

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, 1997

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 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 ISSUERS INVOLVED IN BANKRUPTCY
PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13, or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. YES ___ NO ___

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuers classes of common stock, as of the latest practicable date.

CLASS	Outstanding at April 30, 1997
Common Stock, par value \$.05 per share	9,201,213

Total Pages (10) Exhibit Index at (NO EXHIBITS)

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

Item 1. Financial Statements

CONSOLIDATED BALANCE SHEETS
(unaudited)

	March 31 1997	December 31 1996
	-----	-----
Assets:		
Current assets:		
Cash	\$18,016,563	\$17,799,398
Marketable securities	909,873	889,782
Receivables, net	11,566,707	10,375,080
Inventories - Note 3	15,260,324	13,861,914
Prepaid expenses	603,974	460,692
Deferred income taxes	1,062,283	792,000
	-----	-----
Total current assets	47,419,724	44,178,866
Property, plant and equipment	24,776,642	24,299,704
less accumulated depreciation	(15,792,979)	(15,335,114)
	-----	-----
Net property, plant and equipment	8,983,663	8,964,590
Net assets of discontinued operations		536,679
Other assets:		
Investments in mortgage backed and other securities	4,305,344	4,487,934
Excess of cost over net assets acquired	3,155,163	3,166,422
Deferred income taxes	835,047	835,047
Notes receivable from sale of assets of discontinued operations	4,866,597	4,866,597
Other assets	786,641	559,979
	-----	-----
Total other assets	13,948,792	13,915,979
	-----	-----
Total Assets	\$70,352,179	\$67,596,114
	=====	=====
Liabilities and Stockholders' Equity:		
Current liabilities:		
Accounts payable	\$3,730,982	3,164,406
Accrued expenses	2,599,176	2,622,853
Dividends payable	735,297	728,585
Income taxes payable	2,236,922	2,064,792
	-----	-----
Total current liabilities	9,302,377	8,580,636
Stockholders' Equity	61,049,802	59,015,478
	-----	-----
Total Liabilities and Stockholders' Equity	\$70,352,179	\$67,596,114
	=====	=====

See notes to consolidated financial statements.

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

Three Months Ended March 31

	1997	1996
	-----	-----
Revenues from continuing operations:		

Sales	\$16,816,019	\$15,793,821
Costs and expenses:		
Cost of sales	11,825,031	11,162,664
Selling, general and administrative expenses	2,623,506	2,318,496
Total costs and expenses	14,448,537	13,481,160
Operating income from continuing operations	2,367,482	2,312,661
Other income and (expenses):		
Investment income	376,992	142,054
Interest expense	(935)	(6,398)
Other income, net	376,057	135,656
Income from continuing operations before income taxes	2,743,539	2,448,317
Income taxes (Note 4)	575,000	445,000
Income from continuing operations	2,168,539	2,003,317
Income from discontinued operations, net of income taxes		41,358
Net income	\$2,168,539	\$2,044,675
Net income per share:		
Continuing operations	\$.24	\$.21
Discontinued operations		.01
	\$.24	\$.22
Average common and common equivalent shares outstanding	9,208,000	9,414,000

See notes to consolidated financial statements.

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(unaudited)

<TABLE>
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	Common Stock		Additional Paid in Capital	Retained Earnings	Cumulative Translation Adjustment
	Shares	Amount			
Total					
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BALANCE at December 31, 1995	9,183,401	\$459,170	\$19,706,125	\$34,140,435	(\$230,154)
\$54,075,576					
Net Income				8,232,531	
8,232,531					
Shareholder dividends				(2,868,154)	
(2,868,154)					
Issuance of common stock under Employee Stock Purchase Plan	14,346	717	157,806		
158,523					
Issuance of common stock under Employee Stock Option Plan	52,381	2,619	466,427		
469,046					
Tax benefit from nonqualified employee stock options			12,701		
12,701					
Purchase of Communications Systems Inc. common stock	(255,495)	(12,775)	(601,381)	(2,648,527)	
(3,262,683)					
Issuance of common stock to acquire Automatic Tool and Connector Co.	112,676	5,634	1,712,675		
1,718,309					
Cumulative translation adjustment					479,629

479,629

	-----	-----	-----	-----	-----
BALANCE at December 31, 1996	9,107,309	455,365	21,454,353	36,856,285	249,475
59,015,478					
Net Income				2,168,539	
2,168,539					
Shareholder dividends				(735,297)	
(735,297)					
Issuance of common stock to					
Employee Stock Ownership Plan	20,870	1,044	298,956		
300,000					
Issuance of common stock under					
Employee Stock Option Plan	63,034	3,152	538,157		
541,309					
Cumulative translation adjustment					(240,227)
(240,227)					
	-----	-----	-----	-----	-----
BALANCE at March 31, 1997	9,191,213	\$459,561	\$22,291,466	\$38,289,527	\$9,248
\$61,049,802	=====	=====	=====	=====	=====
	=====				

See notes to consolidated financial

statements.

</TABLE>

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

<TABLE>

	Three Months Ended March 31	
	-----	-----
	1997	1996
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES:		
<S>		
Net income	<C> \$ 2,168,539	<C> \$ 2,044,675
Less: Income from discontinued operations		(41,358)
	-----	-----
Income from continuing operations	2,168,539	2,003,317
Adjustments to reconcile income from continuing operations		
to net cash provided by operating activities:		
Depreciation and amortization	627,392	619,632
Adjustment to marketable securities reserve	(20,091)	34,503
Changes in assets and liabilities:		
Increase in accounts receivable	(1,186,292)	(474,688)
Increase in inventory	(1,468,915)	(778,470)
Increase in prepaid expenses	(145,650)	(80,925)
Increase in deferred income taxes	(269,310)	
Increase (decrease) in accounts payable	644,700	(655,923)
Increase in accrued expenses	618	75,676
Increase in income taxes payable	173,617	247,117
	-----	-----
Net cash provided by operating activities	524,608	990,239
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(650,202)	(815,110)
Decrease in mortgage backed and other investment securities	182,590	294,124
Decrease (increase) in other assets	(327,166)	83,565
Changes in assets and liabilities of discontinued operations	536,679	(283,257)
Payment for purchase of Austin Taylor Communications, Ltd.	(79,947)	(135,131)
Payment for purchase of Automatic Tool and Connector		
Company, Inc., net of cash acquired		(1,173,577)
	-----	-----
Net cash used in investing activities	(338,046)	(2,029,386)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of notes payable		(33,430)
Dividends paid	(728,585)	(642,838)
Proceeds from issuance of common stock	841,309	150,700
	-----	-----
Net cash provided by (used in) financing activities	112,724	(525,568)
	-----	-----
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	(82,121)	(13,566)
	-----	-----
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	217,165	(1,578,281)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	17,799,398	11,703,536

CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$18,016,563	\$10,125,255
	=====	=====
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Income taxes paid	\$391,201	\$227,883
Interest paid	935	6,398

See notes to consolidated financial statements.

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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, 1997 and the statements of income and statements of cash flows for the three month periods ended March 31, 1997 and 1996 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, 1997 and 1996 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, 1996 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.

NOTE 2 - DISCONTINUED OPERATIONS

On November 4, 1996, the Company completed the sale of its contract manufacturing subsidiary, Zercom Corporation, to Nortech Systems, Inc. (Nasdaq National Market: NSYS). Nortech Systems acquired all the assets of Zercom, except cash and accounts receivable, in exchange for \$1.5 million cash and a \$4.9 million term note secured by Zercom's assets.

The Company's financial statements have been restated to separate the net assets and operating results of Zercom Corporation from the Company's continuing operations. Zercom's operating results were as follows:

	Three Months Ended March 31, 1996
Sales	\$ 4,665,292
Costs and expenses	4,599,201
Interest income, net	5,267

Income before income taxes	71,358
Income tax expense	30,000

Net income	\$ 41,358
	=====

Net assets of discontinued Zercom operations at December 31, 1996 consisted of:

Accounts receivable	\$ 567,679
Deferred income taxes	269,000
Accrued expenses	(300,000)

Net assets of discontinued operations	\$ 536,679
	=====

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

NOTE 3 - INVENTORIES

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

	March 31 1997	December 31 1996
Finished Goods	\$ 4,364,980	\$ 3,957,655
Raw Materials	10,895,344	9,904,259
	-----	-----
Total	\$ 15,260,324	\$ 13,861,914

NOTE 4 - 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, 1997 and 1996 income taxes do not bear a normal relationship to income before income taxes, primarily because income from Puerto Rico operations are taxed at rates lower than the U.S. rate.

NOTE 5 - NET INCOME PER COMMON SHARE

Net income per share is based on the weighted average number of common and common equivalent shares outstanding during the periods. Common equivalent shares reflect the dilutive effect of outstanding stock options. Primary and fully diluted earnings per share are substantially the same.

The Financial Accounting Standards Board (FASB) has issued SFAS 128, "Earnings per Share" which requires public companies to present basic earnings per share and, if applicable, diluted earnings per share instead of primary and fully diluted earnings per share. SFAS 128 is effective for interim and annual periods ending after December 15, 1997. The new standard would have no effect on the Company's net income per share for the three month periods ended March 31, 1997 and 1996.

NOTE 6 - ACQUISITION OF AUTOMATIC TOOL AND CONNECTOR CO., INC.

Effective January 4, 1996, the Company purchased all the capital stock of Automatic Tool and Connector Co., Inc. for \$3,191,000, consisting of \$1,473,000 of cash and 112,676 shares of the Company's common stock. The fair value of assets acquired in the transaction was \$4,063,000 (which includes excess of cost over net assets acquired was \$2,864,000, which is being amortized over ten years on a straight line basis) and liabilities of \$872,000 were assumed. Results of Automatic Tool, which are not material to the Company's financial results, are included in Company operations beginning January 4, 1996.

COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

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

Three Months Ended March 31, 1997 Compared to
Three Months Ended March 31, 1996

Revenues from continuing operations increased \$1,022,000 or 6% from the 1996 period. Sales to domestic (U.S. and Puerto Rico) customers increased \$1,058,000 or 9%. Sales to the Big 8 telephone companies (the seven Regional Bell Operating Companies and GTE) increased \$1,109,000 or 15%. The sales increase was due to sales of the Company's CorroShield line of corrosion resistant products to an additional RBOC. The Company's sales of CorroShield products would have been even higher in the 1997 quarter except for problems the Company experienced obtaining sufficient supplies of the gel-filled figs used in CorroShield products. Sales to retailers increased \$361,000 or 34% due to strong sales to Radio Shack stores. Sales to electrical distributors and original equipment manufacturers decreased \$504,000 or 14%, due to lower sales to Lucent Technologies and lower sales of fiber optic connectors.

Sales to international customers decreased \$36,000 or 1%. Sales by Austin Taylor, the Company's United Kingdom based subsidiary, increased \$217,000 or 7%. U.S. export sales, including sales to Canada, decreased \$253,000 or 33%. Gross margin as a percentage of sales was 30% compared to 29% in the 1996 period. Margin percentages improved in U.S. plants due to reduction in manufacturing overheads, which offset higher raw material costs. Margins earned on Austin Taylor products declined to 19% from 21% in the 1996 period due to increased raw material costs.

Selling, general and administrative expenses increased \$305,000 or 13% from the 1996 period. The increase was due to increased international sales expenses associated with efforts to develop export markets for telephone station apparatus products and increase sales of the Company's data products.

Operating income from continuing operations increased \$55,000 or 2%. Investment income, net of interest expense, increased \$240,000 from the 1996 period due to higher interest rates earned on investments and increases in investable cash balances. The Company's effective income tax rate was 21% compared to 18% in the 1996 period. The Company's tax rate is lower than the full U.S. rate due to tax exemptions and benefits received by the Company's Puerto Rico operations. Income from continuing operations increased \$165,000, or 8%. Income from discontinued operations was \$41,000 in the 1996 period. Net income increased \$124,000, or 6%.

At March 31, 1997, the Company held approximately \$18,016,000 of cash compared to \$17,799,000 at December 31, 1996. Working capital was \$38,117,000 compared to \$35,598,000 at December 31, 1996. The Company's current ratio was 5.1 to 1, unchanged from year end 1996.

Net cash provided by operating activities was \$525,000 compared to \$990,000 in the first three months of 1996. Cash was utilized during the period to finance increases in accounts receivable and inventory, purchase new plant and equipment and pay dividends.

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COMMUNICATIONS SYSTEMS, INC. AND SUBSIDIARIES

Liquidity and Capital Commitments (continued)

Under provisions of the Small Business Job Protection Act of 1996, the possessions tax credit, which shelters the Company's Puerto Rico income from U.S. income tax, was repealed for years after 1995. However, companies like CSI which currently qualify for the credit, may continue to claim the credit until 2005, subject to certain limitations. As of July 1, 1996, the credit no longer applied to investment income earned in Puerto Rico. The credit will continue to apply to business income earned in Puerto Rico through 2001. For the years 2002 to 2005, the amount of Puerto Rico business income eligible for the credit will be limited to an inflation adjusted amount based on Puerto Rico business income earned from 1990 to 1994. The possessions tax credit has a materially favorable effect on the Company's income tax expense. Had the Company incurred income tax expense on Puerto Rico operations in 1997 at the full U.S. rate, income tax expense would have increased by \$510,000.

The Company's balance sheet remains strong, with stockholders' equity of \$61,050,000 and no long-term debt. The Company has available a \$2,000,000 bank line of credit. Management believes, based on the Company's current financial position and projected future expenditures, that sufficient funds are available to meet the Company's anticipated needs.

The acquisition of Automatic Tool and Connector Co. and the disposition of Zercom Corporation as well as other acquisitions and dispositions the Company has made over the past several years have served to expand and focus the Company's telecommunications product offerings and customer base in both U.S. and international markets. The Company is seeking to position itself in the marketplace as a growth oriented manufacturer of telecommunications connecting devices. The Company is continuing to search for acquisition candidates with products that will enable the Company to better serve its target markets.

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, 1997

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