

ELECTRO SENSORS INC  
Form 10-K  
March 29, 2017

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**Form 10-K**

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

**For the fiscal year ended December 31, 2016**

**or  
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 No

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 No

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 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 No

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.

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 (Do not check if a smaller reporting company) 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

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 its common stock as reported on The Nasdaq Stock Market® on June 30, 2016.

The number of shares outstanding of the registrant's Common Stock, \$0.10 par value, on March 27, 2017 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.

**ELECTRO-SENSORS, INC.**  
**Form 10-K for the Year Ended December 31, 2016**  
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## PART I

### Item 1. Business.

#### ***Introduction***

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

In addition, through our former subsidiary ESI Investment Company, we periodically made strategic investments in other businesses and companies, primarily when we believed that these investments would facilitate the development of technology complementary to our existing products. During 2015, we sold substantially all our remaining investments in other businesses and companies. Effective December 31, 2015, we merged ESI Investment Company and Senstar Corporation, a subsidiary with no business operations, into the parent company Electro-Sensors, Inc.

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 a variety 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 speed monitoring systems compare revolutions per minute or speed against acceptable rates as determined by a customer. 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 products that measure 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.

We also offer production monitoring devices that include a 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. A vibration monitor will alert an operator when the vibration of a machine in a production system exceeds or is less than 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, a German control and interface devices manufacturer, under which we have the right to distribute Motrona products in the United States. These products interface with our products on various applications.

In 2008, we introduced our Electro-Sentry 1 hazard monitoring system, which integrates our sensors for monitoring 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 their 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 hazard monitoring system.

In 2013, the Company added ION Frequency/Discrete-In, a product that allows users to measure a combination of up to 12 shaft speeds or signal frequencies from pulse-frequency-output sensors. 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 while eliminating redundant component and 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, in 2013 we also introduced product upgrades for sensing capability and ruggedness on our Hall-effect sensors.

In 2014, we introduced a process meter for analog output sensors, such as our TT420, temperature sensors, ST420, speed sensors, and SG1000, slide gate position monitor.

Additionally, in 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”). We market the wireless hazard monitoring products under the HazardPRO™ product line. The product line is manufactured and serviced at our facility in Minnetonka, Minnesota.

In 2016, we developed and produced a Class II Div I, intrinsically safe HazardPRO node, certified for use in explosive environments. We also developed software updates to four of our standard products, new calibration software for our slide gate monitors, and released new versions of the HazardPRO gateway and I/O boards. We also introduced a new EZ mount guard with an extended length.

We expect to continue to expend resources to develop new products and to market new and existing products for use in a wide variety of monitoring applications.

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, United Kingdom, Ukraine, Egypt, Saudi Arabia, India, Indonesia, Australia, New Zealand, China, Korea, Vietnam, Malaysia, Philippines, and Singapore. Sales to customers outside the United States represent approximately 10% of our 2016 sales. We sell our products under the Electro-Sensors, Inc. brand as a range of products from simple sensors to complex motor speed controllers. Our customers are businesses in a wide variety of industries, including grain/feed/milling, bulk materials, manufacturing, food products, ethanol, power generation, and other processing areas.

We continue to explore new industries to expand sales and may also consider acquiring compatible businesses as part of our growth strategy. We believe that a wide variety of organizations could 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. We sell our products into both the “retro-fit” market and into new manufacturing or processing systems.

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***

We face substantial competition in the sale of our production monitoring systems from a broad range of industrial and commercial businesses. Many of these competitors are well established and have greater sales volume. Among our larger competitors are Danaher Controls, Red Lion Controls, 4B Elevator Components Ltd., and Durant Corporation. We believe our competitive advantages include our products superior design and quality, the fact that we sell our products as ready-to-install units, and that our products can be used in 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.



### *Suppliers*

We purchase parts and materials for our systems from various manufacturers and distributors. In some instances, these materials are manufactured in accordance with our proprietary designs. Multiple sources of these parts and materials are generally available, and we do not depend 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 do not depend 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.

We have registered the name “Electro-Sensors” as a trademark with the U.S. Patent and Trademark Office (“USPTO”), Reg. No. 1,142,310. We believe this 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 intend to register this trademark.

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

We seek to protect our 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 we would have adequate remedies for any breach, or that our trade secrets will not otherwise become known or independently developed by competitors.

***Business Development Activities***

We continue to seek growth opportunities, both internally through our existing portfolio of products, technologies and markets, as well as externally through technology partnerships or related-product acquisitions.

***Governmental Approvals***

Although, we are not required to obtain governmental approval of our products, we choose to obtain certain third party certifications to meet our customers' needs. These certifications may expand our market opportunities in certain industries.

***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 (in thousands)***

We invest in research and development programs to develop new products in related markets and to integrate state-of-the-art technology into our existing products. We incurred research and development expenses of approximately \$767 and \$753 during 2016 and 2015, respectively. We undertake development projects based upon the identified specific needs of the markets we serve.

Our future success depends 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.



***Employees***

As of March 27, 2017, we had 34 employees, all of whom 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 past operating results, and expect to 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. These factors include: product competition and acceptance, timing of customer orders, cancellation of orders, the mix of products sold, downturns in the markets we serve and economic disruptions. Because fluctuations may occur, we caution investors that results of our operations for recent periods may not accurately predict how we will perform in the future. We cannot ensure that we will achieve revenue or earnings growth.

***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.

### *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 should be considered forward-looking.

Our forward-looking statements generally relate to our growth strategy, future financial results, product development and sales efforts. We make forward-looking statements 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*. These include statements relating to our beliefs and expectations and intentions with respect to (i) our growth, (ii) our marketing and product development, (iii) the value of our intellectual property, (iv) our competitive position in the marketplace, (v) the effect of governmental regulations on our business, (vi) our employee relations, (vii) the adequacy of our facilities, (viii) our intention to develop new products, (ix) the possibility of acquiring compatible businesses as part of our growth strategy, and (x) our future cash requirements and use of cash.

Forward-looking statements cannot be guaranteed and our actual results may vary materially due to the uncertainties and risks, known and unknown, associated with these 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 these results to differ materially from those anticipated in forward-looking statements made in this document and elsewhere by us or on our behalf. We cannot 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 these factors to be an exhaustive statement of all risks, uncertainties or potentially inaccurate assumptions. These factors include our ability to:

successfully use our cash and liquid assets to develop or acquire new or complementary products or business lines to increase our revenue and profitability;

successfully market the wireless hazard technology and product line we purchased in February 2014;

quickly and successfully adapt to changing industry technological standards;

comply with existing and changing industry regulations;

attract and retain key personnel, including senior management;

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

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 our operations are conducted within this facility. The facility is in excellent condition and we continue to maintain and update the facility as necessary. We believe the facility will be adequate for our needs in 2017.

#### 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.

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.

|             | <b>Period</b>  | <b>High</b> | <b>Low</b> |
|-------------|----------------|-------------|------------|
| <b>2016</b> | First Quarter  | \$3.75      | \$3.15     |
|             | Second Quarter | \$3.61      | \$3.05     |
|             | Third Quarter  | \$3.92      | \$3.08     |
|             | Fourth Quarter | \$3.92      | \$3.36     |
| 2015        | First Quarter  | \$4.38      | \$3.64     |
|             | Second Quarter | \$4.56      | \$3.84     |
|             | Third Quarter  | \$4.40      | \$3.53     |
|             | Fourth Quarter | \$4.02      | \$3.55     |

Based on data provided by our transfer agent, as of February 28, 2017, we had 71 shareholders of record who held 884,389 shares of the Company’s common stock. In addition, nominees held an additional 2,511,132 shares for approximately 716 shareholders holding shares in street name.

From time to time, we may be required to repurchase some of our equity securities as a result of obligations described in Note 10 to our 2016 financial statements. We did not repurchase any equity securities during the years ended December 31, 2016 and 2015.

The information required by Item 201(d) is set forth in Item 12 of this Form 10-K.

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 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 statements of comprehensive income expressed as a percentage of net sales.

|   | <b>Years Ended<br/>December 31,</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2016</b>                         | <b>2015</b> |
| Net Sales                                     | 100.0%                              | 100.0%      |
| Cost of Goods Sold                            | 45.2                                | 44.7        |
| Gross Profit                                  | 54.8                                | 55.3        |
| Operating Expenses                            |                                     |             |
| Selling and marketing                         | 22.2                                | 20.4        |
| General and administrative                    | 19.4                                | 21.3        |
| Research and development                      | 10.8                                | 9.9         |
| Total Operating Expenses                      | 52.4                                | 51.6        |
| Operating Income                              | 2.4                                 | 3.7         |
| Non-operating Income (Expense)                |                                     |             |
| Interest expense                              | (0.0 )                              | (0.1 )      |
| Gain on sale of available-for-sale securities | 0.0                                 | 19.0        |
| Interest income                               | 0.3                                 | 0.0         |
| Other income                                  | 0.2                                 | 0.2         |
| Total Non-operating Income, Net               | 0.5                                 | 19.1        |
| Income before Income Taxes                    | 2.9                                 | 22.8        |
| Income Taxes                                  | 0.0                                 | 6.9         |
| Net Income                                    | 2.9 %                               | 15.9 %      |

The following paragraphs discuss the Company's performance for years ended December 31, 2016 and 2015.

**Comparison of 2016 vs. 2015 (dollars in thousands)**

*Net Sales*

Net sales decreased \$549 or 7.2%, to \$7,087 in 2016 from \$7,636 in 2015. The decrease occurred primarily in the second half of the year as we experienced softening in many industrial markets that impacted all product lines. Furthermore, during the third and fourth quarters of 2016, the value of large strategic orders decreased relative to the comparable period in the prior year as customers shifted their focus to immediate needs while deferring larger capital purchases. We believe both the market softening and decrease in large orders were the result of significant uncertainties facing industrial and manufacturing sectors during this period.

International markets remain an important part of our business, providing approximately 10% of our 2016 revenue from shipments into over 40 countries.

### ***Gross Profit***

Gross profit for 2016 decreased \$342, or 8.1%, to \$3,884 from \$4,226 in 2015. Gross margin for 2016 was 54.8% compared to 55.3% in 2015. The slight decrease in the gross margin was primarily due to product mix and under-utilization of capacity in production due to lower sales.

### ***Operating Expenses***

Total operating expenses decreased \$222, or 5.6%, to \$3,714 in fiscal 2016 from \$3,936 in fiscal 2015 but increased as a percentage of sales to 52.4% from 51.6%.

Selling and marketing expenses increased \$18 or 1.2% in 2016 compared to 2015, and increased as a percentage of sales to 22.2% from 20.4%. The slight increase was primarily due to increased wages and benefits for additional marketing personnel, the cost of providing system demonstrations to potential customers, cost associated with attending additional tradeshow and increased travel. This increase was partially offset by a decrease in outside sales representative expenses due to a decrease in the number of representatives.

General and administrative expenses decreased \$254, or 15.6%, to \$1,371 in 2016 from \$1,625 in 2015, and decreased as a percentage of sales to 19.4% from 21.3%. The decrease was due primarily to a \$260 reduction in the contingent earn-out liability related to the HazardPRO acquisition as a result of the Company's expectation of lower future contingent payments related to a general manufacturing sector slowdown as well as slower adoption of the Company's wireless product offerings.

Research and development expenses increased \$14, or 1.9%, to \$767 in 2016 compared to \$753 in 2015, and increased as a percentage of sales to 10.8% from 9.9%. The increase was the result of contract engineering related to modification of the HazardPRO product line. This was partially offset by decreases in salaries and benefits due to reduced staffing and costs incurred in 2015 related to lab testing fees for the HazardPRO product line.

### ***Operating Income***

Operating income decreased \$120 or 41.4%, to \$170 in 2016 from \$290 in 2015, and decreased as a percentage of sales to 2.4% from 3.7%, due primarily to lower 2016 revenue, which was slightly offset by lower operating expenses discussed above.

*Non-Operating Income*

Non-operating income decreased \$1,420 to \$34 in 2016 from \$1,454 in 2015, primarily as a result of realized gains on sales of shares of Rudolph Technologies, Inc. ("Rudolph") realized in 2015. The Company has sold all of its Rudolph stock.

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.

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 net income of \$202 in 2016 as compared to net income of \$1,214 in 2015, a decrease of \$1,012, or 83.4%. Basic and diluted earnings per share were \$0.06 in 2016, compared to basic and diluted earnings per share of \$0.36 in 2015.

## **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 \$840 and \$569 at December 31, 2016 and 2015, respectively. The increase was mainly due to net cash from operating activities and investing activities, as described below. Working capital was \$10,249 at December 31, 2016 compared to \$9,938 at December 31, 2015.

Cash generated from 2016 operating activities was \$196, compared to the use of cash of \$306 in 2015 operating activities, resulting in a \$502 increase of cash from operating activities. The increase was primarily due to a decrease in inventories and an increase in accounts payable, partially offset by an increase in trade receivables and lower operating income. The 2016 decrease in inventory is due to lower purchases due to lower revenues. The 2016 increase in accounts payable is due to the timing of purchases and payments. The 2016 increase in trade receivables is due to increased sales late in the 2016 fourth quarter.

Cash generated from investing activities in 2016 and 2015 was \$465 and \$66, respectively. During 2016, the Company had net proceeds of Treasury Bills with a maturity date of more than three months of \$473 compared to the 2015 net purchases of \$1,331. In addition, during 2015, the Company generated \$1,467 in proceeds on sales of available-for-sale securities from the sale of Rudolph Technologies, Inc. stock.

Cash used in financing activities was \$390 and \$381 in 2016 and 2015, respectively. During 2016 and 2015, we paid \$390 and \$381, respectively on the long-term note owed to Harvest Engineering, Inc. (Harvest). As of December 31, 2016, the note payable to Harvest has been paid in full.

Our ongoing cash usage 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.



## **CRITICAL ACCOUNTING ESTIMATES**

The preparation of our 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. Those 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 long-lived assets, realizability of trade receivables, valuation of deferred tax assets/liabilities, inventory, investments, contingent earn-out, and stock compensation expense. It is at least reasonably possible that these estimates may change in the near term.

### ***Economic lives of long-lived assets***

We estimate the economic useful life of long-lived assets used in the business. Expected asset lives may be shortened or an impairment may be recorded based on a change in the expected use of the asset. If the expected life of an asset is shortened or an impairment recorded it could result in an additional charge to depreciation expense.

### ***Realizability of trade receivables***

We estimate our allowance for doubtful accounts based on prior history and the aging of our trade receivables. We are unable to predict which, if any, of our customers will be unable to pay their open invoices at a future date. If an account becomes uncollectible and we are required to write off the balance, we would recognize the amount of the additional expense within general and administrative expenses.

### ***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. We recognized changes in deferred tax assets and liabilities in the period in which the tax law changes become effective. Any change in our deferred tax assets or liabilities could have a material negative or positive effect on our income tax expense.

### ***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 will not meet future technological requirements. If we are unable to use the inventory in our products and it does not meet future technological requirements, we would be required to remove the items from inventory and expense the amount in cost of goods sold.

***Valuation of investments***

Our investments in available-for-sale 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. Changes in value of our investments do not affect our profitability until the available-for-sale security is sold. At the time of sale, we would recognize a gain or loss on the sale in net income.

***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 differ from what we estimated. Changes in the life or forfeiture rate of stock options could have a negative or positive impact on our stock-based compensation.

***Valuation of the contingent earn-out***

We estimated the probability of meeting the revenue targets over the measurement period to determine the fair value of the contingent liability. The actual payout could be more or less than what we have estimated. If the payout or projected payout is more than the recorded value, we would recognize an additional charge to general and administrative expense. If the payout or projected payout is less than the recorded value, we would recognize a decrease in expense to general and administrative expense.

Additional information regarding our significant accounting policies is provided below in Part II, Item 8, *Financial Statements and Supplementary Data – Notes to Financial Statements, Note 1, Nature of Business and Significant Accounting Policies*.

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

Not applicable.



Item 8. Financial Statements and Supplementary Data.

**INDEX TO FINANCIAL STATEMENTS**

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors  
Electro-Sensors, Inc. and Subsidiaries

We have audited the accompanying balance sheets of Electro-Sensors, Inc. and Subsidiaries (the Company) as of December 31, 2016 and 2015, and the related statements of comprehensive income, changes in stockholders' equity, and cash flows for each of the years in a two-year period ended December 31, 2016. The Company's management is responsible for these financial statements. Our responsibility is to express an opinion on these 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 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 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 financial statements referred to above present fairly, in all material respects, the financial position of Electro-Sensors, Inc. and Subsidiaries as of December, 2016 and 2015, and the results of its operations and its cash flows for each of the years in the two-year period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

Boulay PLLP

Minneapolis, Minnesota

March 29, 2017

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

(in thousands except share and per share amounts)

|  | December 31 |          |
|--|-------------|----------|
|  | 2016        | 2015     |
| <b>ASSETS</b>  |             |          |
| Current assets   |             |          |
| Cash and cash equivalents                                      | \$840       | \$569    |
| Treasury bills   | 7,427       | 7,872    |
| Trade receivables, less allowance for doubtful accounts of \$8 | 770         | 689      |
| Inventories  | 1,515       | 1,564    |
| Other current assets   | 174         | 170      |
| Income tax receivable  | 66          | 0        |
| Total current assets   | 10,792      | 10,864   |
| Deferred income tax asset                                      | 198         | 184      |
| Intangible assets, net   | 1,035       | 1,270    |
| Property and equipment, net                                    | 1,033       | 1,103    |
| Total assets   | \$13,058    | \$13,421 |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                    |             |          |
| Current liabilities  |             |          |
| Current maturities of note payable                             | \$0         | \$390    |
| Accounts payable   | 239         | 136      |
| Accrued expenses   | 304         | 396      |
| Income tax payable   | 0           | 4        |
| Total current liabilities                                      | 543         | 926      |
| Long-term liabilities  |             |          |
| Contingent earn-out  | 195         | 455      |
| Total long-term liabilities                                    | 195         | 455      |

Commitments and contingencies

Stockholders' equity

|  |          |          |
|--|----------|----------|
| Common stock par value \$0.10 per share; authorized 10,000,000 shares; 3,395,521 shares issued and outstanding     | 339      | 339      |
| Additional paid-in capital   | 1,953    | 1,879    |
| Retained earnings  | 10,057   | 9,855    |
| Accumulated other comprehensive loss (unrealized loss on available-for-sale securities, net of income tax benefit) | (29 )    | (33 )    |
| Total stockholders' equity   | 12,320   | 12,040   |
| Total liabilities and stockholders' equity   | \$13,058 | \$13,421 |

See Notes to Financial Statements

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**STATEMENTS OF COMPREHENSIVE INCOME**

(in thousands except share and per share amounts)

|  | Years ended<br>December 31, |         |   |
|--|-----------------------------|---------|---|
|  | 2016                        | 2015    |   |
| Net Sales  | \$7,087                     | \$7,636 |   |
| Cost of Goods Sold   | 3,203                       | 3,410   |   |
| Gross Profit   | 3,884                       | 4,226   |   |
| Operating Expenses   |                             |         |   |
| Selling and marketing  | 1,576                       | 1,558   |   |
| General and administrative   | 1,371                       | 1,625   |   |
| Research and development   | 767                         | 753     |   |
| Total Operating Expenses   | 3,714                       | 3,936   |   |
| Operating Income   | 170                         | 290     |   |
| Non-operating Income (Expense)   |                             |         |   |
| Interest expense   | (1                          | ) (11   | ) |
| Gain on sale of available-for-sale securities                                  | 0                           | 1,449   |   |
| Interest income  | 20                          | 0       |   |
| Other income   | 15                          | 16      |   |
| Total Non-operating Income, Net  | 34                          | 1,454   |   |
| Income before Income Taxes   | 204                         | 1,744   |   |
| Income Taxes   | 2                           | 530     |   |
| Net Income   | 202                         | 1,214   |   |
| Other Comprehensive Income (Loss)  |                             |         |   |
| Change in unrealized value of available-for-sale securities, net of income tax | 4                           | 131     |   |
| Reclassification of gains included in net income, net of income tax            | 0                           | (898    | ) |
| Other Comprehensive Income (Loss)  | 4                           | (767    | ) |
| Net Comprehensive Income   | \$206                       | \$447   |   |

Net Income per share data

Basic

|                         |           |           |
|-------------------------|-----------|-----------|
| Net income per share    | \$0.06    | \$0.36    |
| Weighted average shares | 3,395,521 | 3,395,521 |

Diluted

|                         |           |           |
|-------------------------|-----------|-----------|
| Net income per share    | \$0.06    | \$0.36    |
| Weighted average shares | 3,395,945 | 3,395,521 |

See Notes to Financial Statements

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

(in thousands except share and per share amounts)

|                                   | <b>Common Stock<br/>Issued<br/>Shares</b> | <b>Common Stock<br/>Amount</b> | <b>Additional<br/>Paid-in<br/>Capital</b> | <b>Retained<br/>Earnings</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income (Loss)</b> | <b>Total<br/>Stockholders'<br/>Equity</b> |
|-----------------------------------|---|--------------------------------|---|------------------------------|--|---|
| <b>Balance, December 31, 2014</b> | 3,395,521                                 | \$ 339                         | \$ 1,816                                  | \$ 8,641                     | \$ 734   | <b>\$ 11,530</b>                          |
| Other comprehensive loss          |   |                                |   |                              | (767)  | (767)                                     |
| Stock-based compensation expense  |   |                                | 63  |                              |  | 63  |
| Net income                        |   |                                |   | 1,214                        |  | 1,214                                     |
| <b>Balance, December 31, 2015</b> | 3,395,521                                 | 339                            | 1,879                                     | 9,855                        | (33)   | <b>12,040</b>                             |
| Other comprehensive income        |   |                                |   |                              | 4  | 4   |
| Stock-based compensation expense  |   |                                | 74  |                              |  | 74  |
| Net income                        |   |                                |   | 202                          |  | 202                                       |
| <b>Balance, December 31, 2016</b> | <b>3,395,521</b>                          | <b>\$ 339</b>                  | <b>\$ 1,953</b>                           | <b>\$ 10,057</b>             | <b>\$ (29)</b>   | <b>\$ 12,320</b>                          |

See Notes to Financial Statements



**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**STATEMENTS OF CASH FLOWS**

(in thousands)

|  | Years ended<br>December 31, |          |
|--|-----------------------------|----------|
|  | 2016                        | 2015     |
| Cash flows from (used in) operating activities                                       |                             |          |
| Net Income   | \$202                       | \$1,214  |
| Adjustments to reconcile net income to net cash from (used in) operating activities: |                             |          |
| Depreciation and amortization  | 313                         | 348      |
| Realized gain on sale of available-for-sale securities                               | 0                           | (1,449 ) |
| Deferred income taxes  | (18 )                       | (104 )   |
| Change in contingent earn-out fair value   | (260 )                      | (17 )    |
| Stock-based compensation expense   | 74                          | 63       |
| Other  | (20 )                       | (1 )     |
| Change in:   |                             |          |
| Trade receivables  | (81 )                       | 51       |
| Inventories  | 49                          | (340 )   |
| Other current assets   | (4 )                        | (7 )     |
| Accounts payable   | 103                         | 10       |
| Accrued expenses   | (92 )                       | 4        |
| Accrued income taxes   | (70 )                       | (78 )    |
| Net cash from (used in) operating activities   | 196                         | (306 )   |
| Cash flows from (used in) investing activities                                       |                             |          |
| Proceeds from sale of available-for-sale securities                                  | 0                           | 1,467    |
| Purchases of treasury bills  | (8,866)                     | (12,674) |
| Proceeds from the maturity of treasury bills   | 9,339                       | 11,343   |
| Purchase of property and equipment   | (8 )                        | (70 )    |
| Net cash from investing activities   | 465                         | 66       |
| Cash flows used in financing activities  |                             |          |
| Payments on long-term debt   | (390 )                      | (381 )   |
| Net cash used in financing activities  | (390 )                      | (381 )   |

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|  |       |        |
|--|-------|--------|
| Net increase (decrease) in cash and cash equivalents | 271   | (621 ) |
| Cash and cash equivalents, beginning                 | 569   | 1,190  |
| Cash and cash equivalents, ending                    | \$840 | \$569  |
| Supplemental cash flow information                   |       |        |
| Cash paid during the year for income taxes           | \$90  | \$712  |
| Cash paid during the year for interest               | \$10  | \$19   |

See Notes to Financial Statements

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES  
NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

**Note 1. Nature of Business and Significant Accounting Policies**

**Nature of business:**

The accompanying financial statements include the accounts of Electro-Sensors, Inc. and its wholly-owned subsidiaries, ESI Investment Company and Senstar Corporation. Senstar has no assets or operations. As of December 31, 2015, these two subsidiaries were merged into the Electro-Sensors, Inc. parent company. Intercompany accounts, transactions and earnings have been eliminated in the 2015 consolidation. The consolidated entity was referred to as “the Company” or “ESI”. For 2016, the only reporting entity is Electro-Sensors, Inc. The Company still refers to itself as Electro-Sensors, Inc. and Subsidiaries though it has no subsidiaries in 2016.

Electro-Sensors, Inc. manufactures and markets a complete line of monitoring and control systems for a variety of 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 sells these products through an internal sales staff, manufacturer’s representatives, and distributors to a wide variety of industries that use the products in a variety of applications to monitor process machinery operations. The Company markets its products to customers located throughout the United States, Canada, Latin America, Europe, and Asia.

In addition, through our former subsidiary ESI Investment Company, we periodically made strategic investments in other businesses, primarily when we believed that these investments would facilitate the development of technology complementary to our existing products. During 2015, we sold substantially all our remaining investments in other businesses and companies. See Note 2 for additional information regarding the Company’s 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 financial statements in accordance with accounting principles generally accepted in the United States of America (US GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Significant estimates, including the underlying assumptions, consist of the economic lives of long lived assets, realizability of trade receivables, valuation of deferred tax assets/liabilities, inventory, investments, contingent earn-out, 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 primarily in two bank deposit accounts, 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**

Trade receivables are uncollateralized customer obligations due under normal trade terms generally requiring payment within 30 days from the invoice date. Trade 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 trade receivables.

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

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES  
NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

The carrying amount of trade receivables 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 trade 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.

**Available-for-sale securities**

The Company's investments have traditionally consisted of government debt securities and equity securities, primarily common stock. The estimated fair value of publicly traded equity securities is based on reported market prices or management's reasonable market price when quoted prices are not available, 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 generally does not make investments in anticipation of short-term fluctuations in market price, the Company classifies its investments in equity securities and treasury bills as available-for-sale. Available-for-sale securities with readily determinable values 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 loss.

Realized gains and losses on securities, 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 recognized in the years ended December 31, 2016 and 2015. The Company sold substantially all of its equity available-for-sale securities during 2015.

## **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 financial statements on a recurring basis. These policies also incorporate the guidance for fair value measurement related to nonfinancial items that are recognized and disclosed at fair value in the 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, trade receivables, accounts payable, and other financial working capital items approximate fair value at December 31, 2016 and 2015 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 net realizable value.

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES  
NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

**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 and intangible assets, 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 the Company to test a long-lived asset 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, the Company recognizes impairment to the extent that the carrying value of an asset exceeds its fair value. The Company determines fair value through various valuation techniques including, but not limited to, discounted cash flow models, quoted market values and third-party independent appraisals.

Estimated useful lives are as follows

|                        | <b>Years</b> |
|------------------------|--------------|
| Equipment              | 3-10         |
| Furniture and Fixtures | 3 - 7        |
| Building               | 7-40         |

**Intangible assets**

Intangible assets are comprised of a noncompete agreement and the HazardPRO™ technology. The Company amortizes the cost of these intangible assets on a straight-line method over the estimated useful lives.

### **Revenue recognition**

The Company recognizes revenue 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 certain. Product revenues are recognized upon shipment because the contracts generally do not include post-shipment obligations. The Company may offer discounts that it generally records at the time of sale. In addition to exchanges and warranty returns, customers have limited refund rights. Historically, returns have been minimal and immaterial to the financial statements and are generally recognized when the returned product is received by the Company. In some situations, the Company receives advance payments from its customers. The Company defers the recognition of revenue associated with these advance payments until the product ships.

### **Advertising costs**

The Company expenses advertising costs as incurred. Total advertising expense was \$55 and \$56 in fiscal 2016 and 2015, respectively.

### **Research and development**

Expenditures for research and development are expensed as incurred. The Company incurred expenses of \$767 and \$753 in fiscal 2016 and 2015, respectively.



**ELECTRO-SENSORS, INC. AND SUBSIDIARIES  
NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

**Income taxes**

The Company presents deferred income taxes on an asset and liability approach to financial accounting and reporting for income taxes. The Company annually determines the difference between the financial reporting and tax bases of assets and liabilities. The Company computes deferred income tax assets and liabilities for those differences that have future tax consequences using the currently enacted tax laws and rates that apply to the periods in which these laws 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 asset or liability allocated to other comprehensive loss. Deferred taxes are reduced by a valuation allowance to the extent that realization of the related deferred tax asset is not certain. No valuation allowance was deemed necessary at December 31, 2016 and 2015.

The Company recognizes the effect of income tax positions only if those positions are more likely than not to be sustained. The Company recognizes income tax positions at the largest amount that is more likely than not to be realized. The Company reflects changes in recognition or measurement 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**

Basic earnings per share (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.

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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<br>share<br>amount |
|--|----------|-----------|------------------------|
| 2016:  |          |           |                        |
| Basic EPS                                    | \$ 202   | 3,395,521 | \$ 0.06                |
| Effect of dilutive stock options             |          | 424       | 0.00                   |
| Diluted EPS                                  | \$ 202   | 3,395,945 | \$ 0.06                |
| 2015:  |          |           |                        |
| Basic EPS                                    | \$ 1,214 | 3,395,521 | \$ 0.36                |
| Effect of dilutive stock options (corrected) |          | 0         | 0.00                   |
| Diluted EPS (corrected)                      | \$ 1,214 | 3,395,521 | \$ 0.36                |

During 2016, the Company noted it had erroneously calculated the 2015 effect of dilutive stock options. Previously, they reported 257,500 common stock equivalents related to stock options. This had a dilutive EPS effect of (\$0.03). The Company had no common stock equivalents outstanding as of December 31, 2015.

### Stock-based 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, 2016, the Company had two stock-based compensation plans.

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES  
NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

**Recently Adopted Accounting Pronouncements**

**Inventory Measurement**

In July 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2015-11, which amended Inventory (Topic 330) Related to Simplifying the Measurement of Inventory of the Accounting Standards Codification. The amended guidance applies to all inventory except that which is measured using last-in, first-out (LIFO) or the retail inventory method. Inventory measured using first-in, first-out (FIFO) or average cost is included in the new amendments. Inventory within the scope of the new guidance should be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Subsequent measurement is unchanged for inventory measured using LIFO or the retail inventory method. The Company implemented the standard in 2016. Adoption of this standard did not have a material effect on the Company's financial statements.

**Deferred Income Taxes**

In November 2015, the FASB issued Accounting Standards Update (ASU) No. 2015-17, which amended the Income Taxes (Topic 740) of the Accounting Standards Codification to simplify the presentation of deferred income taxes by requiring that deferred tax liabilities and assets be classified as noncurrent in a classified balance sheet. The amendments will be effective for financial statements issued for annual periods beginning after December 15, 2017 with early adoption permitted as of the beginning of an interim or annual reporting period. The Company implemented the standard in 2016. Adoption of this standard did not have a material effect on the Company's financial statements.

**Recently Issued Accounting Pronouncements**

**Contract Revenue Recognition (Evaluating)**

In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09 which was amended in August 2015 and during 2016. This standard amended the Revenue from Contracts with Customers (Topic 606) of the

Accounting Standards Codification. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect this standard to have a material effect on its financial statements.

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

**Note 2. Investments**

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

|                                      | Cost     | Gross<br>unrealized<br>gain | Gross<br>unrealized<br>loss | Fair<br>value |
|--------------------------------------|----------|-----------------------------|-----------------------------|---------------|
| December 31, 2016                    |          |                             |                             |               |
| Commercial Paper                     | \$ 348   | \$ 0                        | \$ 0                        | \$ 348        |
| Treasury Bills                       | 7,419    | 8                           | 0                           | 7,427         |
| Equity Securities                    | 54       | 0                           | (54 )                       | 0             |
|                                      | 7,821    | 8                           | (54 )                       | 7,775         |
| Less Cash Equivalents                | 348      | 0                           | 0                           | 348           |
| Total Investments, December 31, 2016 | \$ 7,473 | \$ 8                        | \$ (54 )                    | \$ 7,427      |
| December 31, 2015                    |          |                             |                             |               |
| Money Market Funds                   | \$ 246   | \$ 0                        | \$ 0                        | \$ 246        |
| Commercial Paper                     | 247      | 0                           | 0                           | 247           |
| Treasury Bills                       | 7,872    | 0                           | 0                           | 7,872         |
| Equity Securities                    | 54       | 0                           | (54 )                       | 0             |
|                                      | 8,419    | 0                           | (54 )                       | 8,365         |
| Less Cash Equivalents                | 493      | 0                           | 0                           | 493           |
| Total Investments, December 31, 2015 | \$ 7,926 | \$ 0                        | \$ (54 )                    | \$ 7,872      |

Realized gains and losses on investments are as follows:

Years  
 Ended  
 December  
 31,  
 2016/2015

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|                       |     |         |
|-----------------------|-----|---------|
| Gross Realized Gains  | \$0 | \$1,449 |
| Gross Realized Losses | 0   | 0       |
| Net Realized Gain     | \$0 | \$1,449 |

During fiscal 2015, the Company sold 122,649 shares of Rudolph Technologies, Inc. (ticker symbol RTEC) stock and reported a gain of \$1,447 in other income.

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

**Changes in Accumulated Other Comprehensive Income (Loss)**

Changes in Accumulated Other Comprehensive Income (Loss) are as follows:

|  | December<br>31,<br>2016 | 2015     |
|--|-------------------------|----------|
| Unrealized Gains (Losses)  |                         |          |
| Unrealized holding gains arising during the period                       | \$8                     | \$211    |
| Less: Reclassification of gains included in net income                   | 0                       | (1,449)  |
|  | 8                       | (1,238)  |
| Deferred Taxes on Unrealized Gains (Losses):                             |                         |          |
| Increase in deferred taxes on unrealized gains arising during the period | 4                       | 80       |
| Less: Reclassification of taxes on gains included in net income          | 0                       | (551 )   |
|  | 4                       | (471 )   |
| Net Change in Accumulated Other Comprehensive Income (Loss)              | \$4                     | \$(767 ) |

**Note 3. Fair Value Measurements**

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

**December 31, 2016**

| Carrying<br>amount | Fair Value<br>Measurement Using |
|--------------------|---------------------------------|
|--------------------|---------------------------------|

|                            | <b>in<br/>balance<br/>sheet</b> | <b>Fair<br/>Value</b> | <b>Level<br/>1</b> | <b>Level<br/>2</b> | <b>Level<br/>3</b> |
|----------------------------|---------------------------------|-----------------------|--------------------|--------------------|--------------------|
| Assets:                    |                                 |                       |                    |                    |                    |
| Cash and cash equivalents: |                                 |                       |                    |                    |                    |
| Commercial paper           | \$ 348                          | \$348                 | \$348              | \$ 0               | \$0                |
| Treasury bills             | 7,427                           | 7,427                 | 7,427              | 0                  | 0                  |
| Equity securities          | 0                               | 0                     | 0                  | 0                  | 0                  |
| Liabilities:               |                                 |                       |                    |                    |                    |
| Contingent earn-out        | 195                             | 195                   | 0                  | 0                  | 195                |

**December 31, 2015**

|                            | <b>Carrying<br/>amount<br/>in<br/>balance<br/>sheet</b> | <b>Fair<br/>Value</b> | <b>Fair Value<br/>Measurement Using</b> |                    |                    |
|----------------------------|---|-----------------------|---|--------------------|--------------------|
|                            |   |                       | <b>Level<br/>1</b>                      | <b>Level<br/>2</b> | <b>Level<br/>3</b> |
| Assets:                    |   |                       |   |                    |                    |
| Cash and cash equivalents: |   |                       |   |                    |                    |
| Money market               | \$ 246  | \$246                 | \$246                                   | \$ 0               | \$0                |
| Commercial paper           | 247   | 247                   | 247                                     | 0                  | 0                  |
| Treasury bills             | 7,872   | 7,872                 | 7,872                                   | 0                  | 0                  |
| Equity securities          | 0   | 0                     | 0                                       | 0                  | 0                  |
| Liabilities:               |   |                       |   |                    |                    |
| Contingent earn-out        | 455   | 455                   | 0                                       | 0                  | 455                |



**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

The fair value of the money market funds, commercial paper, and treasury bills is based on quoted market prices in an active market. Closing prices are readily available from active markets and are used as being representative of fair value. The Company classifies these securities as level 1. The only equity security owned by the Company is an investment in a limited-marketable company. There is an insignificant market for this limited-marketable company and the Company has determined the value based on financial and other factors, which are considered level 3 inputs in the fair value hierarchy. Management estimated the probability of meeting the revenue targets over the measurement period to determine the fair value of the contingent earn-out, which is considered a level 3 input in the fair value hierarchy.

The change in level 3 liabilities at fair value on a recurring basis is summarized as follows:

|                    | Years Ended<br>December<br>31, |       |
|--------------------|--------------------------------|-------|
|                    | 2016                           | 2015  |
| Beginning Balance  | \$455                          | \$472 |
| Credit to Earnings | (260)                          | (17)  |
| Ending Balance     | \$195                          | \$455 |

The 2016 decrease in the contingent earn-out, which is recorded in general and administrative expenses reflects the Company's expectation of lower future contingent payments related to a general manufacturing sector slowdown as well as slower adoption of the Company's wireless product offerings. The 2015 decrease in the contingent earn-out reflected the Company's expectation of moderately lower future contingent payments due to delays in releasing the product due to development and obtaining third-party certifications.

**Note 4. Inventories**

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

|                   | December 31, |         |
|-------------------|--------------|---------|
|                   | 2016         | 2015    |
| Raw Materials     | \$907        | \$956   |
| Work In Process   | 286          | 297     |
| Finished Goods    | 322          | 311     |
| Total Inventories | \$1,515      | \$1,564 |

**Note 5. Property and Equipment, Net**

The following is a summary of property and equipment:

|                               | December 31, |         |
|-------------------------------|--------------|---------|
|                               | 2016         | 2015    |
| Equipment                     | \$260        | \$285   |
| Furniture and Fixtures        | 405          | 410     |
| Building                      | 1,370        | 1,365   |
| Land                          | 415          | 415     |
|                               | 2,450        | 2,475   |
| Less Accumulated Depreciation | 1,417        | 1,372   |
| Total Property and Equipment  | \$1,033      | \$1,103 |

Depreciation expense for the years ended December 31, 2016 and 2015 was \$78 and \$113, respectively.

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

**Note 6. Net Intangible Assets**

Intangible assets include the following:

|                       |                             | <b>December 31, 2016</b>     |                                 |                            |
|-----------------------|-----------------------------|------------------------------|---------------------------------|----------------------------|
|                       | <b>Average Useful Lives</b> | <b>Gross Carrying Amount</b> | <b>Accumulated Amortization</b> | <b>Net Carrying Amount</b> |
| Noncompete            | 5 Years                     | \$ 120                       | \$ 70                           | \$ 50                      |
| Technology            | 7 Years                     | 1,478                        | 493                             | 985                        |
| Net Intangible Assets |                             | \$1,598                      | \$ 563                          | \$ 1,035                   |

  

|                       |                             | <b>December 31, 2015</b>     |                                 |                            |
|-----------------------|-----------------------------|------------------------------|---------------------------------|----------------------------|
|                       | <b>Average Useful Lives</b> | <b>Gross Carrying Amount</b> | <b>Accumulated Amortization</b> | <b>Net Carrying Amount</b> |
| Noncompete            | 5 Years                     | \$ 120                       | \$ 46                           | \$ 74                      |
| Technology            | 7 Years                     | 1,478                        | 282                             | 1,196                      |
| Net Intangible Assets |                             | \$1,598                      | \$ 328                          | \$ 1,270                   |

Amortization expense for the years ended December 31, 2016 and 2015 was \$235.

Estimated amortization expense over the next five years is as follows:

|      |        |
|------|--------|
| 2017 | \$ 235 |
| 2018 | \$ 235 |
| 2019 | \$ 213 |
| 2020 | \$ 211 |
| 2021 | \$ 141 |

**Note 7. Accrued Expenses**

Accrued expenses include the following:

|                        | December |       |
|------------------------|----------|-------|
|                        | 31,      |       |
|                        | 2016     | 2015  |
| Wages and Commissions  | \$273    | \$272 |
| Other                  | 31       | 124   |
| Total Accrued Expenses | \$304    | \$396 |

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES  
NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

**Note 8. Note Payable**

The note payable consists of the following:

|   |                      |
|---|----------------------|
|   | December<br>31, 2015 |
| Note payable to seller  | \$ 400               |
| Payable in annual installments of principal of \$400. The note was paid off in February 2016. This note was non-interest bearing and unsecured. |                      |
| Less: Discount of note payable listed above   | (10 )                |
| Net note payable  | 390                  |
| Less: Current maturities  | 390                  |
| Note Payable – Long Term  | \$ 0                 |

**Note 9. Common Stock Options**

**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**

Under the 2013 Plan, the Company is authorized to grant options to purchase up to 600,000 shares of its common stock. As of December 31, 2016, options to purchase an aggregate of 300,000 shares were outstanding under the 2013 Plan, of which 215,000 shares were exercisable, and 300,000 shares were available for issuance pursuant to awards that may be granted under the plan in the future.

Under the 1997 Plan, the Company was authorized to grant options to purchase up to 450,000 shares of its common stock. As of December 31, 2016, options to purchase an aggregate of 7,500 shares were outstanding and exercisable under the 1997 Plan. 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.

During the 2016 first quarter, the Company granted its Chief Executive Officer options to purchase 50,000 shares of common stock. The options were priced at fair market value and vested 20% on the grant date, with an additional 20% vesting on the first four anniversaries of the grant date. The options expire 10 years from the date of grant.

The assumptions made in estimating the fair value of the options on the grant date based upon the BSM option-pricing model for the year ended December 31, 2016 are as follows:

|                         |         |
|-------------------------|---------|
| Dividend Yield          | 0.00%   |
| Expected Volatility     | 36.17%  |
| Risk Free Interest Rate | 1.31%   |
| Expected Life           | 6 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.

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**(in thousands except share and per share amounts)**

The following table summarizes the activity for outstanding incentive stock options under the 2013 Plan to employees of the company:

|  | <b>Options Outstanding</b> |  |   |                                      |
|--|----------------------------|--|---|--------------------------------------|
|  | <b>Number of Shares</b>    | <b>Weighted-Average Exercise Price</b> | <b>Weighted-Average Remaining Contractual Term (in years)</b> | <b>Aggregate Intrinsic Value (1)</b> |
| Balance at January 1, 2015                     | 50,000                     | \$ 4.21                                | 8.6   |                                      |
| Granted  | 0                          |  |   |                                      |
| Exercised                                      | 0                          |  |   |                                      |
| Canceled/forfeited/expired                     | 0                          |  |   |                                      |
| Balance at December 31, 2015                   | 50,000                     | 4.21                                   | 7.6   |                                      |
| Granted  | 50,000                     | 3.41                                   | 10.0  |                                      |
| Exercised                                      | 0                          |  |   |                                      |
| Canceled/forfeited/expired                     | 0                          |  |   |                                      |
| Balance at December 31, 2016                   | 100,000                    | \$ 3.81                                | 8.7   |                                      |
| Vested and exercisable as of December 31, 2016 | 60,000                     |  |   | \$ 3                                 |

(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, 2016.

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO FINANCIAL STATEMENTS**

**YEARS ENDED DECEMBER 31, 2016 AND 2015**

(in thousands except share and per share amounts)

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

|  | <b>Options Outstanding</b>      |   |   |  |
|--|---------------------------------|---|---|--|
|  | <b>Number<br/>of<br/>Shares</b> | <b>Weighted-<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted-<br/>Average<br/>Remaining<br/>Contractual<br/>Term<br/><br/>(in years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value (1)</b> |
| Balance at January 1, 2015                     | 207,500                         | \$ 4.62   | 8.4   |  |
| Granted  | 0                               |   |   |  |
| Exercised                                      | 0                               |   |   |  |
| Canceled/forfeited/expired                     | 0                               |   |   |  |
| Balance at December 31, 2015                   | 207,500                         | 4.62  | 7.4   |  |
| Granted  | 0                               |   |   |  |
| Exercised                                      | 0                               |   |   |  |
| Canceled/forfeited/expired                     | 0                               |   |   |  |
| Balance at December 31, 2016                   | 207,500                         | \$ 4.62   | 6.4   |  |
| Vested and exercisable as of December 31, 2016 | 162,500                         |   |   | \$ 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, 2016.

The weighted average grant date fair value of options granted during the year ended December 31, 2016, under the 2013 Plan, was \$33. The Company recognized compensation expense of approximately \$74 and \$63 during the years ended December 31, 2016 and 2015, respectively, in connection with the issuance of the options.

There were no options exercised during the years ended December 31, 2016 and 2015.



As of December 31, 2016, there was approximately \$68 of unrecognized compensation expense under the 2013 Plan. The Company expects to recognize this expense over the next three 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.

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO FINANCIAL STATEMENTS**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**  
**(in thousands except share and per share amounts)**

**Note 10. 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 135,490 shares of the Company’s stock at December 31, 2016. All shares held by the Plan have been released and allocated. No dividends were paid during the years ended December 31, 2016 and 2015. The Plan had no debt to the Company at December 31, 2016 or 2015.

The Company recognized compensation expense for contributions of \$24 to the ESOP plan in 2016 and 2015.

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, at its election, the Company may distribute the ESOP’s shares to the terminated participant. At December 31, 2016, 135,490 shares of the Company’s stock, with an aggregate fair market value of approximately \$469, 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 that conforms to IRS provisions for 401(k) plans. The Company may make profit sharing contributions with the approval of the Board of Directors. There were no profit sharing contributions by the Company in 2016 or 2015.



**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO FINANCIAL STATEMENTS**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**  
**(in thousands except share and per share amounts)**

**Note 11. Income Taxes**

The components of the income tax provision for the years ended December 31, 2016 and 2015 are as follows:

|                                      | 2016 | 2015  |
|--------------------------------------|------|-------|
| Current:                             |      |       |
| Federal                              | \$19 | \$633 |
| State                                | 1    | 1     |
| Deferred:                            |      |       |
| Federal                              | (19) | (101) |
| State                                | 1    | (3)   |
| Total Federal and State Income Taxes | \$2  | \$530 |

The provision for income taxes for the years ended December 31, 2016 and 2015 differs from the amount obtained by applying the U.S. federal income tax rate to pretax income due to the following:

|  | 2016 | 2015  |
|--|------|-------|
| Computed "Expected" Federal Tax Expense      | \$70 | \$601 |
| Increase (Decrease) in Taxes Resulting From: |      |       |
| State Income Taxes, net of Federal Benefit   | 2    | 10    |
| Credits                                      | (63) | (58)  |
| Domestic Production Activities Deduction     | (5)  | (22)  |
| Permanent Differences                        | 5    | 5     |
| Other  | (7)  | (6)   |
| Total Federal and State Income Taxes         | \$2  | \$530 |

The components of the net deferred tax asset consist of:

2016 2015

|                                    |       |       |
|------------------------------------|-------|-------|
| Deferred Tax Assets:               |       |       |
| Vacation accrual                   | \$37  | \$34  |
| Allowance for doubtful accounts    | 3     | 3     |
| Stock compensation                 | 128   | 102   |
| Bonus                              | 0     | 10    |
| Depreciation and amortization      | 0     | 1     |
| Net unrealized loss on investments | 17    | 21    |
| State carryforward R&D credit      | 73    | 46    |
| Total Deferred Tax Assets          | 258   | 217   |
| Deferred Tax Liabilities:          |       |       |
| Prepaid expenses                   | 40    | 33    |
| Depreciation and amortization      | 20    | 0     |
| Total Deferred Tax Liabilities     | 60    | 33    |
| Net Deferred Tax Asset             | \$198 | \$184 |

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 and state jurisdictions are 2013 through 2015. We have no accrued interest or penalties related to uncertain tax positions as of January 1, 2016 or December 31, 2016 and uncertain tax positions are not significant.

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES**  
**NOTES TO FINANCIAL STATEMENTS**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**  
**(in thousands except share and per share amounts)**

**Note 12. Segment Information**

As of January 1, 2016, the Company has one reportable operating segment: Production Monitoring. During 2015, the Company had 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 held 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 income taxes. The Company has no inter-segment sales.

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

|                                       | 2015    |
|---------------------------------------|---------|
| Net revenues                          |         |
| Production Monitoring                 | \$7,636 |
| Total                                 | 7,636   |
| Sales in foreign countries            |         |
| Production Monitoring                 | 972     |
| Total                                 | 972     |
| Interest income                       |         |
| Production Monitoring                 | 0       |
| ESI Investment Company                | 0       |
| Total                                 | 0       |
| Depreciation and amortization expense |         |
| Production Monitoring                 | 348     |
| Total                                 | 348     |
| Interest expense                      |         |
| Production Monitoring                 | 11      |
| Total                                 | 11      |
| Capital purchases                     |         |

|                            |         |
|----------------------------|---------|
| Production Monitoring      | 70      |
| Total                      | 70      |
| Total assets               |         |
| Production Monitoring      | 4,998   |
| ESI Investment Company     | 8,423   |
| Total                      | 13,421  |
| Income before income taxes |         |
| Production Monitoring      | 295     |
| ESI Investment Company     | 1,449   |
| Total                      | \$1,744 |

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, 2016 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, 2016. 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 (2013)*." 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, 2016.

### ***Changes in Internal Control over Financial Reporting***

There have been no changes in the Company's internal control over financial reporting that occurred during the fourth quarter of fiscal year 2016, 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.**

As of February 28, 2017, Nancy Peterson, the mother of Company director Jeffrey Peterson, was the beneficial owner of, and had voting and dispositive control over, 51.7% of the Company's common stock. As the majority shareholder of the Company, Nancy Peterson had the ability to elect all directors of the Company. Nancy Peterson passed away on March 18, 2017. Nancy Peterson and the Company did not have a formal agreement with respect to the designation or election of Jeffrey Peterson, or any other person, as a director of the Company. The Company believes the ownership and control of Nancy Peterson's common stock will pass to her estate, the trustees of any trust that holds this Company stock, her heirs, and her beneficiaries.

### PART III

Certain information required by Part III is incorporated by reference to the Company's Definitive Proxy Statement pursuant to Regulation 14A (the "2017 Proxy Statement") for its Annual Meeting of Shareholders to be held April 26, 2017 ("Annual Meeting").

#### Item 10. Directors, Executive Officers and Corporate Governance.

The information required by Item 401 under Regulation S-K, to the extent applicable to the Company's directors, will be set forth under the caption "Election of Directors" in the 2017 Proxy Statement and is incorporated herein by reference. The information required with respect to the Company sole executive officer, who is also a director, will be set forth under the caption "Election of Directors."

The information required by Item 405 regarding compliance with Section 16 (a) will be set forth under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in the 2017 Proxy Statement, and is incorporated herein by reference.

#### Code of Ethics and Business Conduct

The Company has adopted the Electro-Sensors Code of Ethics and Business Conduct (the "Code of Conduct") applicable to all officers and employees of the Company. A copy of the Code of Conduct can be obtained free of charge upon written request directed to the Company's Secretary at the Company's executive offices. Any amendment to, or waiver from, a provision of our Code of Conduct will be posted to our website.

The information required by Item 407 regarding corporate governance will be set forth under the caption "Corporate Governance" in the 2017 Proxy Statement and is incorporated herein by reference.

#### Item 11. Executive Compensation.

The information called for by Item 402 under Regulation S-K, will be set forth under the caption "Executive Compensation" in the Company's 2017 Proxy Statement and is incorporated herein by reference.

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

The information called for by Item 403 under Regulation S-K will be set forth under the caption “Security Ownership of Certain Beneficial Owners and Management” in the Company’s 2017 Proxy Statement, and is incorporated herein by reference.

The following table provides information as of December 31, 2016 about the Company’s equity compensation plans.

**Equity Compensation Plan Information**

|  | <b>Number of securities to be issued upon exercise of outstanding options, warrants and rights</b> | <b>Weighted average exercise price of outstanding options, warrants and rights</b> | <b>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</b> |
|--|--|--|--|
|  | <b>(a)</b>   | <b>(b)</b>   | <b>(c)</b>   |
| Equity compensation plans approved by security holders     | 307,500  | \$4.35   | 300,000 <sup>(1)</sup>   |
| Equity compensation plans not approved by security holders | —  | —  | —  |
| <b>Total</b>   | <b>307,500</b>   | <b>\$4.35</b>  | <b>300,000<sup>(1)</sup></b>   |

<sup>(1)</sup> Shares issuable pursuant to the 2013 Equity Incentive Plan.

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

The information required by Item 404 under Regulation S-K will be set forth under the caption “Transactions with Related Persons, Promoters and Certain Control Persons” in the 2017 Proxy Statement, and is incorporated herein by reference.

The information required by Item 407(a) will be set forth in the 2017 Proxy Statement under the caption “Corporate Governance” and is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services.

The information required by Item 14 of Form 10-K and 9(e) of Schedule 14A will be set forth under the caption “Ratification of Independent Registered Public Accounting Firm” in the Company’s 2017 Proxy Statement, and is incorporated herein by reference.

PART IV

Item 15. Exhibits and Financial Statement Schedules.

**Financial Statements.**

Reference is made to the Index to 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 financial statements or the notes thereto included in this Annual Report.

**Exhibits.**

See “Exhibit Index” on the page following the signatures.

**Item 16. Form 10K Summary**

None

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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 29, 2017

By: /s/ GLORIA M.  
GRUNDHOEFER  
Gloria M. Grundhoefer

*Controller*

Date: March 29, 2017

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**

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|                         |                                      |                |
|-------------------------|--------------------------------------|----------------|
| /s/David L. Klenk       | President and Director (CEO and CFO) | March 29, 2017 |
| /s/ Joseph A. Marino    | Chairman and Director                | March 29, 2017 |
| /s/ Scott A. Gabbard    | Director                             | March 29, 2017 |
| /s/ Michael C. Zipoy    | Director                             | March 29, 2017 |
| /s/ Jeffrey D. Peterson | Director                             | March 29, 2017 |

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**EXHIBIT INDEX TO FORM 10-K**

For the Fiscal Year Ended December 31, 2016 Commission File No. 000-09587

| <b>Exhibit Number</b> | <b>Exhibit Description</b>  |
|-----------------------|---|
| ^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. 1997 Stock Option Plan —incorporated by reference to Exhibit 10.6 to the Company's 1997 Form 10-KSB   |
| ^*10.2                | Electro-Sensors, Inc. 2013 Equity Incentive Plan incorporated by reference to Appendix A of the Company's Proxy Statement for the Company's 2016 Annual Meeting of Shareholders   |
| ^*10.4                | Form of Incentive Stock Option Agreement under the 2013 Equity Incentive Plan – incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 29, 2013   |
| ^*10.5                | Form of Non-qualified Stock Option Agreement under the 2013 Equity Incentive Plan – incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on April 29, 2013   |
| 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 10, 2017   |
| 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, 2016, formatted in eXtensible Business Reporting Language (XBRL):<br>(i) Balance Sheets as of December 31, 2016 and 2015, (ii) Statements of Comprehensive Income for the years ended December 31, 2016 and 2015, (iii) Statements of Cash Flows for years ended December 31, 2016 and 2015, (iv) Statement of Changes in Stockholders' Equity, and (v) Notes to Financial Statements. |

^Incorporated by reference to a previously filed report or document—SEC File No. 000-09587

\*Management contract or compensatory plan or arrangement



