ELECTRO SENSORS INC
Form 10-K
March 21, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-K

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

For the fiscal year ended December 31, 2013
or

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

Commission file number 000-09587

ELECTRO-SENSORS, INC.
(Exact name of registrant as specified in its charter)

Minnesota	**41-0943459**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

6111 Blue Circle Drive
Minnetonka, Minnesota 55343-9108
(Address of principal executive offices, including zip code)

(952) 930-0100
(Registrant s telephone number)

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

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. Yes o No x

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 o

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 Regulation 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 x No o

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form

10-K or any amendment to this Form 10-K. x

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 o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

The aggregate market value of the voting stock held by non-affiliates (persons other than officers, directors, or holders of more than 5% of the outstanding stock) of the registrant was approximately $5,200,000 based upon the closing price of the Common Stock as reported on The Nasdaq Stock Market® on June 30, 2013.

The number of shares outstanding of the registrant s Common Stock, $0.10 par value, on March 19, 2014 was 3,395,521.

DOCUMENTS INCORPORATED BY REFERENCE

Certain information called for by Part III of this Form 10-K is incorporated by reference from the registrant s Definitive Proxy Statement which will be filed pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

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PART I

Item 1. Business.

Introduction

Electro-Sensors, Inc. (we , us , our , the Company or ESI) is engaged in the manufacturing and distribution of industrial production monitoring process control systems.

In addition, through our subsidiary ESI Investment Company, we periodically make strategic investments in other businesses and companies, primarily when we believe that these investments will facilitate development of technology complementary to our existing products. Although we invest in other businesses and companies through our subsidiary ESI Investment Company, we do not intend to become an investment company and intend to remain primarily an operating company. As of March 19, 2014, our primary investment is 192,157 shares of Rudolph Technologies, Inc., which is accounted for using the available-for-sale method.

Unless indicated otherwise, the terms Company and ESI when used herein, include Electro-Sensors, Inc. and its consolidated subsidiaries. As of December 31, 2013, ESI had two consolidated subsidiaries: ESI Investment Company and Senstar Corporation. Senstar Corporation does not have any business operations.

ESI was incorporated in Minnesota in July 1968. Our executive offices are located at 6111 Blue Circle Drive, Minnetonka, Minnesota, 55343-9108. Our telephone number is (952) 930-0100.

Products

We manufacture and sell several different types of monitoring systems that measure actual machine production and operation rates, as well as systems that regulate the speed of related machines in production processes.

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

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

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

We have several products used in drive control systems that regulate the speed of motors on related machines in a production sequence to ensure that the performances of various operations are coordinated. The products consist of a line of digital control products for motors that require a complete closed loop PID (Proportional Integral Derivative) control. The closed loop controllers coordinate production speed among process motors and reduce waste.

We have a sales agreement with Motrona GmbH (the West German manufacturer of control and interface devices), giving us rights to distribute their products in the United States. These products interface with our products on various applications.

We believe that a wide variety of organizations can achieve significant savings in both time and materials by adding production monitoring and drive control technology to existing processes to coordinate the operation of related machines. Our products are sold into both the retro-fit market and into new manufacturing or processing systems.

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In 2008, we introduced our Electro-Sentry Hazard Monitoring System, which integrates our sensors for montioring temperature, belt misalignment, and shaft speed with a programmable logic controller and touch screen interface to create a complete system for hazard monitoring. The system enables our customers to locate which part of the material handling system is operating incorrectly, typically in less than ten seconds, by using visual diagrams on a touch screen. In 2012, we introduced the Electro-Sentry 16 hazard monitoring system and added new features to the Electro-Sentry 1 system.

In 2013, the Company added ION Frequency/Discrete-In, a product that allows users to remotely acquire shaft speed from up to 12 pulse-frequency-output shaft speed sensors, or discrete state for up to 12 switches/sensors, or any combination (up to 12) of both. This is our third ION product, completing the ION product line to support all ESI sensor products and providing the customer high-speed/accuracy signal acquisition at low cost and saved wiring costs. The Company also expanded the Series 18 shaft speed sensors to include additional housings and connection options to reach a broader range of installations. In addition, product upgrades for sensing capability and ruggedness were introduced on the Hall-effect sensors.

February 2014 Acquisition of Wireless Hazard Monitoring System

On February 18, 2014, the Company purchased the Insta-Link wireless hazard technology monitoring system and product family, together with related technology and intellectual property rights, from Harvest Engineering Inc., a privately held Illinois-based corporation, and its affiliated parties and owners (Harvest). The Company will market the wireless hazard monitoring products under its new HazardPRO™ product line and manufacture and service these products at its Minnetonka, Minnesota facility.

The Company agreed to pay $1,200,000 for the product line, of which $400,000 was paid at closing, and additional payments of $400,000 will be paid on each of the first and second anniversary of the closing. Harvest may earn up to an additional $550,000 of purchase price, depending upon the achievement of revenue measures during the four calendar years following the closing.

We expect to continue to expend resources in new product development and the marketing of new and existing products for use in a wide variety of monitoring applications.

Our customers have diverse applications for our products in the grain, feed, bio-fuels, power generation, water utilities and waste water treatment, mining, chemical, and other processing areas. We are continuing to look for new industries to expand sales and may also consider acquiring compatible businesses as part of our growth strategy. Our corporate web site provides significant information and product application knowledge to existing and prospective customers and also direct knowledge to our sales partners. Information on our website is not incorporated by reference herein and is not a part of this Form 10-K.

Marketing and Distribution

We sell our products primarily through both our internal sales team and a number of manufacturer s representatives and distributors located throughout the United States, Canada, Mexico, Bolivia, Chile, Colombia, Guatemala, Peru, Great Britain, Egypt, Saudi Arabia, Australia, China, Korea, Malaysia, Philippines, Singapore, and Taiwan. The sensing and control units are sold under the Electro-Sensors, Inc. brand as a range of products from simple sensors to complex motor speed controllers. These products are sold to businesses in wide variety of industries, including grain, feed, biofuels, food processing, chemicals, agricultural, mining, utility, forest products, steel, tire, glass and electronics. Any business that uses machinery with a rotating shaft is a potential customer.

We advertise in national industrial periodicals that cover a range of industrial products and attend several local, national and international tradeshows designated for the industry throughout the year. We also use our corporate website and other related industry websites for advertising and marketing purposes.

Competition

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

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Suppliers

We purchase parts and materials for our systems from various manufacturers and distributors. In some instances, these materials are manufactured in accordance with proprietary designs. Multiple sources of these parts and materials are generally available, and we are not dependent on any single source for these supplies and materials. We have not experienced any significant problem of short supply or delays from our suppliers.

Customers

We are not dependent upon a single or a few customers for a material (10% or more) portion of our sales.

Patents, Trademarks and Licenses

The Company relies on a combination of patent, trademark, and trade secret laws to establish proprietary right in its products.

The name Electro-Sensors is trademark registered with the U.S. Patent and Trademark Office (USPTO), as Reg. No. 1,142,310. We believe our trademark has been and will continue to be useful in developing and protecting market recognition for our products. We established the HazardPRO™ trademark in the first quarter of 2014 and will register the trademark with the USPTO during 2014.

We hold six patents relating to our production monitoring systems. The Company believes strongly in protecting its intellectual property and has a long history of obtaining patents, when available, in connection with its research and product development programs. The Company also relies upon trade secrets and proprietary know-how.

The Company seeks to protect its trade secrets and proprietary intellectual property, including know-how, in part, through confidentiality agreements with employees, consultants, and other parties. We cannot ensure, however, that these agreements will not be breached, that the Company would have adequate remedies for any breach, or that the Company s trade secrets will not otherwise become known or independently developed by competitors.

Business Development Activities

The Company continues to seek growth opportunities, both internally through the Company s existing portfolio of products, technologies and markets, as well as externally through technology partnerships or related-product acquisitions.

Governmental Approvals

We are not required to obtain governmental approval of our products.

Effect of Governmental Regulations

We do not believe that any existing or proposed governmental regulations will have a material effect on our business.

Research and Development

We invest in research and development programs to develop new products in related markets and to integrate state of the art technology into existing products. We incurred research and development expenses of $560,000 and $443,000 during 2013 and 2012, respectively. Our development projects are undertaken based upon the identified specific needs of our customer base.

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

Compliance with Environmental Laws

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

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Employees

As of March 19, 2014, we had 31 employees, of whom all are full-time. We believe that our relations with our employees are good. None of our employees are members of unions.

Our ability to maintain a competitive position and to continue to develop and market new products depends, in part, on our ability to retain key employees and qualified personnel. If we are unable to retain our key employees, or recruit and train others, our product development, marketing and sales could be negatively impacted.

Fluctuations in Operating Results.

We have experienced fluctuations in our operating results in the past, and may experience fluctuations in the future, which may affect the market price of our Common Stock. Sales can fluctuate as a result of a variety of factors, many of which are beyond our control. Some of these factors are: product competition and acceptance, timing of customer orders, cancellation of orders, the mix of products sold, downturns in the market and economic disruptions. Because fluctuations can happen, we caution investors that results of our operations for preceding periods may not be indicative of how we will perform in the future. We cannot ensure that we will experience revenue or earnings growth.

Further, investments held by our subsidiary, ESI Investment Company, are subject to significant positive and negative changes in value. In particular, our significant investment in Rudolph Technologies, Inc. has experienced substantial value fluctuations, both negative and positive, which are expected to continue. Our current intention is to continue to gradually liquidate our investment securities to finance our working capital needs as required.

Expending Funds for Changes in Industry Standards, Customer Preferences or Technology.

Our business depends upon periodically introducing new and enhanced products and solutions for customer needs. Our product development requires us to commit financial resources, personnel and time, usually in advance of significant market demand for these products. In order to compete, we must anticipate both future demand and the technology available to meet that demand. We cannot ensure that our research and development efforts will lead to new products or product innovations that can be made available to or will be accepted by the market.

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Cautionary Statements

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements made by us or on our behalf. We have made, and may continue to make, forward-looking statements with respect to our business and financial matters, including statements contained in this document, other filings with the Securities and Exchange Commission, and reports to shareholders. Forward-looking statements generally include discussion of current expectations or forecasts of future events and can be identified by the use of terminology such as believe, estimate, expect, intend, may, could, will, and similar words or expressions. Any statement that does not relate solely to historical fact sh considered forward-looking.

Our forward-looking statements generally relate to our growth strategy, future financial results, product development and sales efforts. Forward-looking statements are made throughout this Annual Report, but primarily in this Item 1 and Item 7 -*Management s Discussion and Analysis of Financial Condition and Results of Operations*, and include statements relating to management s intentions that we not become an investment company, our expectations and intentions with respect to growth, statements relating to management s beliefs with respect to our marketing and product development, our expectations and beliefs with respect to the value of our intellectual property, our beliefs with respect to our competitive position in the marketplace, our beliefs with respect to the effect of governmental regulations on our business, our beliefs with respect to our employee relations, our intention with respect to gradually liquidating our investment securities to finance working capital needs, our expectations and beliefs with respect to the future performance of our investment securities, the adequacy of our facilities, expansion of the number of our manufacturer s representatives and exclusive distributors, our intention to develop new products, the possibility of acquiring compatible businesses as part of our growth strategy, and our expectations with respect to our cash requirements and use of cash.

Forward-looking statements cannot be guaranteed and actual results may vary materially due to the uncertainties and risks, known and unknown, associated with such statements, including our ability to successfully develop new products and manage our cash requirements. We undertake no obligations to update any forward-looking statements. We wish to caution investors that the following important factors, among others, in some cases have affected and in the future could affect our actual results of operations and cause such results to differ materially from those anticipated in forward-looking statements made in this document and elsewhere by us or on our behalf. It is not possible to foresee or identify all factors that could cause actual results to differ from expected or historical results. As such, investors should not consider any list of such factors to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions. These factors include:

- our ability to successfully develop new products;
- our ability to successfully integrate the wireless hazard technology and product line we purchased in February 2014;
- our ability to quickly and successfully adapt to changing industry technological standards;
- our ability to comply with existing and changing industry regulations;
- our ability to manage cash requirements;
- our ability to attract and retain new manufacturer s representatives and distributors;
- our ability to attract and retain key personnel, including senior management;
- our ability to adapt to changing economic conditions and manage downturns in the economy in general; and
- our ability to keep pace with competitors, some of whom are much larger and have substantially greater resources than us.

Item 1A. Risk Factors.

Not required for smaller reporting companies.

Item 2. Properties.

We own and occupy a 25,400 square foot facility at 6111 Blue Circle Drive, Minnetonka, Minnesota 55343-9108. All operations are conducted within this facility. The facility is in excellent condition and we continue to maintain and update the facility as necessary. The facility is anticipated to be adequate for our needs in 2014.

Item 3. Legal Proceedings.

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

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Item 4. Mine Safety Disclosures.

Not applicable.

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

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

	Period	High	Low
2013	First Quarter	$ 4.62	$ 3.67
	Second Quarter	$ 4.66	$ 4.04
	Third Quarter	$ 4.83	$ 4.00
	Fourth Quarter	$ 4.59	$ 3.85
2012	First Quarter	$ 4.37	$ 3.59
	Second Quarter	$ 4.40	$ 3.99
	Third Quarter	$ 4.20	$ 3.29
	Fourth Quarter	$ 4.11	$ 3.61

Based on data provided by our transfer agent, management was informed that as of March 19, 2014, the number of share owner accounts of record was approximately 87. The Company is aware that there are additional shareholders in which the shares are held in the street name.

The Company paid cash dividends for a number of years, paying $272,000 in 2013 and $543,000 in 2012. In July 2013, the Company s Board announced that it had temporarily suspended the Company s dividend. In February 2014, the Board formally suspended the dividend to give the Company flexibility to pursue opportunities for future growth. The Board will continue to assess its capital resources and its working capital and liquidity needs, as well as strategic opportunities. The Company will consider various options for increasing shareholder value. These options may include acquisitions, partnerships, purchasing our own shares in the open market and in privately negotiated transactions, and resuming the payment of cash dividends.

From time to time, we may be required to repurchase some of our equity securities as a result of obligations described in Note 9 to our 2013 consolidated financial statements. We did not repurchase any equity securities during the years ended December 31, 2013 and 2012.

Item 6. Selected Financial Data.

Not required for smaller reporting companies.

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read in conjunction with our consolidated financial statements and related notes. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated due to various factors discussed under Forward-Looking Statements elsewhere in this Annual Report on Form 10-K.

RESULTS OF OPERATIONS

The following table contains selected financial information, for the periods indicated, from our consolidated statements of comprehensive income expressed as a percentages of net sales.

	Year Ended December 31,	
	2013	2012
Net Sales	100.0%	100.0%
Cost of Goods Sold	42.8	44.0
Gross Profit	57.2	56.0
Operating Expenses		
Selling and marketing	22.0	20.7
General and administrative	20.7	15.7
Research and development	8.6	6.8
Total Operating Expenses	51.3	43.2
Operating Income	5.9	12.8
Non-operating Income		
Gain on sale of available-for-sale securities	8.1	12.2
Interest income	.1	.1
Other income	.2	.2
Total Non-operating Income	8.4	12.5
Income before Income Taxes	14.3	25.3
Income Taxes	3.5	8.6
Net Income	10.8%	16.7%

The following paragraphs discuss the Company s performance for years ended December 31, 2013 and 2012.

Comparison of 2013 vs. 2012

Net Sales

Net sales increased $43,000 or 0.7%, to $6,541,000 in 2013 from $6,498,000 in 2012. Net sales increased steadily throughout the year reaching $3,104,000 for the six-month period ending June 30, 2013 and increasing by 10.7% to $3,438,000 in the second half of the year ending December 31, 2013. This increase was primarily driven by a 25.7% increase in system-level orders, which contain multiple pieces of monitoring equipment. We believe these larger projects were generally related to broader facility improvements, modernization programs, and capacity upgrades as companies responded to more favorable economic conditions and improved harvest yields. In addition, we experienced strong activity in the industrial and agricultural industries in the Canadian market resulting in a 32.7% year-over-year sales increase in that market.

Cost of Sales

Our cost of goods sold decreased $60,000 or 2.1%, to $2,798,000 from $2,858,000 in 2012, primarily due to a change in the mix of products, with a relative increase in the sale of higher margin products. We continue our efforts to maintain or reduce our production costs by manufacturing products in the most cost effective manner.

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Gross Profit

Gross profit for 2013 was 57.2% compared to 56.0% in 2012. The slight increase in the gross margin was primarily due to both a price increase that we put into effect in January 2013, and our focus on driving down manufacturing costs.

Operating Expenses

Total operating expenses increased by $545,000, or 19.4%, to $3,354,000 in 2013 compared to $2,809,000 in 2012. This increase was due to the following:

Selling and marketing costs increased by $98,000, or 7.3%, to $1,442,000 in 2013 compared to $1,344,000 in 2012. The increase was due to increased wages and benefit expense related to additional sales personnel and increased travel costs related to a higher number of customer visits, partially offset by decreases in marketing expenses and bonuses.

General and administrative costs increased by $330,000, or 32.3%, to $1,352,000 in 2013 compared to $1,022,000 in 2012. The increase was due primarily to noncash compensation expense on stock option grants for non-employee directors and our chief executive officer; depreciation and amortization expense related to the upgrade of our enterprise software system and related hardware; legal and professional fees related to our February 2014 acquisition of Harvest Engineering; compensation resulting from the July 2013 management transition; and a new director and officer liability insurance policy. These increases were partially offset by a decrease in bad debt expense due to 2012 write offs that did not occur in 2013. Stock-based compensation for 2013 was approximately $162,000 compared to approximately $6,000 in 2012.

Research and development costs increased $117,000, or 26.4%, to $560,000 in 2013 compared to $443,000 in 2012. The 2013 increase resulted from higher wages and benefits due to changes in management responsibilities and lab testing fees for the certification of new products for use in hazardous locations.

Operating Income

Operating income decreased by $442,000 or 53.2%, to $389,000 in 2013 from $831,000 in 2012, due primarily to the operating expense increases discussed above.

Non-Operating Income

ESI Investment Company continues to provide us with an alternative source of earnings through investments in available-for-sale securities and other investments. We intend to remain an operations-based company. Our investments in available-for-sale securities are subject to significant positive and negative changes in value. In addition to gains from the sale of investments, we also realize interest income from short-term holdings.

Non-operating income decreased by $262,000 to $549,000 in 2013 from $811,000 in 2012, primarily as a result of fewer gains on the sale of investments. The Company recognized a gain on sale of investments of $530,000 and $794,000 in 2013 and 2012, respectively, primarily from sales of shares of Rudolph Technologies, Inc.. The Company is in the process of slowly liquidating that investment.

Available-for-sale securities are stated at fair value, and unrealized holding gains and losses, net of the related deferred tax effect, are reported as a separate component of stockholders equity. Dividends on marketable equity securities are recognized on the ex-dividend date.

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

Net Income After Tax

We reported 2013 net income of $706,000 as compared to net income of $1,086,000 in 2012, a decrease of $380,000, or 35.0%. Basic and diluted earnings per share were $0.20 in 2013, compared to basic and diluted earnings per share of $0.32 and $0.31, respectively, in 2012.

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OFF-BALANCE SHEET ARRANGEMENTS

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

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were $1,505,000 and $1,102,000 at December 31, 2013 and 2012, respectively. The increase was mainly due to net cash from investing activities, as described below. Working capital was $11,068,000 at 2013 year end compared to $11,400,000 at 2012 year end.

Cash generated from 2013 operating activities was $127,000, compared to $732,000 generated in 2012, a decrease of $605,000. The decrease was primarily a result of a decrease in our net income adjusted for the gain on the sale of investments and noncash stock compensation expense, an increase in trade receivable, and a decrease in income tax accruals, partially offset by the change in inventories. The net change in trade receivables was primarily due to an increase of $142,000 in the balance at December 31, 2013 compared to the prior year and a decrease of $57,000 in the balance at December 31, 2012 when compared to the prior year. The increase is due to increased sales in the fourth quarter of 2013. The net change in income taxes was due to an increase in the receivable balance of $314,000 at December 31, 2013 compared to the prior year and an increase in the payable balance of $330,000 at December 31, 2012 when compared to the prior year. The increase in the net receivable was due to the timing of tax payments to meet IRS safe harbor rules. In 2013, the Company made estimated tax payments based on income. The Company made tax payments in 2012 based on the 2011 tax liability and paid the 2012 balance in March 2013. Those changes were partially offset by the $270,000 inventory decrease in the balance at December 31, 2013 compared to the prior year and an increase of $102,000 in the balance at December 31, 2012 when compared to the prior year. The decrease as of December 31, 2013 was due to increased sales in the fourth quarter of 2013.

Cash generated from 2013 investing activities was $539,000, compared to $4,571,000 of cash used in 2012 investing activities. We received $536,000 on the sale of investments during 2013 compared to $874,000 during 2012. During 2012, the Company implemented a significant increase in the purchase of Treasury Bills with maturity dates of more than three months. During 2013, the Company s proceeds from and purchases of Treasury Bills were roughly equivalent and the Company generated 2013 net proceeds of $26,000. We purchased $23,000 and $196,000 of property and equipment in the years ended December 31, 2013 and 2012, respectively.

Cash used in financing activities was $263,000 and $535,000 for 2013 and 2012, respectively. During 2013 and 2012, we paid aggregate dividends of $272,000 and $543,000, respectively. During 2013 and 2012, we had $9,000 and $8,000, respectively, in stock purchases under our 1996 Employee Stock Purchase Plan.

We intend that our ongoing cash requirements will be primarily used for capital expenditures, potential acquisitions, research and development, and working capital. Management believes that cash on hand and any cash provided by operations will be sufficient to meet our cash requirements through at least the next 12 months.

Our primary investment is 231,336 and 273,267 shares of Rudolph Technologies, Inc. (Rudolph), as of December 31, 2013 and 2012, respectively, listed on the Nasdaq stock market. We account for the Rudolph investment using the available-for-sale method. The fair value of the Rudolph investment totaled $2,716,000 and $3,673,000 as of December 31, 2013 and 2012, respectively. Our Rudolph shares are subject to fluctuations in price and could have a negative effect on our liquidity. Liquid securities are periodically sold as deemed appropriate by management. The market value of the Rudolph stock as of March 18, 2014 was approximately $2,169,000.

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CRITICAL ACCOUNTING ESTIMATES

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

Significant estimates, including the underlying assumptions, consist of the economic lives of property and equipment, realizability of accounts receivable, and valuation of deferred tax assets/liabilities, inventory, investments, and stock compensation expense. It is at least reasonably possible that these estimates may change in the near term.

Economic lives of property and equipment
We estimate the economic useful life of property and equipment used in the business. Expected asset lives may be shortened or an impairment would be recorded based on a change in the expected use of the asset.

Realizability of accounts receivable
We estimate our allowance for doubtful accounts based on prior history and the aging of our accounts receivable. We are unable to predict which, if any, of our customers will be unable to pay their open invoices at a future date.

Valuation of deferred tax assets/liabilities
We estimate our deferred tax assets and liabilities based on current tax laws and rates. The tax laws and rates could change in the future to either disallow the deductions or increase/decrease the tax rates.

Valuation of inventory
We purchase inventory based on estimated demand of products. It is possible that the inventory we have purchased will not be used in the products that our customers need or meet future technological requirements.

Valuation of investments
Our investments in equity securities are valued at market prices in an open market. The prices are subject to the normal fluctuations that could be either negative or positive.

Valuation of Stock-based Compensation Expense
We estimate the expected life and forfeiture rates of stock options granted when calculating the value of options using the Black-Sholes-Merton model. The actual life and forfeiture rate could be different from what we estimated.
Additional information regarding our significant accounting policies is provided below in Part II, Item 8, *Financial Statements and Supplementary Data Notes to Consolidated Financial Statements, Note 1, Nature of Business and Significant Accounting Policies*.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Not applicable.

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Item 8. Financial Statements and Supplementary Data.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors
Electro-Sensors, Inc. and Subsidiaries
Minnetonka, Minnesota

We have audited the accompanying consolidated balance sheets of Electro-Sensors, Inc. and Subsidiaries (the Company) as of December 31, 2013, and 2012, and the related consolidated statements of comprehensive income, changes in stockholders equity, and cash flows for each of the years in the two-year period ended December 31, 2013. Electro-Sensors, Inc. and Subsidiaries management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Electro-Sensors, Inc. and Subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2013 in conformity with accounting principles generally accepted in the United States of America.

/s/ Boulay PLLP
Certified Public Accountants

Minneapolis, Minnesota
March 21, 2014

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ELECTRO-SENSORS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands except share and per share amounts)

	December 31	
	2013	**2012**
ASSETS		
Current assets		
Cash and cash equivalents	**$ 1,505**	$ 1,102
Treasury bills	**5,227**	5,248
Available-for-sale securities	**2,718**	3,677
Trade receivables, less allowance for doubtful accounts of $8 and $10, respectively	**746**	602
Inventories	**1,060**	1,330
Income tax receivable	**1**	0
Other current assets	**135**	75
Total current assets	**11,392**	12,034
Property and equipment, net	**1,217**	1,304
Total assets	**$ 12,609**	$ 13,338
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	**$ 59**	$ 94
Accrued expenses	**265**	227
Income tax payable	**0**	313
Total current liabilities	**324**	634
Deferred income tax liability	**1,022**	1,455
Commitments and contingencies		
Stockholders equity		
Common stock par value $0.10 per share; authorized 10,000,000 shares; issued and outstanding: 3,394,707 and 3,391,912 shares, respectively	**339**	339
Additional paid-in capital	**1,746**	1,575
Retained earnings	**7,547**	7,113
Accumulated other comprehensive income (unrealized gain on available-for-sale securities, net of income tax)	**1,631**	2,222
Total stockholders equity	**11,263**	11,249
Total liabilities and stockholders equity	**$ 12,609**	$ 13,338

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ELECTRO-SENSORS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands except share and per share amounts)

	Years ended December 31, 2013	2012
Net Sales	**$ 6,541**	$ 6,498
Cost of Goods Sold	**2,798**	2,858
Gross Profit	**3,743**	3,640
Operating Expenses		
Selling and marketing	**1,442**	1,344
General and administrative	**1,352**	1,022
Research and development	**560**	443
Total Operating Expenses	**3,354**	2,809
Operating Income	**389**	831
Non-operating Income		
Gain on sale of available-for-sale securities	**530**	794
Interest income	**5**	4
Other income	**14**	13
Total Non-operating Income	**549**	811
Income before Income Taxes	**938**	1,642
Income Taxes	**232**	556
Net Income	**706**	1,086
Other Comprehensive Income:		
Change in unrealized value of available-for-sale securities, net of income tax	**(262)**	805
Reclassification of gains included in net income, net of income tax	**(329)**	(492)
Net increase (decrease) in other comprehensive income	**(591)**	313
Total Comprehensive Income	**$ 115**	$ 1,399
Net Income per share data		
Basic		
Net income per share	**$ 0.20**	$ 0.32
Weighted average shares	**3,394,208**	3,391,332
Diluted		
Net income per share	**$ 0.20**	$ 0.31
Weighted average shares	**3,496,873**	3,412,288
Dividends paid per common share	**$ 0.08**	$ 0.16

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ELECTRO-SENSORS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
(in thousands except share and per share amounts)

	Common Stock Issued		Additional		Accumulated	
	Shares	Amount	paid-in capital	Retained earnings	other comprehensive income	Total Stockholders equity
Balance, January 1, 2012	3,389,577	$ 339	$ 1,561	$ 6,570	$ 1,909	**$ 10,379**
Unrealized gains on available-for-sale securities, net of taxes					313	**313**
Stock issued through the employee stock purchase plan	2,335	0	8			**8**
Stock compensation expense			6			**6**
Dividend on common stock				(543)		**(543)**
Net income				1,086		**1,086**
Balance, December 31, 2012	3,391,912	339	1,575	7,113	2,222	**11,249**
Unrealized loss on available-for-sale securities, net of taxes					(591)	**(591)**
Stock issued through the employee stock purchase plan	2,795	0	9			**9**
Stock compensation expense			162			**162**
Dividend on common stock				(272)		**(272)**
Net income				706		**706**
Balance, December 31, 2013	**3,394,707**	**$ 339**	**$ 1,746**	**$ 7,547**	**$ 1,631**	**$ 11,263**

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ELECTRO-SENSORS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Years ended December 31, 2013	2012
Cash flows from (used in) operating activities		
Net Income	**$ 706**	$ 1,086
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation	**110**	71
Realized gain on sale of available-for-sale securities	**(530)**	(794)
Interest accrued on investments	**(5)**	1
Allowance for doubtful accounts	**(2)**	1
Deferred income taxes	**(71)**	38
Stock compensation expense	**162**	6
Changes in:		
Trade receivables	**(142)**	57
Inventories	**270**	(102)
Other current assets	**(60)**	41
Accounts payable	**(35)**	(16)
Accrued expenses	**38**	13
Accrued income taxes	**(314)**	330
Net cash from operating activities	**127**	732
Cash flows from (used in) investing activities:		
Proceeds from sale of available-for-sale securities	**536**	874
Purchase of treasury bills	**(6,425)**	(5,249)
Proceeds from the maturity of treasury bills	**6,451**	0
Purchase of property and equipment	**(23)**	(196)
Net cash from (used in) investing activities	**539**	(4,571)
Cash flows from (used in) financing activities:		
Proceeds from issuance of common stock	**9**	8
Dividends paid	**(272)**	(543)
Net cash used in financing activities	**(263)**	(535)
Net increase (decrease) in cash and cash equivalents	**403**	(4,374)
Cash and cash equivalents, beginning	**1,102**	5,476
Cash and cash equivalents, ending	**$ 1,505**	$ 1,102
Supplemental cash flow information		
Cash paid during the year for income taxes	**$ 617**	$ 207

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ELECTRO-SENSORS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2013 AND 2012
(in thousands except share and per share amounts)

Note 1. Nature of Business and Significant Accounting Policies

Nature of business:

The accompanying consolidated financial statements include the accounts of Electro-Sensors, Inc. and its wholly-owned subsidiaries, ESI Investment Company and Senstar Corporation. Senstar has no operations. Intercompany accounts, transactions and earnings have been eliminated in consolidation. The consolidated entity is referred to as the Company or ESI.

Electro-Sensors, Inc. manufactures and markets a complete line of speed monitoring and motor control systems for industrial machinery. The Company uses leading-edge technology to continuously improve its products and make them easier to use, with the ultimate goal of manufacturing the industry-preferred product for every market served. The Company s products are sold through an internal sales staff, manufacturer s representatives, and distributors in a wide variety of manufacturers, OEMs and processors to monitor process machinery operations. The Company markets its products to a number of different industries located throughout the United States, Canada, Latin America, Europe, and Asia.

In addition, through its subsidiary ESI Investment Company, the Company has in the past made strategic investments in other businesses and companies, primarily when the Company believes that these investments will facilitate development of technology complementary to the Company s products. Although ESI, through its subsidiary ESI Investment Company, invests in other businesses or companies, ESI does not intend to become an investment company and intends to remain primarily an operating company. The Company s primary investment is 231,336 shares of Rudolph Technologies, Inc. (Rudolph) which is accounted for using the available-for-sale method. See Note 2 for additional information regarding its investments. The Company s investments in securities are subject to normal market risks.

Significant accounting policies of the Company are summarized below:

Use of estimates

The preparation of the consolidated financial statements, in accordance with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Significant estimates, including the underlying assumptions, consist of the economic lives of property and equipment, realizability of accounts receivable, valuation of deferred tax assets/liabilities, inventory, investments, and stock compensation expense. It is at least reasonably possible that these estimates may change in the near term.

Cash and cash equivalents

The Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents. Cash equivalents are invested in commercial paper, money market accounts and may also be invested in three month Treasury Bills. Cash equivalents are carried at cost plus accrued interest which approximates fair value.

The Company maintains its cash and cash equivalents in primarily one bank deposit account, which, at times, may exceed federally insured limits. The Company has not experienced any losses on these accounts. The Company believes it is not exposed to any significant credit risk on cash.

Trade receivables and credit policies

Accounts receivable are uncollateralized customer obligations due under normal trade terms requiring payment within 30 days from the invoice date. Accounts receivables are stated at the amount billed to the customer. Customer account balances with invoices over 90 days are considered delinquent. The Company does not accrue interest on delinquent accounts receivable.

Payments of accounts receivable are allocated to the specific invoices identified on the customer s remittance advice or, if unspecified, are applied to the earliest unpaid invoices.

The carrying amount of accounts receivable is reduced by an allowance for doubtful accounts that reflects management s best estimate of the amounts that will not be collected. Management individually reviews all accounts receivable balances that exceed 90 days from the invoice date and based on an assessment of current creditworthiness, estimates the portion, if any, of the balance that may not be collected. Management uses this information to estimate the allowance.

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ELECTRO-SENSORS, INC. AND SUBSIDIARIES
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Available-for-sale securities

The Company s investments consist of equity securities, primarily common stocks and government debt securities. The estimated fair value of publicly traded equity securities is based on reported market prices, and therefore subject to the inherent risk of market fluctuations.

Management determines the appropriate classification of securities at the date individual investments are acquired, and evaluates the appropriateness of this classification at each balance sheet date.

Since the Company does not buy and sell investments with the objective of generating profits on short-term fluctuations in market price, the investments in marketable equity securities have been classified as available-for-sale. Available-for-sale securities are stated at fair value, and unrealized holding gains and losses, net of the related deferred tax effect, are reported as a separate component of stockholders equity and within accumulated other comprehensive income. Dividends on marketable equity securities are recognized as income on the ex-dividend date.

Realized gains and losses, including losses from declines in value of specific securities determined by management to be other-than-temporary, are included in the statement of comprehensive income. Realized gains and losses are determined on the basis of the specific securities sold. There were no other-than-temporary impairments in the years ended December 31, 2013 and 2012.

Fair Value Measurements

The Company s policies incorporate the guidance for accounting for fair value measurements of financial assets and financial liabilities and for fair value measurements of nonfinancial items that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis. The Company s policies also incorporate the guidance for fair value measurement related to nonfinancial items that are recognized and disclosed at fair value in the consolidated financial statements on a nonrecurring basis. The guidance establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to measurements involving significant unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.
- Level 3 inputs are unobservable inputs for the asset or liability.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company currently has no nonfinancial or financial items that are measured on a nonrecurring basis.

The carrying value of cash equivalents, treasury bills, commercial paper, money market funds, trade receivables, accounts payable, and other financial working capital items approximate fair value at December 31, 2013 and 2012 due to the short term maturity nature of these instruments.

Inventories

Inventories include material, labor and overhead and are valued at the lower of cost (first-in, first-out) or market.

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ELECTRO-SENSORS, INC. AND SUBSIDIARIES
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Property and equipment

Property and equipment are stated at cost. Depreciation is provided over estimated useful lives by use of the straight-line method. Maintenance and repairs are expensed as incurred. Major improvements and betterments are capitalized.

Long-lived assets, such as property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If circumstances require a long-lived asset be tested for possible impairment, the Company first compares undiscounted cash flows expected to be generated by an asset to the carrying value of the asset. If the carrying value of the long-lived asset is not recoverable on an undiscounted cash flow basis, impairment is recognized to the extent that the carrying value exceeds its fair value. Fair value is determined through various valuation techniques including, but not limited to, discounted cash flow models, quoted market values and third-party independent appraisals.

Revenue recognition

The Company recognizes revenue from the sale of its production monitoring equipment when persuasive evidence of an arrangement exists, the product has been picked up by common carrier, the fee is fixed and determinable and collection of the resulting receivable is reasonably assured. The Company may offer discounts to its distributors or quantity discounts that are recorded at the time of sale. The Company recognizes revenue on products sold to customers and distributors upon shipment because the contracts do not include post-shipment obligations. In addition to exchanges and warranty returns, customers have refund rights. Our standard products are used in a wide variety of industries; returns have historically been minimal and immaterial to the financial statements and are recognized when the returned product is received by the Company. In some situations, the Company receives advance payments from its customers. Revenue associated with these advance payments is deferred until the product is shipped or services performed.

Advertising costs

The Company expenses advertising costs as incurred. Total advertising expense was $59 and $89 for the years ended December 31, 2013 and 2012, respectively.

Research and development

Expenditures for research and development are expensed as incurred. We incurred expenses of $560 and $443 during the years ended December 31, 2013 and 2012, respectively.

Depreciation

The cost of property and equipment is depreciated on the straight-line method over the estimated economic useful lives.

Estimated useful lives are as follows

	Years
Equipment	3-10
Furniture and Fixtures	3-10
Building	7-40

Depreciation expense for the years ended December 31, 2013 and 2012 was $110 and $71, respectively.

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Income taxes

Deferred income taxes are provided on an asset and liability approach to financial accounting and reporting for income taxes. The difference between the financial statement and tax bases of assets and liabilities is determined annually. Deferred income tax assets and liabilities are computed for those differences that have future tax consequences using the currently enacted tax laws and rates that apply to the periods in which they are expected to affect taxable income. Income tax expense is the current tax payable or refundable for the period plus or minus the net change in the deferred tax assets and liabilities, excluding the portion of the deferred liability allocated to other comprehensive income. Deferred taxes are reduced by a valuation allowance to the extent that realization of the related deferred tax asset is not assured. The Company recognizes the effect of income tax positions only if those positions are more likely than not to be sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely to be realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

The Company records interest and penalties related to unrecognized tax benefits in income tax expense.

Net income per common share

Basis EPS excludes dilution and is determined by dividing net income by the weighted average number of common shares outstanding during the period. Diluted EPS reflects the potential dilution that could occur if securities and other contracts to issue common stock were exercised or converted into common stock.

The following information presents the Company s computations of basic and diluted EPS for the periods presented in the statements of comprehensive income.

	Income		Shares	Per share amount	
2013:					
Basic EPS	$	706	3,394,208	$	0.20
Effect of dilutive stock options			102,665		
Diluted EPS	$	706	3,496,873	$	0.20
2012:					
Basic EPS	$	1,086	3,391,332	$	0.32
Effect of dilutive stock options			20,956		
Diluted EPS	$	1,086	3,412,288	$	0.31

Stock Compensation

The Company records compensation expense for stock options based on the estimated fair value of the options on the date of grant using the Black-Scholes-Merton (BSM) model. The Company uses historical data, among other factors, to estimate the expected price volatility, the expected option life and the expected forfeiture rate. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option. At December 31, 2013, the Company had two stock-based compensation plans.

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Note 2. Investments

The cost and estimated fair value of the investments are as follows:

	Cost	Gross unrealized gain	Gross unrealized loss	Fair value
December 31, 2013				
Money Market Funds	$ 540	$ 0	$ 0	$ 540
Commercial Paper	601	0	0	601
Treasury Bills	5,226	1	0	5,227
Equity Securities	86	2,686	(54)	2,718
	6,453	2,687	(54)	9,086
Less Cash Equivalents	1,141	0	0	1,141
Total Investments, December 31, 2013	$ 5,312	$ 2,687	$ (54)	$ 7,945
December 31, 2012				
Money Market Funds	$ 804	$ 0	$ 0	$ 804
Commercial Paper	200	0	0	200
Treasury Bills	5,249	0	(1)	5,248
Equity Securities	92	3,639	(54)	3,677
	6,345	3,639	(55)	9,929
Less Cash Equivalents	1,004	0	0	1,004
Total Investments, December 31, 2012	$ 5,341	$ 3,639	$ (55)	$ 8,925

Realized gains and losses on investments are as follows:

	Years Ended December 31, 2013	2012
Gross Realized Gains	**$ 530**	$ 794
Gross Realized Losses	**0**	0
Net Realized Gain	**$ 530**	$ 794

At December 31, 2013 and 2012, the Company s significant investment in equity securities is 231,336 and 273,267, respectively, shares of Rudolph, accounted for under the available-for-sale method. As of December 31, 2013 and 2012, the aggregate value of the Company s Rudolph shares as reported on the Nasdaq Stock Exchange was approximately $2,716 and $3,673, respectively, with an approximate cost of $30 and $36, respectively. During the years ended December 31, 2013 and 2012, the Company sold 41,931 and 70,000 shares, respectively, of Rudolph stock and reported a gain of $529 and $794, respectively, in other income.

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Changes in Accumulated Other Comprehensive Income

Changes in Accumulated Other Comprehensive Income are as follows:

	December 31, 2013	December 31, 2012
Unrealized Gains (Losses)		
Unrealized Holding Gains (Losses) arising during the Period	**$ (422)**	$ 1,299
Less: reclassification of gains included in net income	**(530)**	(794)
	(952)	505
Deferred Taxes on Unrealized Gains (Losses):		
Increase in Deferred Taxes on Unrealized Gains (Losses) arising during the Period	**(160)**	494
Less: Reclassification of taxes on gains included in net income	**(201)**	(302)
	(361)	192
Net Change in Accumulated Other Comprehensive Income	**$ (591)**	$ 313

Note 3. Fair Value Measurements

The following table provides information on those assets measured at fair value on a recurring basis.

	Carrying amount in consolidated balance sheet December 31, 2013	Fair Value December 31, 2013	Fair Value Measurement Using Level 1	Level 2	Level 3
Assets:					
Cash and cash equivalents:					
Money Market Funds	$ 540	$ 540	$ 540	$ 0	$ 0
Commercial Paper	601	601	601	0	0
Treasury Bills	5,227	5,227	5,227	0	0
Available-for-sale:					
Equities:					
Small Cap Technology Sector	2,718	2,718	2,718	0	0

	Carrying amount in consolidated balance sheet December 31, 2012	Fair Value December 31, 2012	Fair Value Measurement Using Level 1	Level 2	Level 3
Assets:					
Cash and cash equivalents:					
Money Market Funds	$ 804	$ 804	$ 804	$ 0	$ 0
Commercial Paper	200	200	200	0	0
Treasury Bills	5,248	5,248	5,248	0	0
Available-for-sale:					
Equities:					
Small Cap Technology Sector	3,677	3,677	3,677	0	0

The fair value of the money market funds, commercial paper, and treasury bills are based on quoted market prices in an active market. Available-for-sale securities include equity securities that are traded in an active market. Closing stock prices are readily available from active markets and are used as being representative of fair value. The Company classifies these securities as level 1.

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Note 4. Inventories

Inventories used in the determination of cost of goods sold are as follows:

	December 31, 2013	December 31, 2012
Raw Materials	$ 658	$ 835
Work In Process	226	283
Finished Goods	176	212
Total Inventories	$ 1,060	$ 1,330

Note 5. Property and Equipment

The following is a summary of property and equipment:

	December 31, 2013	December 31, 2012
Equipment	$ 272	$ 259
Furniture and Fixtures	388	382
Building	1,365	1,365
Land	415	415
	2,440	2,421
Less Accumulated Depreciation	1,223	1,117
Total Property and Equipment	$ 1,217	$ 1,304

Note 6. Accrued Expenses

Accrued expenses include the following:

	December 31, 2013	December 31, 2012
Wages and Commissions	$ 195	$ 147
Other	70	80
Total Accrued Expenses	$ 265	$ 227

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Note 7. Commitments

Lease commitments

The Company is leasing office equipment under an operating lease expiring in 2017.

Minimum lease payments required under non-cancelable operating leases are as follows:

Year		Amount
2014	$	8
2015		8
2016		8
2017		3
Total Minimum Lease Payments	$	27

Rental expense charged to operations was $25 and $27 for the years ended December 31, 2013 and 2012, respectively.

Note 8. Common Stock Options and Stock Purchase Plan

Stock options

The 1997 Stock Option Plan (the 1997 Plan) and 2013 Equity Incentive Plan (the 2013 Plan) authorize the issuance of both nonqualified and incentive stock options. Payment for the shares may be made in cash, shares of the Company s Common Stock or a combination thereof. Under the terms of the plans, incentive stock options and non-qualified stock options are granted at a minimum of 100% of fair market value on the date of grant and may be exercised at various times depending upon the terms of the option. All existing options expire 10 years from the date of grant or one year from the date of death.

Stock-based compensation

Pursuant to the 2013 Plan, the Company is authorized to grant options to purchase up to 300,000 shares of its Common Stock. As of December 31, 2013, options to purchase an aggregate of 225,000 shares were outstanding and 85,000 shares were exercisable under the 2013 Plan, and 75,000 shares were available for issuance pursuant to awards that may be granted under the plan in the future.

Pursuant to the 1997 Plan, the Company is authorized to grant options to purchase up to 450,000 shares of its Common Stock. As of December 31, 2013, options to purchase an aggregate of 21,980 shares were outstanding and exercisable under the 1997 Plan, and 250 shares were available for issuance pursuant to awards that may be granted under the 1997 Plan in the future. The board terminated the plan in 2014. The existing grants may be exercised according to the terms of the grant agreements but no additional options will be granted under the 1997 Plan.

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ELECTRO-SENSORS, INC. AND SUBSIDIARIES
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During the third quarter of 2013, the Company granted to its Chief Executive Officer options to purchase 50,000 shares of common stock. The options were granted at a strike price equal to the fair market value, vested immediately, and expire ten years from the date of the grant.

The following table summarizes the activity for outstanding incentive stock options to employees of the company:

	Options Outstanding			
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (1)
Balance at January 1, 2012	11,980	$ 4.16	2.6	
Granted	0			
Exercised	0			
Canceled/forfeited/expired	0			
Balance at December 31, 2012	11,980	4.16	1.6	
Granted	50,000	4.21	10.0	
Exercised	0			
Canceled/forfeited/expired	0			
Balance at December 31, 2013	61,980	$ 4.20	9.7	
Vested and exercisable as of December 31, 2013	61,980			$ 0

(1) The aggregate intrinsic value is calculated as approximately the difference between the weighted average exercise price of the underlying awards and the Company s estimated current fair market value at December 31, 2013.

During the third quarter of 2013, the Company granted to three of its outside directors options to each purchase 50,000 shares of common stock, and granted options to a fourth director to purchase 25,000 shares of common stock. The options granted to outside directors had a strike price above fair market value and vested 20% on the grant date, with an additional 20% vesting on the first four anniversaries of the grant date thereafter. All of the stock option grants expire ten years from the date of the grant.

On July 18, 2012, the Company granted each of its four outside directors options to purchase 2,500 shares of common stock. The options were granted at fair market value, vested immediately, and expire ten years from the date of the grant.

During the year ended December 31, 2012, one former outside director forfeited options to purchase 5,000 shares of common stock.

ELECTRO-SENSORS, INC. AND SUBSIDIARIES
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(in thousands except share and per share amounts)

The following table summarizes the activity for outstanding director stock options:

	Options Outstanding			
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (1)
Balance at January 1, 2012	5,000	$ 5.36	5.3	
Granted	10,000	4.15	10.0	
Exercised	0			
Canceled/forfeited/expired	5,000	5.36		
Balance at December 31, 2012	10,000	4.15	9.5	
Granted	175,000	4.67	10.0	
Exercised	0			
Canceled/forfeited/expired	0			
Balance at December 31, 2013	185,000	$ 4.64	9.5	
Vested and exercisable as of December 31, 2013	35,000			$ 0

(1) The aggregate intrinsic value is calculated as approximately the difference between the weighted average exercise price of the underlying awards and the Company s estimated current fair market value at December 31, 2013.

The Company recognized compensation expense of approximately $162 and $6 during the years ended December 31, 2013 and 2012, respectively, in connection with the issuance of the options.

The assumptions made in estimating the fair value of the options on the grant date based upon the BSM option-pricing model are as follows:

	Year Ended December 31	
	2013	2012
Dividend Yield	0.00%	0.00%
Expected Volatility	44.27-45.00%	22.98%
Risk Free Interest Rate	1.33-1.92%	2.21%
Expected Life	5.5-6 Years	5 Years

The Company calculates expected volatility for stock options and other awards using historical volatility as the Company believes the expected volatility will approximate historical volatility.

There were no options exercised during the years ended December 31, 2013 and 2012.

As of December 31, 2013, there was approximately $204 of unrecognized compensation expense under the 2013 Plan. The Company expects to recognize this expense over the next four years. To the extent the forfeiture rate is different than we have anticipated, stock-based compensation related to these awards will be different from our expectations.

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ELECTRO-SENSORS, INC. AND SUBSIDIARIES
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(in thousands except share and per share amounts)

Stock purchase plan

The 1996 Employee Stock Purchase Plan (the ESPP) allows employees to set aside up to 10% of their earnings for the purchase of shares of the Company s Common Stock. The purchase price is the lower of 85% of the market value at the date of the grant or the exercise date, which is six months from the date of the grant. Under the ESPP, the Company is authorized to sell and issue up to 150,000 shares of its Common Stock to its full-time employees. During 2013 and 2012, 2,795 shares and 2,335 shares, respectively, were issued under the ESPP. At December 31, 2013, 69,161 shares were available for future issuance pursuant to the ESPP. The plan was terminated effective January 1, 2014.

Note 9. Benefit Plans

Employee stock ownership plan

The Company sponsors an employee stock ownership plan (ESOP) that covers substantially all employees who work 1,000 or more hours during the year. The ESOP has, at various times, secured financing from the Company to purchase the Company s shares on the open market. When the Plan purchases shares with the proceeds of the Company loans, the shares are pledged as collateral for these loans. The shares are maintained in a suspense account until released and allocated to participant accounts. The Plan owns 168,382 shares of the Company s stock at December 31, 2013. All shares held by the Plan have been released and allocated. The dividends paid by the Company on shares held by the Plan are allocated to participant accounts. The Plan had no debt to the Company at December 31, 2013.

The Company recognized compensation expense for contributions of $18 to the ESOP plan for both 2013 and 2012.

In the event a terminated ESOP participant desires to sell his or her shares of the Company s stock and the shares are not readily tradable, the Company may be required to purchase the shares from the participant at fair market value. In addition, the Company may distribute the ESOP s shares to the terminated participant at the Company s election. At December 31, 2013, 168,382 shares of the Company s stock, with an aggregate fair market value of approximately $675, are held by ESOP participants who, if terminated, would have rights under the repurchase provisions. The Company believes that the market for its shares meets the ESOP requirements and that there would not be a current obligation to repurchase shares.

Profit sharing plan and savings plan

The Company has a salary reduction and profit sharing plan which conforms to IRS provisions for 401(k) plans. The Company may make profit sharing contributions with the approval of the Board of Directors. The Board of Directors approved Company contributions of $0 and $18 for the years ended December 31, 2013 and 2012, respectively.

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Note 10. Income Taxes

The components of the income tax provision for the years ended December 31, 2013 and 2012 are as follows:

		2013		2012
Current:				
Federal	$	302	$	513
State		1		5
Deferred:				
Federal		(47)		31
State		(24)		7
Total Federal and State Income Taxes	$	232	$	556

The provision for income taxes for the years ended December 31, 2013 and 2012 differs from the amount obtained by applying the U.S. federal income tax rate to pretax income due to the following:

		2013		2012
Computed Expected Federal Tax Expense	$	319	$	560
Increase (Decrease) in Taxes Resulting From:				
State Income Taxes, net of Federal Benefit		9		26
Credits		(70)		(16)
Domestic Production Activities Deduction		(18)		(20)
Permanent Differences		3		6
Rate Change for Deferred Taxes		(11)		0
Total Federal and State Income Taxes	$	232	$	556

The components of the net deferred tax liability consist of:

		2013		2012
Deferred Tax Assets:				
Vacation Accrual	$	27	$	26
Allowance for Doubtful Accounts		3		4
Stock Compensation		57		0
State Carryforward R&D Credit		12		0
Total Deferred Tax Assets	$	99	$	30
Deferred Tax Liabilities:				
Prepaid Expenses	$	30	$	23
Depreciation		91		100
Net Unrealized Gain on Investments		1,000		1,362
Total Deferred Tax Liabilities	$	1,121	$	1,485
Net Deferred Tax Liability	$	(1,022)	$	(1,455)

The Company is subject to the following material taxing jurisdictions: U.S. and Minnesota. The tax years that remain open to examination by the Internal Revenue Service are 2010 through 2013. The tax years that remain open to examination by the Minnesota Department of Revenue are 2010 through 2013. We have no accrued interest or penalties related to uncertain tax positions as of January 1, 2013 or December 31, 2013 and uncertain tax positions are not significant.

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Note 11. Segment Information

As of December 31, 2013, the Company has two reportable operating segments: Production Monitoring and Investments. The Production Monitoring Division manufactures and markets a complete line of production monitoring equipment, in particular speed monitoring and motor control systems for industrial machinery. ESI Investment Company holds investments in marketable and non-marketable securities.

The accounting policies of the segments are the same as those described in Note 1. In evaluating segment performance, management focuses on sales and income before taxes. The Company has no inter-segment sales.

The following is financial information relating to the continuing operating segments:

	2013	2012
Net revenues		
Production Monitoring	**$ 6,541**	$ 6,498
Total	**6,541**	6,498
Sales in foreign countries		
Production Monitoring	**932**	809
Total	**932**	809
Interest income		
Production Monitoring	**1**	1
ESI Investment Company	**4**	3
Total	**5**	4
Depreciation expense		
Production Monitoring	**110**	71
Total	**110**	71
Capital purchases		
Production Monitoring	**23**	196
Total	**23**	196
Total assets		
Production Monitoring	**3,022**	3,016
ESI Investment Company	**9,587**	10,322
Total	**12,609**	13,338
Income before income taxes		
Production Monitoring	**404**	845
ESI Investment Company	**534**	797
Total	**$ 938**	$ 1,642

Note 12. Subsequent Events

During the first quarter of 2014, the Company sold 39,179 shares of Rudolph Technology stock for proceeds of $439 resulting in a gain on the sale of $434.

On February 18, 2014, the Company purchased the Insta-Link wireless hazard technology monitoring system and product family, together with related technology and intellectual property rights, from an independent third party. The Company agreed to pay $1,200 for the product line, of which $400 was paid at closing, and additional payments of $400 will be paid on each of the first and second anniversary of the closing. The seller may earn up to an additional $550 of purchase price, depending upon the achievement of revenue measures during the four calendar years following the closing.

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Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

The person serving as our principal executive officer and principal financial officer evaluated the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act). Based on this evaluation, the person serving as the Company s principal executive officer and principal financial officer has concluded that the Company s disclosure controls and procedures were effective as of December 31, 2013 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to the Company s management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Management s Report on Internal Control over Financial Reporting

Under Section 404 of the Sarbanes-Oxley Act of 2002, our management is required to assess the effectiveness of the Company s internal control over financial reporting as of the end of each fiscal year and report, based on that assessment, whether the Company s internal control over financial reporting is effective.

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Company s internal control over financial reporting is designed to provide reasonable assurance as to the reliability of the Company s financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Internal control over financial reporting, no matter how well designed, has inherent limitations. Therefore, internal control over financial reporting determined to be effective can provide only reasonable assurance with respect to financial statement preparation and may not prevent or detect all misstatements. Moreover, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company s management has assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2013. In making this assessment, the Company used the criteria established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework (1992)*. These criteria are in the areas of control environment, risk assessment, control activities, information and communication, and monitoring. The Company s assessment included extensive documenting, evaluating and testing the design and operating effectiveness of its internal control over financial reporting. Based on this evaluation, the person serving as the Company s principal executive officer and principal financial officer has concluded that the Company s internal controls were effective as of December 31, 2013.

Changes in Internal Control over Financial Reporting

There were no changes in the Company s internal control over financial reporting during the fourth quarter of 2013, which were identified in connection with management s evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

Item 9B. Other Information.

None.

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PART III

Certain information required by Part III is incorporated by reference to the Company s Definitive Proxy Statement pursuant to Regulation 14A (the Proxy Statement) for its Annual Meeting of Shareholders to be held April 23, 2014 (Annual Meeting).

Item 10. Directors, Executive Officers and Corporate Governance.

The information required by Item 10 is incorporated herein by reference to the sections entitled Election of Directors, Section 16(a) Beneficial Ownership Reporting Compliance, Corporate Governance Code of Ethics and Business Conduct and Corporate Governance Audit Committee that appear in the Company s Definitive Proxy Statement for its Annual Meeting. Information concerning the Company s sole executive officer is included in the sections referred to above.

Item 11. Executive Compensation.

The information required by Item 11 is incorporated herein by reference to the section entitled Executive Compensation that appears in the Company s Definitive Proxy Statement for its Annual Meeting.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information required by Item 12 relating to security ownership of certain beneficial owners and management is incorporated herein by reference to the section entitled Security Ownership of Certain Beneficial Owners and Management that appears in the Company s Definitive Proxy Statement for its Annual Meeting.

The following table provides information as of December 31, 2013 about the Company s equity compensation plans.

Equity Compensation Plan Information

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	246,980	$4.53	144,411(1)
Equity compensation plans not approved by security holders			
Total	246,980	$4.53	144,411(1)

(1) Includes 250 shares issuable pursuant to the 1997 Stock Option Plan, 75,000 shares issuable pursuant to the 2013 Equity Incentive Plan and 69,161 shares issuable pursuant to the 1996 Employee Stock Purchase Plan. The 1997 Stock Option Plan was terminated in January 2014 and the remaining 250 shares were cancelled. The 1996 Employee Stock Purchase Plan was terminated effective January 1, 2014.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

The information required by Item 13 is incorporated herein by reference to the sections entitled Corporate Governance Independence, Election of Directors and Transactions with Related Persons, Promoters and Certain Control Persons that appear in the Company s Definitive Proxy Statement for its Annual Meeting.

Item 14. Principal Accountant Fees and Services.

The information required by Item 14 relating to principal accounting fees and services is incorporated herein by reference to the section entitled Disclosure of Fees Paid to Independent Auditors that appears in the Company s Definitive Proxy Statement for its Annual Meeting.

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PART IV

Item 15. Exhibits and Financial Statement Schedules.

Financial Statements.

Reference is made to the Index to Consolidated Financial Statements appearing on Page 13 hereof.

Financial Statement Schedules.

The Financial Statement Schedules have been omitted either because they are not required or because the information has been included in the consolidated financial statements or the notes thereto included in this Annual Report.

Exhibits.

See Exhibit Index on the page following the signatures.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

ELECTRO-SENSORS, INC.
(Registrant)
By: /s/ DAVID L. KLENK
David L. Klenk
President, Chief Executive Officer, and Chief Financial Officer
Date: March 21, 2014

By: /s/ GLORIA M. GRUNDHOEFER
Gloria M. Grundhoefer
Controller
Date: March 21, 2014

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

(Power of Attorney)

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

Signature	**Title**	**Date**
/s/ David L. Klenk	President and Director (CEO and CFO)	March 21, 2014
/s/ Joseph A. Marino	Chairman and Director	March 21, 2014
/s/ Scott A. Gabbard	Director	March 21, 2014
/s/ Michael C. Zipoy	Director	March 21, 2014
/s/ Jeffrey D. Peterson	Director	March 21, 2014

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SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

EXHIBIT INDEX TO FORM 10-K

For the Fiscal Year Ended
December 31, 2013 Commission File No. 000-9587

Exhibit Number	Exhibit Description
^3.1	Registrant s Restated Articles of Incorporation, as amended incorporated by reference to Exhibit 3.1 to the Company s 1991 Form 10-KSB
^3.2	Registrant s Bylaws, as amended to date incorporated by reference to Exhibit 3.2 to the Company s 1997 Form 10-KSB
^*10.1	Electro-Sensors, Inc. s 1996 Employee Stock Purchase Plan incorporated by reference to the Company s Proxy Statement for the Company s 1996 Annual Meeting of Shareholders
^*10.2	Electro-Sensors, Inc. s 1997 Stock Option Plan and forms of Incentive and Nonqualified Stock Option Agreements thereunder incorporated by reference to Exhibit 10.6 to the Company s 1997 Form 10-KSB
^*10.3	Electro-Sensors, Inc. s 2013 Stock Incentive Plan and forms of Incentive and Nonqualified Stock Option Agreements thereunder incorporated by reference to the Company s Proxy Statement for the Company s 2013 Annual Meeting of Shareholders
**10.4	Asset Purchase Agreement dated as of February 14, 2014 by and among Harvest Engineering Inc., Harvest Engineering, LLC, Stephen Meyer, Bruce Meyer, and Electro-Sensors, Inc.
21	Subsidiaries of Registrant (Name and State of Incorporation): ESI Investment Company Minnesota Senstar Corporation Minnesota
23.1	Consent of Independent Registered Public Accounting Firm
24.1	Power of Attorney (see Signature page)
31.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.1	Letter to Shareholders dated March 17, 2014
99.2	Investor Information
101	The following financial information from Electro-Sensors, Inc. s Annual Report on Form 10-K for the annual period ended December 31, 2013, formatted in eXtensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets as of December 31, 2013 and 2012, (ii) Consolidated Statements of Comprehensive Income for the years ended December 31, 2013 and 2012, (iii) Consolidated Statements of Cash Flows for years ended December 31, 2013 and 2012, (iv) Consolidated Statement of Changes in Stockholders Equity, and (v) Notes to Consolidated Financial Statements.

^ Incorporated by reference to a previously filed report or document SEC File No. 000-9587
* Management contract or compensatory plan or arrangement
** Pursuant to Rule 24b-2 adopted under the Securities Exchange Act of 1934, the Company has deleted certain information from these Agreements, as filed, on the basis that disclosure of this information would be detrimental to the Company and is not necessary for the protection of investors. The Company has filed a request for Confidential Treatment of this information.