632 | $ 161,274 | $ 262,243 | $ 159,138 | $ 1,112,287 |

| | | | | | |
|---|---|---|---|---|---|
| Assets | $ 55,284,130 | $ 6,903,216 | $ 11,786,255 | $ 11,981,592 | $ 85,955,193 |
| Capital expenditures | $ 280,093 | $ 117,705 | $ 60,145 | $ 20,278 | $ 478,221 |
| Three Months Ended March 31, 1998: | | | | | |
| Revenues | $ 14,148,314 | $ 3,337,749 | | | $ 17,486,063 |
| Cost of sales | 9,601,030 | 2,641,064 | | | 12,242,094 |
| Gross profit | 4,547,284 | 696,685 | | | 5,243,969 |
| Selling, general and administrative expenses | 2,235,389 | 323,321 | | $ 399,667 | 2,958,377 |
| Operating income (loss) | $ 2,311,895 | $ 373,364 | | $ (399,667) | $ 2,285,592 |
| Depreciation and amortization | $ 507,527 | $ 138,521 | | $ 31,764 | $ 677,812 |
| Assets | $ 56,258,045 | $ 9,900,317 | | $ 12,192,432 | $ 78,350,794 |
| Capital expenditures | $ 935,029 | $ 49,773 | | $ 21,073 | $ 1,005,875 |

</TABLE>

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

### Three Months Ended March 31, 1999 Compared to Three Months Ended March 31, 1998

Consolidated sales increased 52% to $26,597,000. Consolidated operating income increased 43% to $3,261,000.

Suttle sales increased 13% to $15,970,000. Sales to customers in the United States (U.S.) increased 14% to $15,384,000. Sales to the Big 6 telephone companies (the five Regional Bell Operating Companies (RBOCs) and GTE) increased 27% to $10,009,000. Sales to these customers accounted for 65% of Suttle's U.S. customer sales. Sales to distributors, original equipment manufacturers (OEMs), and electrical contractors increased $426,000, or 12%. Sales to retail customers decreased $550,000 or 39% due to decreased sales to Radio Shack, which is Suttle's principal retail customer. Suttle's export sales, including sales to Canada decreased 9% to $586,000.

The sales increases were mainly of Suttle's CorroShield and data products. CorroShield product sales increased 33%, reflecting a return to more normal buying patterns by the RBOCs, which are CorroShield's major customers. CorroShield products are continuing to displace conventional voice connecting products, sales of which declined 3% in the 1999 quarter. Sales of data products increased 22%. Sales of fiber-optic connector products decreased 26%.



Suttle's gross margins increased 26% to $5,724,000. Gross margin percentage improved to 35.8% in 1999 from 32.1% in 1998. The improvement in gross margin was due to product mix. The fastest selling products in 1999 (CorroShield and data products) tended to be the products with the highest margins. Margins also benefited from Suttle's inventory overstock at the end of 1998. No extra production costs were incurred to meet the increase in sales. Selling, general and administrative expenses declined $288,000 or 13%. 1998 expenses were higher than normal due to a campaign to increase export sales and sales of data products. Suttle's operating income increased $1,465,000 or 63%.

Austin Taylor's sales decreased 16% to $2,807,000. The decrease was due to reduced sales of CATV products caused by major reductions of cable television construction activity in the U.K. and below plan sales to Pacific Rim telephone companies. Austin Taylor's gross margin declined 20% to $556,000. Gross margin as a percentage of sales was 19.8% compared to 20.9% in 1998. The decline in gross margin was principally due to lower business volume. Selling, general and administrative expenses increased $16,000. Operating income decreased $158,000 or 42%.

The Company acquired JDL Technologies, Inc. in August, 1998 and Transition Networks, Inc. in December, 1998. While the Company expects both acquisitions to make positive contributions in future periods, neither had a positive impact in the 1999 period. JDL had sales of $1,054,000 in the period and an operating loss of $242,000. Government funding delays for new telecommunications infrastructure in the public schools negatively affected JDL's performance. TNI had sales of $6,765,000 and an operating loss of $92,000. Transition Network's performance was hurt by the lack of manufacturing margins on sales inventory in stock at the time it was acquired by the Company. CSI's corporate operating expenses were $396,000 compared to $399,000 in the 1998 period.

Consolidated investment income, net of interest expense, decreased $407,000 due to decreased levels of funds available for investment and interest on notes payable associated with acquisitions. Income from continuing operations before income taxes increased $568,000 or 21%. The Company's effective income tax rate was 25.4% compared to 20.0% in 1998. The increase in the tax rate was because the Company did not generate sufficient tax credits in Puerto Rico to shelter all of its Puerto Rico earnings. Net income increased $278,000 or 13%.

## Liquidity and Capital Resources

At March 31, 1999, the Company had approximately $21,833,000 of cash and cash equivalents compared to $20,405,000 of cash and cash equivalents at December 31, 1998. The Company had working capital of approximately $39,348,000 and a current ratio of 2.9 to 1 compared to working capital of $37,268,000 and a current ratio of 2.8 to 1 at the end of 1998.

Cash flow provided by operations was approximately $3,037,000 in the first three months of 1999 compared to $4,654,000 in the same period in 1998. The decrease was due to the need to finance increased accounts receivable levels caused by the Company's increased sales volume. Cash flow benefited in the 1999 period from decreased inventory levels, as the Company was able to satisfy some of the increased customer demand out of existing stocks.



Investing activities utilized $459,000 of cash in the 1999 period. Cash investments in new plant and equipment totaled $478,000, which was financed by internal cash flows. The Company expects to spend $3,500,000 on capital additions in 1999. The Company spent an additional $6,000,000 in April, 1999 to acquire LANart Corporation. The Company financed that acquisition using a combination of internal funds and short-term borrowing from U.S. Bank. Short-term notes payable outstanding, which were $9,069,000 at March 31, 1999, increased to $10,166,000 after the LANart acquisition was completed. . The Company expects to repay or refinance this debt in 1999.

Net cash used in financing activities was $1,121,000. The Company purchased and retired 23,400 shares of its stock in open market transactions during the 1999 period. At March 31, 1999 Board authorizations are outstanding to purchase an additional 186,200 shares. The Company purchased an additional 180,000 shares under this authorization in April 1999. Dividends paid on common stock increased to $879,000.

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.

## Year 2000 Issues

Most older computer software was originally designed to use references to calendar dates on an abbreviated basis. Under this system, references to the calendar year are abbreviated to the last two digits of the year, i.e. 1999 is abbreviated as "99". Software using this system often fails to recognize that the year 2000, abbreviated as "00", follows 1999. This "Y2K" problem can cause computing errors in date sensitive processes. In 1998, the Company surveyed its operations to locate computer systems that could be subject to this error and initiated a program of corrective action.

The Company's accounting and management control systems at Suttle and Austin Taylor utilize a company-wide computer network centered in the Company's Hector, MN corporate office. The hardware and software used in operating the network are all purchased from third party suppliers. The Company has contracted with these suppliers and obtained the necessary hardware and software to bring its central computer system and data network into Y2K compliance on a current basis. Cost hardware and software purchased as part of the Y2K compliance program was $150,000. The Company did not separately track internal costs of Y2K compliance.

In 1998, the Company acquired JDL Technologies, Inc. and Transition Networks, Inc. These operations are not presently part of the Company's central computer network. Both operations utilize personal computer based computing networks that were materially Y2K compliant prior to their acquisition by the Company.

At the present time, Suttle, Austin Taylor and Transition Networks do not manufacture products containing embedded controllers or microprocessors that are date sensitive or subject to the Y2K problem. The Company does not believe it has any warranty exposure to customers due to potential Y2K problems.



The Company has also been in contact with its major customers and suppliers to estimate the extent to which it may be vulnerable to their respective Y2K problems. The Company is reliant on third parties for critical functions, including raw materials and supplies, transportation, utilities and communications services. Multiple sources of supply are available for most of these products and services. The Company has not received any indication from these parties that they will not be Y2K compliant. If the Company does experience any Y2K related problems with third parties it is likely to be in the nature of short-term spot shortages of raw materials or manufacturing supplies which would not materially affect the Company's operations.

At the present time, the Company expects to handle any Y2K problems that occur as part of the ordinary course of business. No special contingency plans have been developed. The Company will continue to monitor its Y2K situation and will respond appropriately if any problem arises.

PART II. OTHER INFORMATION

Items 1 - 6. Not Applicable

Signatures

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

Communications Systems, Inc.

By /s/ Paul N. Hanson

-----------------------------

Paul N. Hanson
Vice President and
Chief Financial Officer

Date: May 14, 1999

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