

NORTECH SYSTEMS INC
Form 10-Q
November 05, 2015
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549**

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2015

OR

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

For the transition period from _____ to _____

NORTECH SYSTEMS INCORPORATED

Commission file number **0-13257**

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State of Incorporation: **Minnesota**

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

Executive Offices: **7550 Meridian Circle N, Maple Grove, MN 55369**

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large Accelerated Filer

Accelerated Filer

Non-accelerated Filer

Smaller Reporting Company

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

Number of shares of \$.01 par value common stock outstanding at October 30, 2015 - 2,746,325

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| | September 30 2015 (Unaudited) | DECEMBER 31 2014 |
|--|-------------------------------------|---------------------|
| ASSETS | | |
| Current Assets | | |
| Cash | \$ 12,234 | \$ 66,371 |
| Accounts Receivable, Less Allowance for Uncollectible Accounts | 19,193,424 | 17,367,668 |
| Inventories, Less Reserve for Excess and Obsolete | 20,262,206 | 18,528,418 |
| Prepaid Expenses | 1,224,697 | 816,775 |
| Income Taxes Receivable | 995,264 | 465,236 |
| Deferred Income Taxes | 416,964 | 436,000 |
| Total Current Assets | 42,104,789 | 37,680,468 |
| Property and Equipment, Net | 10,789,523 | 10,888,717 |
| Finite Life Intangibles | 2,100,084 | 34,395 |
| Goodwill | 3,283,453 | 75,006 |
| Other Assets | 7,726 | 7,726 |
| Total Assets | \$ 58,285,575 | \$ 48,686,312 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current Liabilities | | |
| Current Maturities of Long-Term Debt | 1,399,860 | 732,835 |
| Accounts Payable | 14,296,078 | 9,008,426 |
| Accrued Payroll and Commissions | 3,433,767 | 2,896,557 |
| Other Accrued Liabilities | 2,863,629 | 732,012 |
| Total Current Liabilities | 21,993,334 | 13,369,830 |
| Long-Term Liabilities | | |
| Line of Credit | 6,896,452 | 7,998,184 |
| Long-Term Debt, Net of Current Maturities | 6,101,664 | 4,072,506 |
| Deferred Income Taxes | 185,649 | 149,000 |
| Other Long-Term Liabilities | 961,942 | 268,400 |
| Total Long-Term Liabilities | 14,145,707 | 12,488,090 |
| Total Liabilities | 36,139,041 | 25,857,920 |
| Shareholders Equity | | |
| Preferred Stock, \$1 par value; 1,000,000 Shares Authorized: | | |
| 250,000 Shares Issued and Outstanding | 250,000 | 250,000 |
| Common Stock - \$0.01 par value; 9,000,000 Shares Authorized: | | |
| 2,746,325 Shares Issued and Outstanding | 27,463 | 27,430 |
| Additional Paid-In Capital | 15,764,024 | 15,751,160 |
| Accumulated Other Comprehensive Loss | (62,936) | (62,936) |

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| | | |
|--|---------------|---------------|
| Retained Earnings | 6,167,983 | 6,862,738 |
| Total Shareholders' Equity | 22,146,534 | 22,828,392 |
| Total Liabilities and Shareholders' Equity | \$ 58,285,575 | \$ 48,686,312 |

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

| | THREE MONTHS ENDED SEPTEMBER 30 | |
|--|------------------------------------|---------------|
| | 2015 | 2014 |
| Net Sales | \$ 30,409,064 | \$ 28,037,865 |
| Cost of Goods Sold | 27,518,479 | 24,510,862 |
| Gross Profit | 2,890,585 | 3,527,003 |
| Operating Expenses | | |
| Selling Expenses | 1,244,521 | 1,303,920 |
| General and Administrative Expenses | 1,623,521 | 1,749,593 |
| Total Operating Expenses | 2,868,042 | 3,053,513 |
| Income (Loss) From Operations | 22,543 | 473,490 |
| Other Expense | | |
| Interest Expense | (133,960) | (89,598) |
| Miscellaneous Expense, net | (88,189) | (13,195) |
| Total Other Expense | (222,149) | (102,793) |
| Income (Loss) Before Income Taxes | (199,606) | 370,697 |
| Income Tax Expense (Benefit) | (76,000) | 38,000 |
| Net Income (Loss) | \$ (123,606) | \$ 332,697 |
| Earnings (Loss) Per Common Share: | | |
| Basic | \$ (0.05) | \$ 0.12 |
| Weighted Average Number of Common Shares Outstanding - Basic | 2,746,325 | 2,742,992 |
| Diluted | \$ (0.05) | \$ 0.12 |
| Weighted Average Number of Common Shares Outstanding - Diluted | 2,746,325 | 2,747,943 |

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

| | NINE MONTHS ENDED SEPTEMBER 30 | |
|--|-----------------------------------|---------------|
| | 2015 | 2014 |
| Net Sales | \$ 83,750,159 | \$ 81,595,474 |
| Cost of Goods Sold | 75,563,295 | 71,711,557 |
| Gross Profit | 8,186,864 | 9,883,917 |
| Operating Expenses | | |
| Selling Expenses | 3,918,318 | 3,570,066 |
| General and Administrative Expenses | 4,930,964 | 5,256,963 |
| Total Operating Expenses | 8,849,282 | 8,827,029 |
| Income (Loss) From Operations | (662,418) | 1,056,888 |
| Other Expense | | |
| Interest Expense | (341,148) | (271,661) |
| Miscellaneous Expense, net | (88,189) | (46,672) |
| Total Other Expense | (429,337) | (318,333) |
| Income (Loss) Before Income Taxes | (1,091,755) | 738,555 |
| Income Tax Expense (Benefit) | (397,000) | 73,000 |
| Net Income (Loss) | \$ (694,755) | \$ 665,555 |
| Earnings (Loss) Per Common Share: | | |
| Basic | \$ (0.25) | \$ 0.24 |
| Weighted Average Number of Common Shares Outstanding - Basic | 2,745,568 | 2,742,992 |
| Diluted | \$ (0.25) | \$ 0.24 |
| Weighted Average Number of Common Shares Outstanding - Diluted | 2,745,568 | 2,747,552 |

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

| | NINE MONTHS ENDED SEPTEMBER 30 | |
|---|-----------------------------------|--------------|
| | 2015 | 2014 |
| Cash Flows From Operating Activities | | |
| Net Income (Loss) | \$ (694,755) | \$ 665,555 |
| Adjustments to Reconcile Net Income (Loss) to Net Cash Provided by (Used in) Operating Activities | | |
| Depreciation | 1,618,791 | 1,517,153 |
| Amortization | 50,312 | 3,969 |
| Compensation on Stock-Based Awards | 1,320 | 22,445 |
| Compensation on Equity Appreciation Rights | (94,652) | |
| Loss on Disposal of Property and Equipment | 1,129 | 1,837 |
| Deferred Taxes | 55,685 | 51,680 |
| Changes in Current Operating Items, Net of Acquisition | | |
| Accounts Receivable | (1,625,756) | 424,782 |
| Inventories | (1,729,429) | (2,988,729) |
| Prepaid Expenses | (377,554) | (340,252) |
| Income Taxes Receivable | (530,028) | (259,877) |
| Accounts Payable | 5,238,304 | 1,443,580 |
| Accrued Payroll and Commissions | 422,436 | 687,373 |
| Other Accrued Liabilities | 1,592,378 | 175,669 |
| Net Cash Provided by (Used in) Operating Activities | 3,928,181 | 1,405,185 |
| Cash Flows from Investing Activities | | |
| Business Acquisition, Net of Cash Acquired | (1,990,143) | |
| Purchases of Property and Equipment | (1,456,795) | (1,800,819) |
| Net Cash Used in Investing Activities | (3,446,938) | (1,800,819) |
| Cash Flows from Financing Activities | | |
| Borrowings on Line of Credit | 83,642,816 | 83,477,209 |
| Repayments on Line of Credit | (84,744,548) | (82,881,103) |
| Proceeds from Long-Term Debt | 1,358,767 | 510,000 |
| Principal Payments on Long-Term Debt | (755,247) | (506,990) |
| Debt Issuance Costs | (48,745) | |
| Excess Tax Benefit from Stock-Based Compensation | 911 | |
| Proceeds from Issuance of Common Stock | 10,666 | |
| Net Cash Provided by (Used in) Financing Activities | (535,380) | 599,116 |
| Net Increase in Cash | (54,137) | 203,482 |
| Cash - Beginning | 66,371 | |
| Cash - Ending | \$ 12,234 | \$ 203,482 |
| Supplemental Disclosure of Cash Flow Information | | |
| Cash Paid During the Period for Interest | \$ 320,381 | \$ 268,371 |
| Cash Paid During the Period for Income Taxes | | 417,615 |
| Supplemental Noncash Investing and Financing Activities | | |
| Capital Expenditures in Accounts Payable | 13,700 | 35,720 |

See Accompanying Condensed Notes to Consolidated Financial Statements

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

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

Principles of Consolidation

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

Revenue Recognition

We recognize manufacturing revenue when we ship goods or the goods are received by our customer, when title has passed, all contractual obligations have been satisfied, the price is fixed or determinable and collection of the resulting receivable is reasonably assured. Generally, there are no formal substantive customer acceptance requirements or further obligations related to manufacturing services. If such requirements or obligations exist, then we recognize the related revenues at the time when such requirements are completed and the obligations are fulfilled. We also provide engineering services separate from the manufacture of a product. Revenue for engineering services is generally recognized on a time and material basis or upon completion of the engineering process. In addition, we have another separate source of revenue that comes from short-term repair services, which are recognized when the repairs are completed and the repaired products are shipped back to the customer. Our

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net sales for services were less than 5% of our total sales for all periods presented, and accordingly, are included in net sales in the consolidated statement of operations. Shipping and handling costs charged to our customers are included in net sales, while the corresponding shipping expenses are included in cost of goods sold.

Stock Options

Following is the status of all stock options outstanding as of September 30, 2015:

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| | Shares | Weighted-Average Exercise Price Per Share | Weighted-Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|----------------------------------|----------|---|--|---------------------------|
| Outstanding - January 1, 2015 | 181,000 | \$ 6.36 | | |
| Granted | | | | |
| Exercised | (3,333) | 3.20 | | |
| Cancelled | (37,917) | 5.52 | | |
| Outstanding - September 30, 2015 | 139,750 | \$ 6.66 | 2.24 | \$ 16,800 |
| Exercisable - September 30, 2015 | 134,917 | \$ 6.78 | 2.06 | \$ 11,725 |

The total intrinsic value of options exercised during the three and nine months ended September 30, 2015 was \$8,166. Cash received from options exercised during the three and nine months ended September 30, 2015 was \$10,666. There were no options exercised during the three and nine months ended September 30, 2014. There were no stock options granted during the three and nine months ended September 30, 2015 and 2014.

Total compensation expense related to stock options for the three months ended September 30, 2015 and 2014 was \$1,989 and \$7,482, respectively. Total compensation expense related to stock options for the nine months ended September 30, 2015 and 2014 was \$1,320 and \$22,445, respectively. As of September 30, 2015, there was approximately \$3,000 of unrecognized compensation related to unvested option awards that we expect to recognize over a weighted-average period of 0.37 years.

Equity Appreciation Rights Plan

In November 2010, the Board of Directors approved the adoption of the Nortech Systems Incorporated Equity Appreciation Rights Plan (the 2010 Plan). The total number of Equity Appreciation Right Units (Units) the Plan can issue shall not exceed an aggregate of 1,000,000 Units as amended and restated on March 11, 2015 and approved by the shareholders on May 6, 2015. The 2010 Plan provides that Units issued shall fully vest three years from the base date as defined in the agreement unless terminated earlier. Units give the holder a right to receive a cash payment equal to the appreciation in book value per share of common stock from the base date, as defined, to the redemption date. Unit redemption payments under the 2010 Plan shall be paid in cash within 90 days after we determine the value as of the redemption date.

During the nine months ended September 30, 2015, we granted 57,500 Units with a base date of January 1, 2015 and vesting dates through January 1, 2018.

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Total compensation expense (income) related to the vested outstanding Units based on the estimated appreciation over their remaining terms was approximately \$(37,000) and \$38,000 for the three months ended September 30, 2015 and 2014, respectively and \$(95,000) and \$119,000 for the nine months ended September 30, 2015 and 2014, respectively. The income for the three and nine months ended September 30, 2015 was the result of a change in the assumption of the appreciation of book value per share of common stock.

As of September 30, 2015 and December 31, 2014, approximately \$118,000 and \$259,000 is accrued under this plan, respectively. As of September 30, 2015, approximately \$55,000 of this balance is included in Other Accrued Liabilities and the remaining \$63,000 balance was included in Other Long-term Liabilities. As of December 31, 2014, approximately \$47,000 of this balance is included in Other Accrued Liabilities and the remaining \$212,000 was included in Other Long-term Liabilities.

Earnings per Common Share

For the three and nine months ended September 30, 2015, the effect of all stock options is antidilutive due to the net loss incurred and, therefore, were not included in the computation of per-share amounts. For the three and nine months ended September 30, 2015, stock options of 123,750 and 125,500, respectively, were excluded because their inclusion would be antidilutive.

For both the three and nine months ended September 30, 2014, 26,750 stock options were included in the computation of diluted per share amounts as their impact was dilutive. For the three and nine months ended September 30, 2014, stock options of 169,250 and 178,139, respectively were excluded because their inclusion would be antidilutive.

Segment Reporting Information

All of our operations fall under the Contract Manufacturing segment within the Electronic Manufacturing Services industry. We strategically direct production between our various manufacturing facilities based on a number of considerations to best meet our customers' requirements. We share resources for sales, marketing, engineering, supply chain, information services, human resources, payroll, and all corporate accounting functions. Consolidated financial information is available that is evaluated regularly by the chief operating decision maker in assessing performance and allocating resources.

Accounts Receivable and Allowance for Doubtful Accounts

We grant credit to customers in the normal course of business. Accounts receivable are unsecured and are presented net of an allowance for doubtful accounts. The allowance for doubtful accounts was \$130,000 and \$137,000 at September 30, 2015 and December 31, 2014, respectively. We determine our allowance by considering a number of factors, including the length of time accounts receivable are past due, our previous loss history, the customers' current ability to pay their obligations to us, and the condition of the general economy and the industry as a whole. We write-off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for uncollectible accounts.

Table of Contents*Inventories*

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

Inventories are as follows:

| | September 30 2015 | December 31 2014 |
|-----------------|----------------------|---------------------|
| Raw Materials | \$ 14,238,633 | \$ 12,745,623 |
| Work in Process | 3,840,602 | 3,653,670 |
| Finished Goods | 2,999,565 | 2,861,373 |
| Reserve | (816,594) | (732,248) |
| Total | \$ 20,262,206 | \$ 18,528,418 |

Finite Life Intangible Assets

Finite life intangible assets at September 30, 2015 and December 31, 2014 are as follows:

| | Remaining Lives (Years) | September 30, 2015 | | |
|------------------------|-------------------------------|-----------------------------|-----------------------------|-------------------|
| | | Gross Carrying Amount | Accumulated Amortization | Net Book Value |
| Customer Relationships | 9.0 | \$ 1,302,000 | \$ 36,167 | \$ 1,265,833 |
| Trade Names | 20.0 | \$ 814,000 | \$ 10,174 | \$ 803,826 |
| Bond Issue Costs | 6.0 | \$ 79,373 | \$ 48,948 | \$ 30,425 |
| Totals | | \$ 2,195,373 | \$ 95,289 | \$ 2,100,084 |

| | Remaining Lives (Years) | December 31, 2014 | | |
|------------------|-------------------------------|-----------------------------|-----------------------------|-------------------|
| | | Gross Carrying Amount | Accumulated Amortization | Net Book Value |
| Bond Issue Costs | 7.0 | \$ 79,373 | \$ 44,978 | \$ 34,395 |
| Totals | | \$ 79,373 | \$ 44,978 | \$ 34,395 |

Amortization expense for the three months ended September 30, 2015 and 2014 was \$47,665 and \$1,323, respectively. Amortization expense for the nine months ended September 30, 2015 and 2014 was \$50,312 and \$3,969, respectively.

Estimated future amortization expense related to these assets is as follows:

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| | | |
|-------------------|----|-----------|
| Remainder of 2015 | \$ | 49,000 |
| 2016 | | 160,000 |
| 2017 | | 160,000 |
| 2018 | | 160,000 |
| 2019 | | 160,000 |
| Thereafter | | 1,411,084 |
| Total | \$ | 2,100,084 |

Impairment Analysis

We evaluate long-lived assets, primarily property and equipment, as well as the related depreciation periods, whenever current events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. Recoverability for assets to be held and used is based on our projection of the undiscounted future operating cash flows of the underlying assets. To the extent such projections indicate that future undiscounted cash flows are not sufficient to recover the carrying amounts of related assets, a charge might be required to reduce the carrying amount to equal estimated fair value.

Recent Accounting Pronouncements

In July 2015, the Financial Accounting Standards Board issued changes to the subsequent measurement of inventory. Currently, an entity is required to measure its inventory at the lower of cost or market, whereby market can be replacement cost, net realizable value, or net realizable value less an approximately normal profit margin. The changes require that inventory be measured at the lower of cost and net realizable value, thereby eliminating the use of the other two market methodologies. Net realizable value is defined as the estimated selling prices in the ordinary course of business less reasonably predictable costs of completion, disposal, and transportation. These changes do not apply to inventories measured using LIFO (last-in, first-out) or the retail inventory method. Currently, Nortech applies the net realizable value market option to measure non-LIFO inventories at the lower of cost or market. These changes become effective for Nortech on January 1, 2017. Management has determined that the adoption of these changes will not have an impact on the Consolidated Financial Statements.

In May 2014, the FASB issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This standard outlines a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that revenue is recognized when a customer obtains control of a good or service. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Transfer of control is not the same as transfer of risks and rewards, as it is considered in current guidance. In the first quarter of 2015, the FASB approved a deferral of the effective date to January 1, 2018. Upon adoption in 2018, the company will record an adjustment to retained earnings as of the beginning of the year of initial application, which can be either the earliest comparative period presented, with all periods

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presented under the new rules, or January 1, 2018, without restating prior periods presented. Management has not yet determined which transition reporting option it will apply.

In April 2014, the FASB issued ASU No. 2015-03, *Interest Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Cost*. This ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs is not affected by the new guidance. The updated standard will be effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. All entities have the option of adopting the new requirements as of an earlier date for financial statements that have not been previously issued. The guidance should be adopted on a retrospective basis, wherein the balance sheet of each individual period presented is adjusted to reflect the period-specific effects of applying the new guidance. The Company has adopted ASU 2015-03 and presented its debt issuance costs as a component of long term debt.

NOTE 2. CONCENTRATION OF CREDIT RISK AND MAJOR CUSTOMERS

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash and accounts receivable. With regard to cash, we maintain our excess cash balances in checking accounts at two high-credit quality financial institutions. These accounts may at times exceed federally insured limits. We grant credit to customers in the normal course of business and do not require collateral on our accounts receivable.

Our largest customer, General Electric, has two divisions that collectively account for more than 10% of net sales for the three and nine months ended September 30, 2015 and 2014:

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|------------------------|------------------------------------|------|-----------------------------------|------|
| | 2015 | 2014 | 2015 | 2014 |
| GE Healthcare | 18% | 23% | 18% | 24% |
| GE Transportation | 11 | 7 | 9 | 5 |
| Total General Electric | 29% | 30% | 27% | 29% |

Combined accounts receivable from both divisions represented 22% and 20% of total accounts receivable at September 30, 2015 and December 31, 2014, respectively.

Export sales represented 12% of net sales for the three and nine months ended September 30, 2015. Export sales represented 13% of net sales for the three and nine months ended September 30, 2014.

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NOTE 3. FINANCING ARRANGEMENTS

We have a credit agreement with Wells Fargo Bank (WFB) which was most recently amended on May 7, 2015 and provides for a line of credit arrangement of \$15.0 million that expires, if not renewed, on May 31, 2018. The credit arrangement also has a \$1.8 million real estate term note outstanding with a maturity date of March 31, 2027, an additional \$1.7 million real estate term note outstanding that is due, if not renewed, on December 31, 2027, an equipment loan for \$2.7 million and a new term loan facility of up to \$1.0 million for capital expenditures, both with maturity dates of May 31, 2018. We incurred \$54,838 of related costs and fees associated with the amended credit agreement. These fees were capitalized as a debt discount and are being amortized as interest expense over the term of the debt agreement. As of September 30, 2015, we have not borrowed against the \$1.0 million capital term note.

Long-term debt at September 30, 2015 and December 31, 2014 consisted of the following:

| | September 30 2015 | December 31 2014 |
|---|----------------------|---------------------|
| Real Estate Term Loan 1, interest at three month LIBOR + 2.75%, due in installments through March 31, 2027 | \$ 1,326,611 | \$ 1,415,461 |
| Real Estate Term Loan 2, interest at three month LIBOR + 2.75%, due in installments through December 31, 2027 | 1,376,400 | 1,460,100 |
| Equipment loan, interest at three month LIBOR + 2.75%, due January 31, 2016 | | 102,917 |
| Equipment loan, interest at three month LIBOR + 2.75%, due May 31, 2018 | | 1,117,863 |
| Equipment loan, interest at three month LIBOR + 2.75%, due May 31, 2018 | | 349,000 |
| Equipment loan, interest at three month LIBOR + 2.75%, due May 31, 2018 | 2,552,480 | |
| Blue Earth Bond, which bears a variable interest rate, due in installments through June 30, 2021 | 280,000 | 360,000 |
| Devicix Acq Note 1, subordinate debt, interest at 4.0% due July 1, 2019 | 942,070 | |
| Devicix Acq Note 2, subordinate debt, interest at 4.0% due July 1, 2019 | 1,224,691 | |
| Discount on Devicix Notes Payable | (151,984) | |
| Debt Issuance Costs | (48,744) | |
| Total debt | 7,501,524 | 4,805,341 |
| Less current maturities | 1,399,860 | 732,835 |
| Long-term debt | \$ 6,101,664 | \$ 4,072,506 |

Under the credit agreement, both the line of credit and real estate term notes are subject to variations in the LIBOR rate. Our line of credit bears interest at three-month LIBOR + 2.25% (approximately 2.6% at September 30, 2015) while our real estate term notes bear interest at three-month LIBOR + 2.75% (approximately 3.1% at September 30, 2015). The weighted-average interest rate on our line of credit was 2.6% and 2.8% for the three and nine months ended September 30, 2015. We had borrowing on our line of credit of \$6,896,452 and \$7,998,184 outstanding as of September 30, 2015 and December 31, 2014, respectively. The line of credit requires a lock box arrangement; however there are no acceleration clauses that would accelerate the maturity of our outstanding borrowings.

As part of the July 1, 2015 Devicix acquisition we entered into two unsecured subordinated promissory notes payable to the seller in the principal amounts of \$1.0 million and \$1.3 million. The \$1.0 million promissory note has a four-year term, bearing interest at 4% per annum, requiring monthly principal and interest payments of \$22,579 and is subject to offsets if certain revenue levels are not met. The \$1.3 million promissory note has a four year term and bears interest at 4% per annum, requiring monthly principal and interest payments of \$29,353 and is not subject to

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offset. The fair value of these loans is approximately \$931,000 and \$1,210,000, respectively assuming a market rate of 8%.

The credit agreement contains certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures.

The availability under the line is subject to borrowing base requirements, and advances are at the discretion of the lender. At September 30, 2015, we have net unused availability under our line of credit of approximately \$7.5 million. The line is secured by substantially all of our assets.

NOTE 4. INCOME TAXES

On a quarterly basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision based on the anticipated rate. As the year progresses, we refine our estimate based on the facts and circumstances, including discrete events, by each tax jurisdiction. Our effective tax rate for the three and nine months ended September 30, 2015 was 38% and 36%, respectively. Our effective tax rate for the three and nine months ended September 30, 2014 was 10%. The lower effective tax rate for 2014 was the result of a favorable audit settlement with the Minnesota Department of Revenue which included the acceptance of our research and development credits of \$100,000 which were previously reserved for as an uncertain position. The effective tax rate for the year ended December 31, 2015 is expected to be 36% compared to 8.4% for the year ended December 31, 2014. The decreased tax rate in 2014 was largely due to the result of the favorable audit settlement with the Minnesota Department of Revenue.

The differences between federal income taxes computed at the federal statutory rate and reported income taxes for the three and nine months ended September 30, 2015 and 2014 are as follows:

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|---|------------------------------------|------------|-----------------------------------|------------|
| | 2015 | 2014 | 2015 | 2014 |
| Statutory federal tax provision (benefit) | \$ (57,000) | \$ 129,000 | \$ (327,000) | \$ 259,000 |
| State income taxes (benefits) | (6,000) | 14,000 | (32,000) | 33,000 |
| Income tax credits | (14,000) | (19,000) | (39,000) | (33,000) |
| Change in uncertain tax positions | (4,000) | 1,000 | (4,000) | (99,000) |
| Return to provision true-up | 5,000 | (84,000) | 5,000 | (84,000) |
| Other | | (3,000) | | (3,000) |
| Income tax expense (benefit) | \$ (76,000) | \$ 38,000 | \$ (397,000) | \$ 73,000 |

At September 30, 2015, we had \$51,750 of net uncertain tax benefit positions remaining in other long-term liabilities related to research and development credits that would increase our effective income tax rate if recognized. At December 31, 2014, we had \$56,000 of net uncertain tax

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benefit positions recorded in other long-term liabilities that would reduce our effective income tax rate if recognized.

NOTE 5. COMMITMENTS AND CONTINGENCIES

We have various operating leases for production and office equipment, office space, and buildings under non-cancelable lease agreements expiring on various dates through 2022.

On April 1, 2015, we entered into an 89 month lease for approximately 19,000 square feet of space in Maple Grove, Minnesota for our new corporate headquarters. Annual rent payments during the lease term will increase from approximately \$139,000 to \$165,000. In addition to this rent obligation, we will also be responsible for certain costs, among other things, operating expenses, taxes, and insurance costs.

Rent expense for the three months ended September 30, 2015 and 2014 amounted to approximately \$272,000 and \$163,000, respectively. Rent expense for the nine months ended September 30, 2015 and 2014 amounted to approximately \$635,000 and \$499,000, respectively.

Approximate future minimum lease payments under non-cancelable leases subsequent to September 30, 2015 are as follows:

| Years Ending December 31, | Amount |
|--------------------------------------|---------------------|
| 2015 | \$ 231,710 |
| 2016 | 594,365 |
| 2017 | 551,734 |
| 2018 | 556,906 |
| 2019 | 400,299 |
| Thereafter | 452,303 |
| Total | \$ 2,787,317 |

NOTE 6. ACQUISITIONS

On July 1, 2015, the company completed the acquisition of substantially all of the assets of Devicix, LLC upon the terms and conditions contained in an Asset Purchase Agreement entered into on June 17, 2015.

Devicix is an innovative medical product design and engineering firm with a proven track record of helping clients move from concept to production. The addition of Devicix will enhance and broaden our capabilities for complete design, manufacturing and service, particularly for regulated medical devices.

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Acquisition date fair value of the consideration transferred totaled \$5.1 million which was comprised of cash payments of \$2.0 million from our operating line of credit at closing, \$0.5 million of customer deposits with the majority of the work to be completed by 2015 year end, assumed working capital deficit of \$0.5 million and two promissory notes payable to the seller in the aggregate principal amounts of \$1.0 million and \$1.3 million. The \$1.0 million promissory note has a four-year term, bearing interest at 4% per annum and is subject to offsets if certain revenue levels are not met. The \$1.3 million promissory note has a four year term and bears interest at 4% per annum and is not subject to offset. The fair value of these loans is approximately \$931,000 and \$1,210,000, respectively assuming a market rate of 8%.

The asset purchase agreement also includes additional consideration payable within 90 days of the completion of each of the first four 12-month periods after July 1, 2015. The earnout will be equal to 15% of eligible engineering revenue over a \$6,000,000 threshold and 3% of eligible production revenue generated from Devicix customers. The maximum dollar amount of earnout payments under the Asset Purchase Agreement is \$2,500,000. We estimated the fair value of the contingent consideration to be \$851,000 using a probability-weighted discounted cash flow model. This fair value measurement is based on significant inputs not observable in the market and thus represents a Level 3 measurement as defined in ASC 820.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the acquisition date:

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| | July 1, 2015 | |
|--|---------------------|-----------|
| Cash | \$ | 131,054 |
| Accounts Receivable | | 372,736 |
| AR due to Seller | | (172,736) |
| Prepaid Expenses and Inventory | | 34,727 |
| Total Current Assets | | 365,781 |
| Fixed Assets | | 83,149 |
| Trade Names | | 814,000 |
| Customer Relationship | | 1,302,000 |
| Goodwill | | 3,208,447 |
| Total Assets | \$ | 5,773,378 |
| Accounts Payable | \$ | 63,048 |
| Accrued Payroll, Benefits and Other Current Liab | | 121,837 |
| Customer Deposits | | 474,887 |
| Total Current Liabilities | \$ | 659,772 |
| Loans to Seller | \$ | 2,141,408 |
| Cash Paid at 7/1 | | 2,002,162 |
| Adjustment Paid in August | | 119,035 |
| Contingent Consideration | | 851,000 |
| Business Enterprise Value | | 5,113,605 |
| Total Liabilities & Equity | \$ | 5,773,378 |

Pending finalization of the earnout and fair value of the intangible assets in the fourth quarter of 2015, the Devicix acquisition has preliminarily resulted in \$3.2 million of goodwill, which is expected to be deductible for tax purposes. Specifically, the goodwill recorded as part of the acquisition of Devicix includes the following:

- the expected synergies and other benefits that we believe will result from combining the operations of Devicix with the operations of Nortech Systems;
- any intangible assets that did not qualify for separate recognition, as well as future, yet unidentified projects and products.

The company incurred \$62,000 in legal, professional, and other costs related to this acquisition accounted for as selling and administrative expenses. The weighted-average useful life of intangible assets acquired is 11.4 years.

The table below reflects our unaudited pro forma combined results of operations as if the acquisition had taken place as of January 1, 2014:

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| | Pro Forma Three Months Ended September 30, 2014 (unaudited) | Pro Forma Nine Months Ended September 30, 2014 (unaudited) | Pro Forma Nine Months Ended September 30, 2015 (unaudited) |
|--------------------------------|--|---|---|
| Net Sales | \$ 29,091,310 | \$ 84,997,713 | \$ 86,065,773 |
| Income (Loss) from Operations | \$ 433,417 | \$ 1,005,358 | \$ (449,260) |
| Net Income (Loss) | \$ 290,951 | \$ 623,218 | \$ (519,516) |
| Basic & Diluted | | | |
| Income (Loss) per Common Share | \$ 0.11 | \$ 0.23 | \$ (0.19) |

The pro forma unaudited results do not purport to be indicative of the results which would have been obtained had the acquisition been completed as of the beginning of the earliest period presented. In addition they do not include any benefits that may result from the acquisition due to synergies that may be derived from the elimination of any duplicative costs.

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

We are a Maple Grove, Minnesota based full-service electronics manufacturing services (EMS) contract manufacturer of wire and cable assemblies, printed circuit board assemblies, higher-level assemblies and box builds for a wide range of industries. We provide value added engineering services and technical support including design, testing, prototyping and supply chain management to customers mainly in the aerospace and defense, medical, and industrial equipment markets. We maintain facilities in Bemidji, Blue Earth, Eden Prairie, Mankato, Merrifield, and Milaca, Minnesota; Augusta, Wisconsin; and Monterrey, Mexico. All of our facilities are certified to one or more of the ISO standards, including 9001 and 13485, with most having additional certifications based on the needs of the customers they serve.

Summary of Results:

Our third quarter results reported increases in revenue and backlog over prior quarter along with improved income and cash provided from operations. Our net income and EPS were again impacted by customer and market mix and further investment costs associated with growth initiatives including the acquisition of Devicix, expansion of PCB assembly operations in Mexico and business development activities in Asia.

Actions taken during the first half of the year to improve the gross margin are showing some signs of improvement but not to the levels needed to achieve expected profitability. Increased focus on lean initiatives by work order and improvements to our NPI (new product introduction) process to reduce ramp up costs and time to market are underway. Additional business strategy adjustments and improvements to the pipe line qualification and quoting processes are being

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implemented. Other longer-term actions include reductions to excess capacity and possible divestitures of non-profitable businesses and a continued commitment to our growth initiatives.

Major events in the third quarter included the strategic acquisition of Devicix LLC, a medical product design and engineering firm that completes our service offering in the Medical market accounting for an increase in revenue in the third quarter of \$1.1 million. We shipped approximately \$400,000 of our first production runs of PCB assemblies in the quarter out of our Mexico operation and we relocated our Corporate offices from Wayzata MN to Maple Grove MN.

Revenue in the third quarter of 2015 was up approximately 8% or \$2.4 million compared to third quarter of 2014, and up approximately 13% or \$3.6 million compared to second quarter of 2015 along with backlog increasing over both prior year and previous quarter.

Our gross profit percentage for the three months ended September 30, 2015 was 9.5% compared to 12.6% for the three months ended September 30, 2014. Our gross profit percentage for the nine months ended September 30, 2015 was 9.8% compared to 12.1% for the nine months ended September 30, 2014. The gross profit percentage is being negatively affected by customer and market mix, new part start up costs and ramp up expense in Mexico. The quarter also had approximately \$700,000 in excess material sales with low margin.

We reported \$23,000 Income from Operations in the third quarter after two quarters of losses in fiscal 2015. Revenue increases and associated margin dollars account for the majority of the profit improvement along with continued SG&A expense controls.

Net loss for the three months ended September 30, 2015 was approximately \$124,000 or \$0.05 per diluted common share, compared to net income for the three months ended September 30, 2014 of approximately \$333,000 or \$0.12 per diluted common share. Net loss for the first nine months of 2015 was approximately \$695,000 or \$0.25 per diluted common share, compared to net income of approximately \$666,000 or \$0.24 per diluted common share for the same period in 2014.

Cash provided by operating activities for the first nine months of 2015 was approximately \$3.9 million. Cash was generated from the noncash addback of depreciation and amortization and the timing of working capital changes. Working capital increases in accounts receivable and inventory were offset by extending accounts payable terms and conditions.

Results of Operations:

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

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| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|-------------------------------------|------------------------------------|--------|-----------------------------------|--------|
| | 2015 | 2014 | 2015 | 2014 |
| Net Sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of Goods Sold | 90.5 | 87.4 | 90.2 | 87.9 |
| Gross Profit | 9.5 | 12.6 | 9.8 | 12.1 |
| Selling Expenses | 4.1 | 4.7 | 4.7 | 4.4 |
| General and Administrative Expenses | 5.3 | 6.2 | 5.9 | 6.4 |
| Income (Loss) from Operations | 0.1 | 1.7 | (0.8) | 1.3 |
| Other Expenses, Net | (0.7) | (0.4) | (0.5) | (0.4) |
| Income (Loss) Before Income Taxes | (0.6) | 1.3 | (1.3) | 0.9 |
| Income Tax Expense (Benefit) | (0.2) | 0.1 | (0.5) | 0.1 |
| Net Income (Loss) | (0.4)% | 1.2% | (0.8)% | 0.8% |

Net Sales:

We reported net sales of approximately \$30.4 million and \$28.0 million for the three months ended September 30, 2015 and 2014, respectively. We reported net sales of approximately \$83.8 million and \$81.6 million for the nine months ended September 30, 2015 and 2014, respectively. Our Industrial customers are leading the increase in revenue up 14% over prior year for both the quarter and nine months and our Devicix acquisition accounted for \$1.1 million of the increase. Net sales by our major EMS industry markets for the three and nine month periods ended September 30, 2015 and 2014 were as follows:

| (in thousands) | Three Months Ended September 30 | | | Nine Months Ended September 30 | | |
|-----------------------|------------------------------------|------------|-------------|-----------------------------------|------------|-------------|
| | 2015 \$ | 2014 \$ | % Change | 2015 \$ | 2014 \$ | % Change |
| Aerospace and Defense | 4,004 | 3,656 | 10 | 10,724 | 11,737 | (9) |
| Medical | 10,887 | 10,792 | 1 | 28,376 | 30,837 | (8) |
| Industrial | 15,518 | 13,590 | 14 | 44,650 | 39,021 | 14 |
| Total Sales | 30,409 | 28,038 | 8 | 83,750 | 81,595 | 3 |

Backlog:

Our 90-day order backlog as of September 30, 2015 increased 23% to approximately \$24.0 million, compared to approximately \$19.4 million at the beginning of the quarter. Backlog for our industrial and defense customers have increased over prior year and prior quarter. Backlog for our medical customers, which includes \$1.3 million in Devicix backlog, rebounded in the third quarter. Our manufacturing backlog consists of firm purchase orders and we expect a

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major portion of the current 90 day backlog to be realized as revenue during the following quarter. Our services backlog consists of contractual commitments for engineering services.

90 day backlog by our major EMS industry markets are as follows:

| (in thousands) | Backlog as of the Quarter Ended | | |
|-----------------------|---------------------------------|-----------------|----------------------|
| | September 30 2015 | June 30 2015 | September 30 2014 |
| Aerospace and Defense | \$ 5,455 | \$ 4,307 | \$ 3,689 |
| Medical | 9,120 | 6,143 | 10,112 |
| Industrial | 9,396 | 8,990 | 7,127 |
| Total Backlog | \$ 23,971 | \$ 19,440 | \$ 20,928 |

Our 90 day backlog varies due to order size, manufacturing delays, contract terms and conditions and timing from customer delivery schedules and releases. These variables cause inconsistencies in comparing the backlog from one period to the next.

Gross Profit:

Gross profit as a percent of net sales for the three months ended September 30, 2015 and 2014 was 9.5% and 12.6%, respectively. Gross profit as a percent of net sales for the nine months ended September 30, 2015 and 2014 was 9.8% and 12.1%, respectively. The gross profit percentage is being negatively affected by customer and market mix, new part number start up costs and ramp up costs related to Mexico. The quarter also had approximately \$700,000 in excess material sales with low margin.

Selling Expense:

Selling expense for the three months ended September 30, 2015 and 2014 was approximately \$1.2 million or 4.1% of sales and approximately \$1.3 million or 4.7% of sales, respectively. Selling expense for the nine months ended September 30, 2015 and 2014 was approximately \$3.9 million or 4.7% of sales and approximately \$3.6 million or 4.4% of sales, respectively. We will continue to match sales expense with demand to support business development activities needed to support growth initiatives.

General and Administrative Expense:

General and administrative expenses for the three months ended September 30, 2015 and 2014 were approximately \$1.6 million or 5.3% of sales and approximately \$1.7 million or 6.2% of sales, respectively. General and administrative expenses for the nine months ended September 30, 2015 and 2014 were approximately \$4.9 million or 5.9% of sales and approximately \$5.3 million or 6.4% of sales, respectively. The decrease in

general and administrative expense was due to cost reduction activities needed to match current customer demand.

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Income Taxes:

On a quarterly basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision based on the anticipated rate. As the year progresses, we refine our estimate based on the facts and circumstances, including discrete events, by each tax jurisdiction. Our effective tax rate for the three and nine months ended September 30, 2015 was 38% and 36%, respectively. Our effective tax rate for the three and nine months ended September 30, 2014 was 10%. The lower effective tax rate for 2014 was the result of a favorable audit settlement with the Minnesota Department of Revenue which included the acceptance of our research and development credits of \$100,000 which were previously reserved for as an uncertain position. The effective tax rate for the year ended December 31, 2015 is expected to be 36% compared to 8.4% for the year ended December 31, 2014. The decreased tax rate in 2014 was largely due to the result of the favorable audit settlement with the Minnesota Department of Revenue.

The differences between federal income taxes computed at the federal statutory rate and reported income taxes for the three and nine months ended September 30, 2015 and 2014 are as follows:

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|---|------------------------------------|------------|-----------------------------------|------------|
| | 2015 | 2014 | 2015 | 2014 |
| Statutory federal tax provision (benefit) | \$ (57,000) | \$ 129,000 | \$ (327,000) | \$ 259,000 |
| State income taxes (benefits) | (6,000) | 14,000 | (32,000) | 33,000 |
| Income tax credits | (14,000) | (19,000) | (39,000) | (33,000) |
| Change in uncertain tax positions | (4,000) | 1,000 | (4,000) | (99,000) |
| Return to provision true-up | 5,000 | (84,000) | 5,000 | (84,000) |
| Other | | (3,000) | | (3,000) |
| Income tax expense (benefit) | \$ (76,000) | \$ 38,000 | \$ (397,000) | \$ 73,000 |

Liquidity and Capital Resources:

We have satisfied our liquidity needs over the past several years with cash flows generated from operations and an operating line of credit through WFB. We also have real estate and equipment term loans. On May 7, 2015, we entered into an amendment to our credit agreement with WFB providing for a \$15.0 million line of credit through May 31, 2018, which is a \$1.5 million increase from the previous line. The amendment also provides a new equipment term note in the amount of approximately \$1.0 million, which is in addition to the existing equipment term notes in the aggregate amount of approximately \$2.7 million, all of which equipment term notes having a maturity date of May 31, 2018. In addition, the amendment provides for a new term loan of up to \$1.0 million for capital expenditures to be made prior to May 31, 2018 with a maturity date of May 31, 2018. The amendment did not amend any terms of the two real estate term loans outstanding in an aggregate amount of approximately \$3.5 million under the existing agreement.

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Both the line of credit and real estate term notes are subject to fluctuations in the LIBOR rates. The line of credit, real estate term notes, and equipment loans with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. The availability under our line is subject to borrowing base requirements, and advances are at the discretion of the lender. The line of credit is secured by substantially all of our assets.

On September 30, 2015, we had outstanding advances of \$6.9 million under the line of credit and unused availability of \$7.5 million supported by our borrowing base. We believe our financing arrangements and cash flows to be provided by operations will be sufficient to satisfy our future working capital needs. Our working capital was \$20.1 million and \$24.3 million as of September 30, 2015 and December 31, 2014, respectively.

Our credit agreement with WFB requires us to maintain a minimum fixed charge coverage ratio of not less than 1.10 to 1.00 for the trailing twelve month period ending January 31, 2015, up to and including September 30, 2015, and 1.20 to 1.00 for each period thereafter. The minimum fixed charge coverage ratio at September 30, 2015 was 1.22 to 1.00. We believe our performance will be sufficient to comply with this covenant going forward.

Net cash provided by operating activities for the nine months ended September 30, 2015 was \$3.9 million. Cash was generated by the noncash addback of amortization and depreciation and the timing of accounts payable.

Net cash used in investing activities of \$3.4 million for the nine months ended September 30, 2015 is comprised of \$1.4 million of property and equipment purchases to support the business, and \$2.0 million related to the Devicix acquisition.

Off-Balance Sheet Arrangements:

We have not engaged in any off-balance sheet activities as defined in Item 303(a)(4) of Regulation S-K.

Critical Accounting Policies and Estimates:

Our significant accounting policies and estimates are summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2014. There have been no significant changes in these critical accounting policies since December 31, 2014. Some of our accounting policies require us to exercise significant judgment in selecting the appropriate assumptions for calculating financial estimates. Such judgments are subject to an inherent degree of uncertainty. These judgments are based on our historical experience, known trends in our industry, terms of existing contracts and other information from outside sources, as appropriate. Actual results could differ from these estimates.

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Recent Accounting Pronouncements:

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This standard outlines a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that revenue is recognized when a customer obtains control of a good or service. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Transfer of control is not the same as transfer of risks and rewards, as it is considered in current guidance. In the first quarter of 2015, the FASB approved a deferral of the effective date to January 1, 2018. Upon adoption in 2018, the company will record an adjustment to retained earnings as of the beginning of the year of initial application, which can be either the earliest comparative period presented, with all periods presented under the new rules, or January 1, 2018, without restating prior periods presented. Management has not yet determined which transition reporting option it will apply.

Forward-Looking Statements:

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

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

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The factors identified above are believed to be important factors (but not necessarily all of the important factors) that could cause actual results to differ materially from those expressed in any forward-looking statement made by us. Unpredictable or unknown factors not discussed herein could also have material adverse effects on forward-looking statements. All forward-looking

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statements included in this Form 10-Q are expressly qualified in their entirety by the forgoing cautionary statements. We undertake no obligations to update publicly any forward-looking statement (or its associated cautionary language) whether as a result of new information or future events.

Please refer to forward-looking statements and risks as previously disclosed in our report on Form 10-K for the fiscal year ended December 31, 2014.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures:

In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q, our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Exchange Act). These controls and procedures are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation of these disclosure controls and procedures as of the date of the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective.

Changes in Internal Control Over Financial Reporting:

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

PART II

ITEM 1. LEGAL PROCEEDINGS

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

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ITEM 6. EXHIBITS

Exhibits

- 10.1 Restated Amendment to Employment Agreement restated as of August 5, 2015 between the Company and Michael J. Degen
- 31.1* Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
- 31.2* Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
- 32* Certification of the Chief Executive Officer and Chief Financial Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101* Financial statements from the quarterly report on Form 10-Q for the quarter ended September 30, 2015, formatted in XBRL: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Cash Flows, and (iv) the Condensed Notes to Consolidated Financial Statements.

*Filed herewith

Signatures

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

Nortech Systems Incorporated and Subsidiaries

Date: November 4, 2015

by /s/ Richard G. Wasielewski
Richard G. Wasielewski
Chief Executive Officer and President
Nortech Systems Inc.

Date: November 4, 2015

by /s/ Paula M. Graff
Paula M. Graff
Vice President and Chief Financial Officer
Nortech Systems Inc.