NORTECH SYSTEMS INC
Form 10-Q
November 14, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from to

NORTECH SYSTEMS INCORPORATED

Commission file number **0-13257**

State of Incorporation: **Minnesota**

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

Executive Offices: **1120 Wayzata Blvd E., Suite 201, Wayzata, MN 55391**

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

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

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

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

Large Accelerated Filer o	Accelerated Filer o
Non-accelerated Filer o	Smaller Reporting Company x

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

Number of shares of $.01 par value common stock outstanding at November 7, 2013 - 2,742,992

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PART 1

ITEM 1. FINANCIAL STATEMENTS

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

	SEPTEMBER 30 2013 (Unaudited)	DECEMBER 31 2012
ASSETS		
Current Assets		
Cash	$ 482,631	$
Accounts Receivable, Less Allowance for Uncollectible Accounts	15,082,610	13,607,933
Inventories	18,648,401	17,664,862
Prepaid Expenses	902,057	561,576
Income Taxes Receivable	200,126	
Deferred Income Taxes	642,000	857,000
Total Current Assets	35,957,825	32,691,371
Property and Equipment, Net	11,126,638	11,566,315
Other Assets	123,742	257,213
Total Assets	$ 47,208,205	$ 44,514,899
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Line of Credit	$ 7,983,140	$ 7,923,487
Current Maturities of Long-Term Debt	564,705	453,105
Accounts Payable	8,459,211	9,051,978
Accrued Payroll and Commissions	3,225,344	1,965,657
Other Accrued Liabilities	706,413	676,336
Income Taxes Payable		60,878
Total Current Liabilities	20,938,813	20,131,441
Long-Term Liabilities		
Long-Term Debt, Net of Current Maturities	4,148,570	2,865,899
Deferred Income Taxes	183,000	227,000
Other Long-Term Liabilities	246,420	155,328
Total Long-Term Liabilities	4,577,990	3,248,227
Total Liabilities	25,516,803	23,379,668
Shareholders Equity		
Preferred Stock, $1 par value; 1,000,000 Shares Authorized: 250,000 Shares Issued and Outstanding	250,000	250,000
Common Stock - $0.01 par value; 9,000,000 Shares Authorized: 2,742,992 Shares Issued and Outstanding	27,430	27,430
Additional Paid-In Capital	15,735,337	15,725,392
Accumulated Other Comprehensive Loss	(62,936)	(62,936)
Retained Earnings	5,741,571	5,195,345

Total Shareholders Equity		21,691,402		21,135,231
Total Liabilities and Shareholders Equity	$	47,208,205	$	44,514,899

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30			
		2013		2012
Net Sales	$	27,389,275	$	25,520,963
Cost of Goods Sold		24,373,696		22,736,923
Gross Profit		3,015,579		2,784,040
Operating Expenses:				
Selling Expenses		1,228,583		992,295
General and Administrative Expenses		1,410,815		1,463,074
Total Operating Expenses		2,639,398		2,455,369
Income From Operations		376,181		328,671
Other Income (Expense)				
Interest Expense		(103,977)		(111,999)
Miscellaneous Income (Expense), net		32,713		(54,507)
Total Other Expense		(71,264)		(166,506)
Income Before Income Taxes		304,917		162,165
Income Tax Expense		87,000		57,000
Net Income	$	217,917	$	105,165
Earnings Per Common Share:				
Basic and Diluted	$	0.08	$	0.04
Weighted Average Number of Common Shares Outstanding Used for Basic and Diluted Earnings Per Common Share		2,742,992		2,742,992

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30 2013		2012	
Net Sales	$	81,765,375	$	81,915,222
Cost of Goods Sold		72,153,707		73,031,193
Gross Profit		9,611,668		8,884,029
Operating Expenses:				
Selling Expenses		3,618,354		3,232,919
General and Administrative Expenses		4,946,402		4,675,422
Impairment Charge		74,003		
Total Operating Expenses		8,638,759		7,908,341
Income From Operations		972,909		975,688
Other Income (Expense)				
Interest Expense		(302,997)		(349,107)
Miscellaneous Income (Expense), net		40,314		(80,685)
Total Other Expense		(262,683)		(429,792)
Income Before Income Taxes		710,226		545,896
Income Tax Expense		164,000		192,000
Net Income	$	546,226	$	353,896
Earnings Per Common Share:				
Basic and Diluted	$	0.20	$	0.13
Weighted Average Number of Common Shares Outstanding Used for Basic and Diluted Earnings Per Common Share		2,742,992		2,742,992

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30 2013	2012
Cash Flows From Operating Activities		
Net Income	$ 546,226	$ 353,896
Adjustments to Reconcile Net Income to Net Cash Provided by (Used in) Operating Activities:		
Depreciation	1,505,367	1,382,757
Amortization	3,969	15,246
Compensation on Stock-Based Awards	9,945	
Impairment on Assets Held for Sale	74,003	
Deferred Taxes	171,000	(80,000)
(Gain) Loss on Disposal of Property and Equipment	(1,007)	3,490
Changes in Current Operating Items		
Accounts Receivable	(1,474,677)	1,226,912
Inventories	(983,539)	1,343,271
Prepaid Expenses	(340,481)	(239,537)
Income Taxes Receivable	(200,126)	
Income Taxes Payable	(60,878)	124,268
Accounts Payable	(650,810)	(2,905,432)
Accrued Payroll and Commissions	1,259,687	425,364
Other Accrued Liabilities	120,092	83,709
Net Cash Provided by (Used in) Operating Activities	(21,229)	1,733,944
Cash Flows from Investing Activities:		
Proceeds from Sales of Assets	56,810	36,856
Purchases of Property and Equipment	(1,006,874)	(1,476,868)
Net Cash Used in Investing Activities	(950,064)	(1,440,012)
Cash Flows from Financing Activities:		
Net Borrowings (Repayments) on Line of Credit	59,653	(1,469,396)
Proceeds from Long-Term Debt	1,884,000	1,600,970
Principal Payments on Long-Term Debt	(489,729)	(425,506)
Net Cash Provided by (Used in) Financing Activities	1,453,924	(293,932)
Net Increase in Cash	482,631	
Cash - Beginning		
Cash - Ending	$ 482,631	$
Supplemental Disclosure of Cash Flow Information:		
Cash Paid During the Period for Interest	$ 278,387	$ 293,740
Cash Paid During the Period for Income Taxes	187,300	116,155
Supplemental Noncash Investing and Financing Activities Capital Expenditures in Accounts Payable	105,468	

See Accompanying Condensed Notes to Consolidated Financial Statements

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

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

Principles of Consolidation

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

Revenue Recognition

We recognize revenue upon shipment of manufactured products to customers, when title has passed, all contractual obligations have been satisfied and collection of the resulting receivable is reasonably assured. We also provide engineering services separate from the manufacture of a product. Revenue for engineering services is recognized upon completion of the engineering process, providing standalone fair value to our customers. Our engineering services are short-term in nature. In addition, we have another separate source of revenue that comes from short-term repair services, which are recognized upon completion of the repairs and shipment of product back to the customer.

Shipping and handling costs charged to our customers are included in net sales, while the corresponding shipping expenses are included in cost of goods sold.

Stock Options

Following is the status of all stock options as of September 30, 2013, including changes during the nine-month period then ended:

	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding - January 1, 2013	288,750	$ 7.19		
Granted	29,000	$ 3.20		
Cancelled	(51,750)	$ 7.23		
Outstanding - September 30, 2013	266,000	$ 6.75	3.03	$ 45,530
Exercisable - September 30, 2013	237,000	$ 7.18	2.25	$

There were no options exercised during the three and nine months ended September 30, 2013 and 2012. There were no stock options granted during the three months ended September 30, 2013. The weighted-average fair value of options granted during the nine months ended September 30, 2013 was $1.65 per share.

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Total compensation expense related to stock options for the three months ended September 30, 2013 and 2012 was $4,444 and $0, respectively. Total compensation expense related to stock options for the nine months ended September 30, 2013 and 2012 was $9,945 and $0, respectively. As of September 30, 2013, there was approximately $38,000 of unrecognized compensation related to unvested option awards that we expect to recognize over a weighted-average period of 2.37 years.

Equity Appreciation Rights Plan

In November 2010, the Board of Directors approved the adoption of the Nortech Systems Incorporated Equity Appreciation Rights Plan (the 2010 Plan). The total number of Equity Appreciation Right Units (Units) the Plan can issue shall not exceed an aggregate of 750,000 Units. The 2010 Plan provides that Units issued shall fully vest three years from the base date as defined in the agreement unless terminated earlier. Units give the holder a right to receive a cash payment equal to the appreciation in book value per share of common stock from the base date, as defined, to the redemption date. Unit redemption payments under this plan shall be paid in cash within 90 days after we determine the value as of the redemption date.

During the year ended December 31, 2010, 100,000 Units were issued with a vesting date of December 31, 2012. On March 7, 2012, the Company granted an additional 250,000 Units with vesting dates ranging from December 31, 2014 through December 31, 2016. On February 13, 2013, the Company granted an additional 350,000 Units with vesting dates ranging from December 31, 2015 through December 31, 2019.

Total compensation expense related to these Units based on the estimated appreciation over their remaining terms was $12,262 and $4,690 for the three months ended September 30, 2013 and 2012, respectively and $49,092 and $18,695 for the nine months ended September 30, 2013 and 2012, respectively.

As of September 30, 2013 and December 31, 2012, approximately $64,000 and $101,000 have been accrued under this plan, respectively. As of December 31, 2012, approximately $86,000 of this balance was included in Other Accrued Liabilities and the remaining $15,000 balance was included in Other Long-term Liabilities. A payment of $86,817 was made during the first quarter of 2013 related to these Units. As of September 30, 2013, the balance is included in Other Long-term Liabilities.

Earnings per Common Share

For the three and nine months ended September 30, 2013 and 2012, the effect of all stock options is antidilutive. Therefore, no outstanding options were included in the computation of per-share amounts.

Segment Reporting Information

All of our operations fall under the Contract Manufacturing segment within the Electronic Manufacturing Services industry. We strategically direct production between our various manufacturing facilities based on a number of considerations to best meet our customers   requirements. We share resources for sales, marketing, engineering, supply chain, information

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services, human resources, payroll, and all corporate accounting functions. Consolidated financial information is available that is evaluated regularly by the chief operating decision maker in assessing performance and allocating resources.

Inventories

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

Inventories are as follows:

		September 30 2013		**December 31 2012**
Raw Materials	$	13,387,802	$	13,325,525
Work in Process		3,655,339		2,704,653
Finished Goods		2,727,809		3,108,839
Reserve		(1,122,549)		(1,474,155)
Total	$	18,648,401	$	17,664,862

Impairment Analysis

We evaluate long-lived assets, primarily property and equipment, as well as the related depreciation periods, whenever current events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. Recoverability for assets to be held and used is based on our projection of the undiscounted future operating cash flows of the underlying assets. To the extent such projections indicate that future undiscounted cash flows are not sufficient to recover the carrying amounts of related assets, a charge might be required to reduce the carrying amount to equal estimated fair value. Assets held for sale are reported at the lower of the carrying amount or fair value less costs to dispose. We recorded an impairment charge for the three and nine months ended September 30, 2013 of $0 and $74,000, respectively, related to an asset held for sale which was ultimately sold in the second quarter of 2013. The impairment charge was included in general and administrative expenses in the statements of income. There were no impairment charges for the three and nine months ended September 30, 2012.

Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists , which states that entities should present the unrecognized tax benefit as a reduction of the deferred tax asset for a

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net operating loss (NOL) or similar tax loss or tax credit carryforward rather than as a liability when the uncertain tax position would reduce the NOL or other carryforward under the tax law. The Company will be required to adopt this new standard on a prospective basis in the first interim reporting period of fiscal 2015, however, early adoption is permitted as is a retrospective application. We are currently evaluating the impact, if any, that this new standard will have on its Consolidated Financial Statements.

NOTE 2. CONCENTRATION OF CREDIT RISK AND MAJOR CUSTOMERS

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

Our largest customer has two divisions which accounted for 10% or more of our net sales for the three and nine months ended September 30, 2013 and 2012. The first division accounted for 22% and 20% of net sales for the three and nine months ended September 30, 2013, respectively and 16% and 17% of net sales for the three and nine months ended September 30, 2012, respectively. The second division accounted for 6% of net sales for the three and nine months ended September 30, 2013 and 7% for the three and nine months ended September 30, 2012. Together the divisions accounted for 28% and 26% of net sales for the three and nine months ended September 30, 2013, respectively and 23% and 24% for the three and nine months ended September 30, 2012, respectively.

Combined accounts receivable from both divisions represented 21% and 15% of total accounts receivable at September 30, 2013 and December 31, 2012, respectively.

Export sales represented 13% of net sales for the three and nine months ended September 30, 2013. Export sales represented 6% and 7% of net sales for the three and nine months ended September 30, 2012, respectively. The increase in export sales relates to increased sales volume to existing customers.

NOTE 3. FINANCING ARRANGEMENTS

We have a credit agreement with Wells Fargo Bank (WFB) which provides for a line of credit arrangement of $13.5 million that expires, if not renewed, on May 31, 2015. The credit arrangement also provides a $1.8 million real estate term note with a maturity date of March 31, 2027 which replaced the $0.9 million real estate term note that was to expire on May 31, 2012, and a new term loan of up to $2.0 million for capital expenditures to be made prior to December 31, 2013 with a maturity date of December 31, 2017. At September 30, 2013, we ve used $1.1 million of the $2.0 million capital term loan.

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On December 31, 2012, in connection with our purchase of the Mankato building, we amended our credit agreement with WFB to include an additional $1.7 million real estate term note that expires, if not renewed, on May 31, 2015. The purchase of the building was funded through our line of credit which was paid down when the new real estate term note was funded on January 9, 2013.

Under the credit agreement, both the line of credit and real estate term notes are subject to variations in the LIBOR rate. Our line of credit bears interest at three-month LIBOR + 2.75% (approximately 3.0% at September 30, 2013) while our real estate term notes bear interest at three-month LIBOR + 3.25% (approximately 3.5% at September 30, 2013). The weighted-average interest rate on our line of credit was 3.2% and 3.3% for the three and nine months ended September 30, 2013, respectively, while the weighted-average rate on our real estate term loan was 3.7% and 3.6% for the same periods. We had borrowings on our line of credit of $7,983,140 and $7,923,487 outstanding as of September 30, 2013 and December 31, 2012, respectively.

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

The availability under the line is subject to borrowing base requirements, and advances are at the discretion of the lender. At September 30, 2013, we have net unused availability under our line of credit of approximately $4.3 million. The line is secured by substantially all of our assets.

NOTE 4. INCOME TAXES

On a quarterly basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision based on the anticipated rate. As the year progresses, we refine our estimate based on the facts and circumstances by each tax jurisdiction. Our effective tax rate for the three months ended September 30, 2013 was 29%, compared with 35% for the three months ended September 30, 2012, respectively. The effective tax rate for the year ended December 31, 2013 is expected to be 28% compared to 32% for the year ended December 31, 2012. The decreases are principally due to the federal government retroactively reinstating the research and development credit for the 2012 tax year and extending it to 2013.

The differences between federal income taxes computed at the federal statutory rate and reported income taxes for the three and nine months ended September 30, 2013 and 2012 are as follows:

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	Three Months Ended September 30		Nine Months Ended September 30	
	2013	2012	2013	2012
Statutory federal tax provision	$ 105,000	$ 61,000	$ 245,000	$ 186,000
State income taxes	16,000	2,000	39,000	18,000
Income tax credits	(48,000)	(4,000)	(151,000)	(10,000)
Change in uncertain tax positions	11,000	10,000	33,000	18,000
Other	3,000	(12,000)	(2,000)	(20,000)
Income tax expense	$ 87,000	$ 57,000	$ 164,000	$ 192,000

At September 30, 2013, we had $182,000 of net uncertain tax benefit positions recorded in other long-term liabilities that would reduce our effective income tax rate if recognized. The $42,000 increase from December 31, 2012 primarily relates to 2012 and 2013 state research and experimentation credits.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview:

We are a Wayzata, Minnesota based full-service Electronics Manufacturing Services (EMS) contract manufacturer of wire and cable assemblies, printed circuit board assemblies, higher-level assemblies and box builds for a wide range of industries. We provide value added services and technical support including design, testing, prototyping and supply chain management to customers mainly in the Aerospace and Defense, Medical, and Industrial Equipment markets. We maintain manufacturing facilities in Baxter, Bemidji, Blue Earth, Mankato, Merrifield, and Milaca, Minnesota; Augusta, Wisconsin; and Monterrey, Mexico.

Summary of Results:

For the quarter ended September 30, 2013, we reported net sales of $27.4 million compared to $25.5 million reported in the same quarter of 2012, a 7% increase year over year. For the nine months ended September 30, 2013, we reported net sales of $81.8 million compared to $81.9 million for the nine months ended September 30, 2012.

Our gross profit percentage for the three and nine months ended September 30, 2013 was 11.0% and 11.8%, respectively. The gross profit percentage for the three and nine months ended September 30, 2012 was 10.9% and 10.8%, respectively. The improvement in gross margin is the result of an increased investment in automation along with our continued lean initiatives.

Income from operations was approximately $376,000 and $973,000 for the three and nine months ended September 30, 2013, respectively and $329,000 and $976,000 for the three and nine months ended September 30, 2012, respectively.

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Net income for the third quarter of 2013 was $217,917 or $0.08 per diluted common share, compared to net income of $105,165 or $0.04 per diluted common share for the same period in 2012. Net income for the nine months ended September 30, 2013 was $546,226 or $0.20 per diluted common share, while net income for the same period in 2012 totaled $353,896 or $0.13 per diluted common share.

Cash used in operating activities in the first nine months of 2013 was $21,229. Cash provided by operating activities in the third quarter of 2013 was $1.4 million. Cash provided by operating activities was $1.7 million in the first nine months of 2012. The difference in cash used in the first nine months of 2013 compared to the first nine months of 2012 is mainly due to increased inventory to support future production schedules, new product, customer order move-outs and timing differences on collections of our accounts receivable.

Results of Operations:

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

	Three Months Ended September 30		Nine Months Ended September 30	
	2013	2012	2013	2012
Net Sales	100.0%	100.0%	100.0%	100.0%
Cost of Goods Sold	89.0	89.1	88.2	89.2
Gross Profit	11.0	10.9	11.8	10.8
Selling Expenses	4.4	3.9	4.4	3.9
General and Administrative Expenses	5.2	5.7	6.1	5.7
Restructuring and Impairment Charges	0.0	0.0	0.1	0.0
Income from Operations	1.4	1.3	1.2	1.2
Other Expenses, Net	(0.3)	(0.7)	(0.3)	(0.5)
Income Before Income Taxes	1.1	0.6	0.9	0.7
Income Tax Expense	0.3	0.2	0.2	0.2
Net Income	0.8%	0.4%	0.7%	0.5%

Net Sales:

We reported net sales of $27.4 million and $25.5 for the three months ended September 30, 2013 and 2012, respectively. Our Aerospace and Defense customer shipments increased as a result of launching a number of new programs and assemblies. Our Medical customers also contributed to the increased revenue, while our commercial industrial customers were flat after a number of quarters of decline. Net sales for the nine months ended September 30, 2013 and 2012 were $81.8 million and $81.9 million, respectively.

Net sales by industry markets for the three and nine month periods ended September 30, 2013 and 2012 are as follows:

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	Three Months Ended September 30			Nine Months Ended September 30		
	2013	2012	%	2013	2012	%
(in thousands)	$	$	Change	$	$	Change
Aerospace and Defense	4,693	3,756	25	14,394	11,823	22
Medical	9,045	8,192	10	24,959	24,084	4
Industrial	13,651	13,573	1	42,412	46,008	(8)
Total Sales	27,389	25,521	7	81,765	81,915	(0)

Backlog:

Our 90-day order backlog as of September 30, 2013 was approximately $18.8 million, compared to approximately $19.3 million at the beginning of the quarter and $16.8 million at September 30, 2012. Our backlog consists of firm purchase orders and we expect a major portion of the current 90 day backlog to be realized as revenue during the following quarter.

Orders for Aerospace and Defense and Industrial customers are strong heading into the 4th quarter while our Medical orders have softened. Our Industrial customers are beginning to show signs of recovery compared to the past several quarters. Our Medical orders have softened mainly due to project delays.

Backlog by industry market is shown below:

	Backlog as of the Quarter Ended		
	September 30	June 30	September 30
(in thousands)	2013	2013	2012
Aerospace and Defense	$ 5,222	$ 5,117	$ 3,196
Medical	5,576	7,366	6,288
Industrial	7,994	6,768	7,308
Total Backlog	$ 18,792	$ 19,251	$ 16,792

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

Gross Profit:

Gross profit as a percent of net sales for the three months ended September 30, 2013 and 2012 was 11.0% and 10.9% of net sales. Gross profit percentage for the nine months ended September 30, 2013 and 2012 was 11.8% and 10.8%, respectively. For the quarter, we did not experience leveraging from the volume increase due to launch costs associated with a large number of new assemblies across several of our operations. The improvement in gross margin for the nine months results from our investment in automation and our continued lean initiatives.

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Selling Expense:

Our selling expenses were $1.2 million or 4.4% of net sales and $1.0 million or 3.9% of net sales for the three months ended September 30, 2013 and 2012, respectively. Selling expenses were $3.6 million or 4.4% of net sales and $3.2 million or 3.9% of net sales for the nine months ended September 30, 2013 and 2012, respectively. We continue to invest in business development infrastructure and marketing initiatives in an effort to stimulate sales.

General and Administrative Expense:

Our general and administrative expenses were $1.4 million or 5.2% of net sales and $1.5 million or 5.7% of net sales for the three months ended September 30, 2013 and 2012, respectively. General and administrative expenses were $4.9 million or 6.1% of net sales and $4.7 million or 5.7% of net sales for the nine months ended September 30, 2013 and 2012, respectively. General fixed spending was flat in the third quarter and up slightly for the nine months of 2013.

Income Taxes:

Our effective tax rate for the three and nine months ended September 30, 2013 was 29% and 23%, respectively, compared with 35% for the three and nine months ended September 30, 2012. The decreases are principally due to the federal government retroactively reinstating the research and development credit in the first quarter of 2013 for the 2012 tax year and extending it to 2013. The differences between federal income taxes computed at the federal statutory rate and reported income taxes for the three and nine months ended September 30, 2013 and 2012 are as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
	2013	**2012**	**2013**	**2012**
Statutory federal tax provision	$ 105,000	$ 61,000	$ 245,000	$ 186,000
State income taxes	16,000	2,000	39,000	18,000
Income tax credits	(48,000)	(4,000)	(151,000)	(10,000)
Change in uncertain tax positions	11,000	10,000	33,000	18,000
Other	3,000	(12,000)	(2,000)	(20,000)
Income tax expense	$ 87,000	$ 57,000	$ 164,000	$ 192,000

Liquidity and Capital Resources:

We have satisfied our liquidity needs over the past several years with cash flows generated from operations and an operating line of credit through WFB. We also have real estate and equipment term loans. Both the line of credit and real estate term notes are subject to fluctuations in the LIBOR rates. The line of credit, real estate term notes, and equipment loans with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. The availability under our

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line is subject to borrowing base requirements, and advances are at the discretion of the lender. The line of credit is secured by substantially all of our assets.

On September 30, 2013, we had outstanding advances of $8.0 million under the line of credit and unused availability of $4.3 million supported by our borrowing base. We believe our financing arrangements and cash flows to be provided by operations will be sufficient to satisfy our future working capital needs. Our working capital was $15.0 million and $12.6 million as of September 30, 2013 and December 31, 2012, respectively. The increase in working capital relates primarily to increased accounts receivable and inventory levels due to higher production volumes in the third quarter.

Net cash used in operating activities for the nine months ended September 30, 2013 was $21,229. Increased inventories, accounts receivables and decreases in accounts payable were partially offset by an increase in accrued payroll and commissions and noncash depreciation expense.

Net cash used in investing activities of $1.0 million for the nine months ended September 30, 2013 is comprised primarily of property and equipment purchases to support the business.

Net cash provided by financing activities for the nine months ended September 30, 2013 was $1.5 million, mainly due to loan proceeds of $1.9 million related to the purchase of the Mankato facility and increased equipment note, and increased borrowings on the line of credit, offset by payments on long-term debt of $0.5 million.

Critical Accounting Policies and Estimates:

Our significant accounting policies and estimates are summarized in Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2012. There have been no significant changes in these critical accounting policies since December 31, 2012. Some of our accounting policies require us to exercise significant judgment in selecting the appropriate assumptions for calculating financial estimates. Such judgments are subject to an inherent degree of uncertainty. These judgments are based on our historical experience, known trends in our industry, terms of existing contracts and other information from outside sources, as appropriate. Actual results could differ from these estimates.

Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists , which states that entities should present the unrecognized tax benefit as a reduction of the deferred tax asset for a net operating loss (NOL) or similar tax loss or tax credit carryforward rather than as a liability when the uncertain tax position would reduce the NOL or other carryforward under the tax law. The Company will be required to adopt this new standard on a prospective basis in the first interim reporting period of fiscal 2015, however, early adoption is permitted as is a retrospective application. We are currently evaluating the impact, if any, that this new standard will have on its Consolidated Financial Statements.

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Forward-Looking Statements:

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

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

The factors identified above are believed to be important factors (but not necessarily all of the important factors) that could cause actual results to differ materially from those expressed in any forward-looking statement made by us. Unpredictable or unknown factors not discussed herein could also have material adverse effects on forward-looking statements. All forward-looking statements included in this Form 10-Q are expressly qualified in their entirety by the forgoing cautionary statements. We undertake no obligations to update publicly any forward-looking statement (or its associated cautionary language) whether as a result of new information or future events.

Please refer to forward-looking statements and risks as previously disclosed in our report on Form 10-K for the fiscal year ended December 31, 2012.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures:

In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q, our management evaluated, with the participation of our Chief Executive Officer and President, Chief Operating and Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the Chief Executive Officer and the President, Chief Operating and Financial Officer have

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concluded that the disclosure controls and procedures were effective as of the date of such evaluation in ensuring that information required to be disclosed in our Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to management, including our Chief Executive Officer and President, Chief Operating and Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting:

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

PART II

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 6. EXHIBITS

Exhibits

31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
31.2	Certification of the President, Chief Operating and Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
32	Certification of the Chief Executive Officer and President, Chief Operating and Financial Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	Financial statements from the quarterly report on Form 10-Q for the quarter ended September 30, 2013, formatted in XBRL: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Cash Flows, and (iv) the Condensed Notes to Consolidated Financial Statements.

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Signatures

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

Nortech Systems Incorporated and Subsidiary

Date: November 14, 2013	by	/s/ Michael J. Degen
	Michael J. Degen Chief Executive Officer	
Date: November 14, 2013	by	/s/ Richard G. Wasielewski
	Richard G. Wasielewski President, Chief Operating and Financial Officer	