

ELECTRO SENSORS INC
Form 10QSB
August 05, 2005

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

Form 10-QSB

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2005

**TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE
EXCHANGE ACT**

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File Number 0-9587

ELECTRO-SENSORS, INC.

(Exact name of small business issuer as specified in its charter)

Minnesota
(State or other jurisdiction of incorporation or
organization)

41-0943459
(IRS Employer Identification No.)

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

(952) 930-0100
(Issuer's telephone number)

Check whether the issuer (1) 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.

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Yes No

The number of shares outstanding of the registrant's Common Stock, \$0.10 par value, on August 5, 2005 was 3,234,516.

Transitional Small Business Disclosure Format (check one): Yes No

ELECTRO-SENSORS, INC.
Form 10-QSB
For the Period Ended June 30, 2005

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
**ELECTRO-SENSORS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET**

| | June 30, 2005 (unaudited) |
|--|---------------------------------|
| ASSETS | |
| CURRENT ASSETS | |
| Cash and cash equivalents | \$ 6,437,000 |
| Investments | 7,769,000 |
| Trade receivables, less allowance for doubtful accounts of \$6,000 | 496,000 |
| Inventories | 838,000 |
| Prepaid income tax | 65,000 |
| Other current assets | 60,000 |
| | <hr/> |
| Total current assets | 15,665,000 |
| | <hr/> |
| Property and equipment, net | 1,381,000 |
| | <hr/> |
| Investment in equity method investee | 129,000 |
| | <hr/> |
| TOTAL ASSETS | \$ 17,175,000 |
| | <hr/> |
| LIABILITIES AND STOCKHOLDERS EQUITY | |
| LIABILITIES | |
| Accounts payable | \$ 165,000 |
| Accrued expenses | 206,000 |
| Deferred revenue | 64,000 |
| Deferred income tax | 2,794,000 |
| | <hr/> |
| TOTAL LIABILITIES | \$ 3,229,000 |
| | <hr/> |
| STOCKHOLDERS EQUITY | |

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June 30,
2005
(unaudited)

| | |
|---|----------------------|
| Common stock par value \$0.10 per share; authorized 10,000,000 shares; issued 3,228,962 | 323,000 |
| Additional paid-in capital | 1,128,000 |
| Retained earnings | 7,804,000 |
| Accumulated other comprehensive income | 4,691,000 |
| TOTAL STOCKHOLDERS EQUITY | 13,946,000 |
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 17,175,000 |

See accompanying notes to consolidated financial statements

ELECTRO-SENSORS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------------|--------------------------------|--------------|------------------------------|--------------|
| | 2005 | 2004 | 2005 | 2004 |
| Net sales | \$ 1,147,000 | \$ 1,206,000 | \$ 2,351,000 | \$ 2,422,000 |
| Cost of goods sold | 452,000 | 449,000 | 898,000 | 916,000 |
| Gross profit | 695,000 | 757,000 | 1,453,000 | 1,506,000 |
| Operating expenses: | | | | |
| Selling and marketing | 312,000 | 312,000 | 620,000 | 627,000 |
| General and administrative | 259,000 | 200,000 | 587,000 | 520,000 |
| Research and development | 215,000 | 190,000 | 419,000 | 361,000 |
| Total operating expenses | 786,000 | 702,000 | 1,626,000 | 1,508,000 |
| Operating income (loss) | (91,000) | 55,000 | (173,000) | (2,000) |

Non-operating income (expense):

ELECTRO-SENSORS, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

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| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------------|------------------------------|-------------------|
| Gain on sale of investment securities | 128,000 | 102,000 | 264,000 | 426,000 |
| Interest income | 40,000 | 13,000 | 72,000 | 24,000 |
| Other income | 4,000 | 3,000 | 8,000 | 6,000 |
| Equity in losses of equity method investee | 0 | (60,000) | (11,000) | (125,000) |
| Total non-operating income | 172,000 | 58,000 | 333,000 | 331,000 |
| Income before income taxes | 81,000 | 113,000 | 160,000 | 329,000 |
| Federal and state income tax provision | 35,000 | 70,000 | 62,000 | 183,000 |
| Net income | \$ 46,000 | \$ 43,000 | \$ 98,000 | \$ 146,000 |

Net income per share data:

| Basic | | | | |
|---------------------------------|----------------|----------------|----------------|----------------|
| Net income per share | \$ 0.01 | \$ 0.01 | \$ 0.03 | \$ 0.05 |
| Weighted average shares | 3,227,128 | 3,205,458 | 3,223,406 | 3,194,043 |
| Diluted | | | | |
| Net income per share | \$ 0.01 | \$ 0.01 | \$ 0.03 | \$ 0.04 |
| Weighted average shares | 3,332,867 | 3,310,149 | 3,326,309 | 3,305,879 |
| Dividends paid per share | \$ 0.04 | \$ 0.04 | \$ 0.08 | \$ 0.08 |

See accompanying notes to consolidated financial statements

**ELECTRO-SENSORS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)**

| | Six Months Ended June 30, | |
|---|------------------------------|-------------------|
| | 2005 | 2004 |
| Cash flows from operating activities | | |
| Net income | \$ 98,000 | \$ 146,000 |

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

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| | Six Months Ended June 30, | |
|---|------------------------------|------------------|
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation | 49,000 | 45,000 |
| Realized gain on sale of investments | (264,000) | (426,000) |
| Equity in loss of equity method investee | 11,000 | 125,000 |
| (Increase)/decrease in: | | |
| Trade receivables | 63,000 | 26,000 |
| Inventory | (28,000) | (60,000) |
| Other current assets | 8,000 | 14,000 |
| Increase/(decrease) in: | | |
| Accounts payable | 3,000 | (15,000) |
| Accrued expenses | (42,000) | (47,000) |
| Deferred revenue | (4,000) | 10,000 |
| Prepaid income taxes | 62,000 | (67,000) |
| | <u>(44,000)</u> | <u>(249,000)</u> |
| Cash flows from investing activities: | | |
| Proceeds from sale of investments | 278,000 | 690,000 |
| Purchase of equity securities | 0 | (253,000) |
| Payment for purchase of investments | 0 | (160,000) |
| Purchase of property and equipment | (28,000) | (20,000) |
| | <u>250,000</u> | <u>257,000</u> |
| Cash flows from financing activities: | | |
| Proceeds from issuance of stock | 25,000 | 104,000 |
| Dividends paid | (258,000) | (256,000) |
| | <u>(233,000)</u> | <u>(152,000)</u> |
| Net decrease in cash & cash equivalents | | |
| | (27,000) | (144,000) |
| Cash & cash equivalents, beginning | 6,464,000 | 6,862,000 |
| Cash & cash equivalents, ending | <u>6,437,000</u> | <u>6,718,000</u> |
| Supplemental schedule of non-cash investing and financing activities | | |
| Net change in unrealized loss on investments | \$ (449,000) | \$ (4,608,982) |

See accompanying notes to consolidated financial statements

ELECTRO-SENSORS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Nature of Business

The accompanying consolidated financial statements include the accounts of Electro-Sensors, Inc. and its wholly owned subsidiaries, ESI Investment Company and Senstar Corporation. Senstar Corporation does not have any business transactions. Intercompany accounts, transactions and earnings have been eliminated in consolidation. The consolidated entity is referred to as the Company.

Electro-Sensors, Inc. operates two distinct businesses. The first is the Controls Division, which manufactures and markets a complete line of speed monitoring and motor control systems for industrial machinery. The Controls Division utilizes leading-edge technology to continuously improve its products and make them easier to use. The Controls Division's goal is to manufacture the industry-preferred product for every market served. These products are sold through an internal sales staff, manufacturer's representatives, and distributors to a wide variety of manufacturers, OEM's and processors to monitor process machinery operations. The Controls Division markets its products to a number of different industries located throughout the United States and abroad.

The second business is AutoData® Systems (ADS). ADS designs and markets a desktop software based system that reads hand printed characters, checkmarks and bar code information from scanned or faxed forms. ADS products are designed to provide capabilities to automate data collection and are sold by internal sales staff to end users, resellers and developers in the United States, Canada, Europe and Asia.

ESI Investment Company (INV) owns marketable securities which have experienced significant appreciation in value since the IPO of August Technology in 2000. August Technology Corporation designs, manufactures, and sells automated defect inspection systems used in the manufacture of microelectronic devices. The Company has recognized income from the sale of its holdings in August Technology Corporation. See Note 6 for additional information regarding its investments. The Company's investments in marketable securities are subject to normal market risks, and are extremely concentrated in one security.

Note 2. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. It is the opinion of management that the unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring accruals, necessary to fairly state the financial position and results of operations for the three and six month periods ended June 30, 2005 and June 30, 2004. The results of interim periods may not be indicative of results to be expected for the year.

This report should be read together with the Company's annual report on Form 10-KSB for the year ended December 31, 2004, including the audited financial statements and footnotes therein.

Note 3. Revenue Recognition

Revenue recognition of production monitoring equipment:

All production monitoring equipment is shipped without an evaluation or acceptance period. Revenues from the sale of the products and any related warranty costs are recognized at the time of shipment. The Company's distributors are not granted any price protection. Sales to all customers, including distributors, are final and no right of return after shipment exists.

Software revenue recognition:

The Company recognizes revenue upon shipment of its character recognition software. The product is sold to the end user and risk of loss is transferred, and the Company has no continuing obligations, once its products are delivered to the shipper. The Company recognizes revenue upon shipment, net of return reserves based on historical experience. To recognize revenue, it must also be probable that the Company will collect the accounts receivable from its customers. In some situations, the Company receives advance payments from its customers. Revenue associated with these advance payments is deferred until the product is shipped.

Software revenue recognition:

Note 4. Stock-Based Compensation

In accordance with Accounting Principles Board (APB) Opinion No. 25 and related interpretations, the Company uses the intrinsic value-based method for measuring stock-based compensation cost which measures compensation cost as the excess, if any, of quoted market price of the Company's common stock at the grant date over the amount the employee must pay for the stock. The Company's general policy is to grant stock options at fair value at the date of grant.

Had compensation cost been recognized based on the fair values of options at the grant dates consistent with the provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock Based Compensation, the Company's net income and basic and diluted net income per common share would have been changed to the following pro forma amounts:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------------|-----------|---------------------------------|------------|
| | 2005 | 2004 | 2005 | 2004 |
| Net income (loss): | | | | |
| As reported | \$ 46,000 | \$ 43,000 | \$ 98,000 | \$ 146,000 |
| Pro forma | \$ 32,000 | \$ 37,000 | \$ 70,000 | \$ 135,000 |
| Basic net income (loss) per common share: | | | | |
| As reported | 0.01 | 0.01 | 0.03 | 0.05 |
| Pro forma | 0.01 | 0.01 | 0.02 | 0.04 |
| Diluted net income (loss) per common share: | | | | |
| As reported | 0.01 | 0.01 | 0.03 | 0.04 |
| Pro forma | 0.01 | 0.01 | 0.02 | 0.04 |
| Stock based compensation: | | | | |
| As reported | 0 | 0 | 0 | 0 |
| Pro forma | \$ 14,000 | \$ 6,000 | \$ 28,000 | \$ 11,000 |

The company did not grant any options during the six months ended June 30, 2005. Please read the information in Recent Accounting Standards elsewhere in this report for additional information on our stock option accounting.

Note 5. Net Income Per Share

The Company's basic net income per share amounts have been computed by dividing net income by the weighted average number of outstanding common shares. The Company's diluted net income per share is computed by dividing net income by the weighted average number of outstanding common shares and common share equivalents relating to stock options and warrants, when dilutive. For the three months ended June 30, 2005, 105,739 shares of common stock equivalents were included in the computation of diluted net income per share. For the six months ended June 30, 2005, 102,903 shares of common stock equivalents were included in the computation of diluted net income per share. For the three months ended June 30, 2004, 104,691 shares of common stock equivalents were included in the computation of diluted net income per share. For the six months ended June 30, 2004, 111,836 shares of common stock equivalents were included in the computation of diluted net income per share.

Options to purchase 9,000 shares of common stock with a weighted average exercise price of \$4.49 were outstanding for the three months ending June 30, 2005, but were excluded from the computation of common share equivalents because their exercise prices were greater than the

average market price of the common shares for the period.

Note 6. Investments

INV's investments consist of equity securities, primarily common stocks, government debt securities and money market funds. The estimated fair value of publicly traded equity securities (other than those accounted for based upon the equity method of accounting) is based on quoted market prices, and therefore subject to the inherent risk of market fluctuations. Shares of common stock for which there is no readily determinable value (i.e., no quoted market price) are accounted for on a historical cost method (unless accounted for based upon the equity method of accounting). Management determines the appropriate classification of securities at the date individual investments are acquired, and evaluates the appropriateness of such classification at each balance sheet date. Since the Company generally does not buy investments in anticipation of short-term fluctuations in market prices, investments in equity securities are classified as available-for-sale (unless accounted for on the equity method of accounting). 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 separate component of stockholders' equity.

Realized gains and losses on securities, including losses from declines in value of specific securities determined by management to be other-than-temporary (unless accounted for on the equity method of accounting), are included in income in the period realized. The Company's significant investment in equity securities is 645,265 shares of August Technology Corporation whose shares are traded on the Nasdaq Stock Exchange with a June 30, 2005 market value of approximately \$7,517,000 with an approximate cost of \$65,000.

Investment Reported on Equity Method:

At June 30, 2005, the Company owned 551,759 shares of PPT, which is approximately 18.4% of PPT's outstanding common stock. The fair value of its holdings based on the quoted market price at June 30, 2005 was approximately \$937,990 with an approximate cost of \$2,434,000.

Since the Company owns approximately 18.4% of PPT's outstanding stock, and the Company's Secretary, Peter R Peterson owns approximately 22.2% of PPT's outstanding stock, it has been determined that the Company has significant influence over the operations of PPT, and as a result its ownership interest should be reported using the equity method of accounting for investments.

Under the equity method of accounting, the Company's proportionate share of PPT net income/(loss) is included in the Company's net income/(loss) with a corresponding increase or decrease in the carrying value of its investment. Losses in excess of invested amounts are not recognized in the financial statements, but rather are suspended and applied against future equity in earnings for the investee until exhausted. At June 30, 2005, the Company had approximately \$970,000 in suspended losses from its investment in PPT that will be used to offset future recognition of equity method earnings from the investment.

In April 2004, INV purchased 20% of a la mode, LLC's outstanding membership interests for \$160,000. The Company has adopted the equity method of accounting for this investment.

Under the equity method of accounting, the Company's proportionate share of a la mode's loss is included in the Company's net income with a corresponding decrease in the carrying value of its investment.

Note 7. Comprehensive Income

Comprehensive income includes the Company's net income plus other comprehensive income items that are excluded from net income. The Company's other income consists of unrealized gains (losses), net of income taxes and reclassification adjustments for gains and losses included in net income.

| Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------------------------|------|------------------------------|------|
| 2005 | 2004 | 2005 | 2004 |
| | | | |

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| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|----------------|------------------------------|----------------|
| | | | | |
| Net Income (Loss) | \$ 46,000 | \$ 43,000 | \$ 98,000 | \$ 146,000 |
| Other Comprehensive Gain (Loss): | | | | |
| Change in unrealized gain on investments, net of tax | (56,000) | (1,141,000) | 440,000 | (2,670,000) |
| Less: | | | | |
| Reclassification adjustment for gains included in net income | (85,000) | (66,000) | (162,000) | (298,000) |
| Total comprehensive income (loss) | \$ (95,000) | \$ (1,164,000) | \$ 376,000 | \$ (2,822,000) |

Note 8. Segment Information

The Company has three reportable operating segments based on the nature of its product lines: production monitoring, character recognition, and investments. The production monitoring division (or Controls Division) manufactures and markets a complete line of speed monitoring and motor control systems for industrial machinery. The character recognition division (or ADS) designs and markets a desktop software-based system that reads hand-printed characters, checkmarks, and bar code information from scanned or faxed forms. Sales of this system include software and can include hardware. The investments division (or INV) holds investments in freely tradable and restricted securities.

In evaluating segment performance, management focuses on sales and income before taxes. The Company has no inter-segment sales.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------------------------|--------------------------------|--------------|------------------------------|--------------|
| | 2005 | 2004 | 2005 | 2004 |
| External sales | | | | |
| Production monitoring | \$ 1,007,000 | \$ 1,053,000 | \$ 2,083,000 | \$ 2,060,000 |
| Character recognition | 140,000 | 153,000 | 268,000 | 362,000 |
| Investments | 0 | 0 | 0 | 0 |
| Total | \$ 1,147,000 | \$ 1,206,000 | \$ 2,351,000 | \$ 2,422,000 |
| Net income before taxes | | | | |
| Production monitoring | \$ 65,000 | \$ 200,000 | \$ 150,000 | \$ 276,000 |
| Character recognition | (24,000) | (29,000) | (60,000) | (43,000) |
| Investments | 40,000 | (58,000) | 70,000 | 96,000 |
| Total | \$ 81,000 | \$ 113,000 | \$ 160,000 | \$ 329,000 |

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Certain expenses related to the conduct of our investment activities are included in general and administrative expenses in the accompanying consolidated statements of operations, but have been allocated to net income from our INV segment in the above table.

Recent Accounting Standards:

In December 2004, FASB issued SFAS No. 153 Exchanges of Nonmonetary Assets, which amends APB Opinion No. 29, Accounting for Nonmonetary Transactions. APB No. 29 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. SFAS No. 153 amends APB No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges occurring in fiscal periods beginning after the date SFAS No. 153 was issued. SFAS No. 153 is to be applied prospectively. The Company does not expect the adoption of SFAS No. 153 to have a material effect on its financial statements.

In December 2004, FASB issued SFAS No. 123 (revised 2004), Share-Based Payment, that focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. This statement replaces SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Beginning with our quarterly period that begins January 1, 2006, we will be required to expense the fair value of employee stock options and similar awards. As a public company, we are allowed to select from two alternative transition methods, each having different reporting implications. We have not yet determined the impact of SFAS No. 123R on us.

Item 2. Management's Discussion and Analysis or Plan of Operation

RESULTS OF OPERATIONS

We set forth below a discussion of certain aspects of our results of operations for the three and six month periods ended June 30, 2005 compared to the same periods in 2004. Percentage changes for each item discussed below are shown in the aggregate for the Company on a consolidated basis, as well as separately (i.e., on a non-consolidated basis) for the Controls Division and ADS.

Net Sales

Net sales for the three month period ended June 30, 2005 were \$1,147,000, a decrease of \$59,000 or 4.9% from \$1,206,000 for the same period in 2004. The decrease from the three months ended June 30, 2005 compared the same period in 2004 includes a decrease in net sales from the Controls Division of \$46,000 or 4.4%. ADS had a decrease in net sales of \$13,000 or 8.5% for the three months ended June 30, 2005 compared to the same period in 2004.

For the six month period ended June 30, 2005, net sales were \$2,351,000, a decrease of \$71,000 or 2.9% from \$2,422,000 for the same period in 2004. For the six months ended June 30, 2005, the Controls Division contributed an increase in net sales of \$23,000 or 1.1%. The Controls Division has experienced an increase in sales for 2005 due in part to the recovery in the US economy and increased capital spending by our installed customer base. The bulk of our sales volume continues to be derived from the Speed Monitoring product lines to the grain and feed markets, as well as other key industrial markets. For the six months ended June 30, 2005, ADS contributed a decrease in net sales of \$94,000 or 26.0%. All products contributed to this decrease. As of July 2005, ADS has signed on a manufacturer's representative to sell its product to the medical market.

Cost of Goods Sold

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The Company's cost of goods sold increased \$3,000 or 0.7% for the three months ended June 30, 2005 compared to the same period in 2004. For the six months ended June 30, 2005, the cost of goods sold decreased by \$18,000 or 2.0% compared to the same period in 2004.

Gross Profit

Gross margins for the three month period ended June 30, 2005 were 60.6% versus 62.8% compared to the same period in 2004. For the six months ended June 30, 2005 gross margins were 61.8% versus 62.2% compared to the same period in 2004. The decreases in margins are due primarily to the decrease in sales and cost of living increase in wages and salaries for production employees. The Company continues its efforts to effectively manage and reduce production costs in both divisions.

Operating Expenses

Total operating expenses increased \$84,000 or 12.0% for the three months ended June 30, 2005 compared to the same period in 2004. Of this increase, the Controls Division contributed \$98,000 or 19.3%, which was partially offset by a decrease in operating expense for ADS. ADS contributed a decrease of \$14,000 or 7.2%.

For the six months ended June 30, 2005 operating expenses increased \$118,000 or 7.8% compared to the same period for 2004. Of this increase, the Controls Division contributed an increase of \$152,000 or 13.9%, which was partially offset by a decrease in operating expenses for ADS. ADS decrease in operating expenses was \$34,000 or 8.2%.

Selling and marketing costs had no change for the three months ended June 30, 2005 compared to the same period in 2004. For the six months ended June 30, 2005, selling and marketing costs decreased \$7,000 or 1.1%.

General and administrative costs increased \$59,000 or 29.5% for the three months ended June 30, 2005 compared to the same period in 2004. For the six months ended June 30, 2005, general and administrative costs increased \$67,000 or 12.9%. Of this increase for the three months ended June 30, 2005, the Controls Division contributed an increase of \$50,000 or 26.9%, and ADS contributed an increase of \$9,000 or 64.3%. Of the increase for the six months ended June 30, 2005, the Controls Division contributed an increase of \$58,000 or 12.3%. ADS had an increase for the six months ended June 30, 2005 of \$9,000 or 18.0%. The primary reason for the G&A increasing costs are due to additional and heightened costs of being a publicly held company. We expect these costs to significantly increase over the next 2 years as we prepare for our Sarbanes-Oxley Act internal controls compliance costs.

Research and development costs increased \$25,000 or 13.2% for the three months ended June 30, 2005 compared to the same period in 2004. For the six months ended June 30, 2005, research and development costs increased \$58,000 or 16.1% compared to the same period in 2004. Of the increase for the three months ended June 30, 2005, the Controls Division contributed \$25,000 or 26.9%. For the six months ended June 30, 2005, the Controls Division contributed an increase of \$46,000 or 26.4%. For the six months ended June 30, 2005, ADS contributes an increase of \$12,000 or 6.4%. The increase in the Controls Division was due to additional lab testing and prototype development including product testing and certification at nationally recognized test labs. The increase in ADS was due to increased software development costs.

Non-Operating Income (Loss)

Non-operating income increased by \$114,000 or 196.6% for the three month period ended June 30, 2005 compared to the same period for 2004. For the six months ended June 30, 2005, compared to the same period in 2004, non-operating income increased \$2,000 or 0.6%.

Gain on the sale of investment securities increased \$26,000 or 25% for the three month period ended June 30, 2005 compared to the same period in 2004. For the six month period ended June 30, 2005, gain on sale of investment securities decreased \$162,000 or 38% compared to the same period in 2004.

Interest income increased \$27,000 or 207.7% when comparing the three months ended June 30, 2005 to the same period in 2004. For the six months ended June 30, 2005, the increase was \$48,000 or 200.0% compared to the same period in 2004. This increase was due to the higher interest rates received on treasury bills.

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Equity in losses of equity method investee decreased \$60,000 or 100% for the three months ended June 30, 2005 compared to the same period in 2004. For the six months ended June 30, 2005, the loss decreased \$114,000 or 91%.

Income Before Income Taxes

Income before income taxes decreased \$32,000, to an income before income tax of \$81,000 for the three-month period ended June 30, 2005 compared to the same period in 2004. For the six month period ended June 30, 2005, income before income taxes was \$160,000, a decrease of \$169,000 compared to the same period for 2004.

The Controls Division had income before income tax of \$65,000 for the three months ended June 30, 2005 compared to \$200,000 for the same period in 2004, a decrease of \$135,000. For the six months ended June 30, 2005, the Controls Division had income before taxes of \$150,000 compared to \$276,000 for the same period in 2004, a decrease of \$126,000. These decreases were primarily due to increased operating expenses.

ADS had net loss before income taxes of \$24,000 for the three months ended June 30, 2005 compared to the net loss before income taxes of \$29,000 for same period in 2004. For the six months ended June 30, 2005, ADS had a loss of \$60,000 compared to a loss of \$43,000 for the same period in 2004. These losses are a direct result of decreased sales and increased operating expenses.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were \$6,437,000 at June 30, 2005 and \$6,718,000 at June 30, 2004. Cash used in operating activities of \$44,000 for the six months ended June 30, 2005 was primarily a result of our net operating loss adjusted for non-cash charges.

Cash provided by investing activities was \$250,000 for the six month period ended June 30, 2005 and \$257,000 for the same period in 2004. Proceeds from the sale of investments for the six months ended June 30, 2005 decreased to \$278,000 from \$690,000 compared to the same period in 2004 and cash used for the purchase of investments decreased to \$0 from \$413,000 compared to the same period in 2004.

Cash used in financing activities was \$233,000 and \$152,000 for the six months ended June 30, 2005 and June 30, 2004, respectively. During the six months ended June 30, 2005 and 2004, the Company paid aggregate dividends of \$258,000 and \$256,000, respectively.

Our ongoing cash requirements will be primarily for capital expenditures, 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.

INV's primary investments are 645,265 shares of August Technology Corporation and 551,759 shares of PPT Vision, Inc. both of which are traded on the Nasdaq Stock Exchange. The investment in PPTV is accounted for under the equity method of accounting. These stocks are subject to fluctuations in price and could have a negative effect on the liquidity of the Company.

FORWARD-LOOKING STATEMENTS

This Form 10-QSB contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company's expectations, beliefs, intentions or strategies regarding the future. Forward-looking statements include, but are not limited to, statements regarding the extent and timing of future revenues and expenses and customer demand, the market value of our investment securities, future financial condition and availability of capital resources, changes in worldwide general economic conditions, cyclical capital spending by customers, the Company's ability to keep pace with technological developments and evolving industry standards, worldwide competition, and the Company's ability to protect its existing intellectual property from challenges from third parties and other factors. Any statement that is not based solely upon historical facts, including strategies for the future and the outcome of events that have not yet occurred, is considered a forward-looking statement.

All forward-looking statements in this document are based on information available to the Company as of the date hereof, and the Company assumes no obligation to update any such forward-looking statements. It is important to note that the Company's actual results could differ materially from those in such forward-looking statements. The forward-looking statements of the Company are subject to risks and uncertainties. Some of the factors that could cause future results to differ materially from the Company's recent results or those projected in the

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forward-looking statements are detailed in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2004, filed with the Securities and Exchange Commission.

Item 3. Controls and Procedures.

As of the end of the period covered by this report, the Company conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)). Based on this evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

There was no change in the Company's internal control over financial reporting during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 4. Submission of Matters to Vote of Security Holders

The Company held its Annual Meeting of Shareholders on April 20, 2005.

At the meeting the following matters were voted upon, and the number of votes cast for or against, as well as the number of abstentions and broker nonvotes, as to each such matter, along with a separate tabulation with respect to each nominee for office, is set forth below:

1. Set the number of directors at five for the ensuing year.

| <u>For</u> | <u>Against</u> | <u>Abstention</u> |
|------------|----------------|-------------------|
| 2,982,441 | 9,252 | 3,450 |

2. Election of directors to serve for the ensuing year and until their successors are duly elected and qualified.

| | <u>For</u> | <u>Withheld</u> |
|--------------------|------------|-----------------|
| Bradley D. Slye | 2,972,020 | 23,123 |
| Peter R. Peterson | 2,971,045 | 24,098 |
| Geoffrey W. Miller | 2,972,520 | 22,623 |
| Joseph A. Marino | 2,972,520 | 22,623 |
| John S. Strom | 2,971,545 | 23,598 |

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3. Ratification of the appointment of Virchow, Krause & Company, LLP as the Company's independent accountants for the current fiscal year ending December 31, 2005.

| <u>For</u> | <u>Against</u> | <u>Abstention</u> |
|------------|----------------|-------------------|
| 2,985,802 | 1,252 | 8,089 |

Item 6. Exhibits

See Exhibit Index following signature page.

SIGNATURES

In accordance with 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.

August 5, 2005

Electro-Sensors, Inc.

/s/ Bradley D. Slye

Bradley D. Slye
Chief Executive Officer and Principal Accounting Officer

EXHIBIT INDEX

ELECTRO-SENSORS, INC.

FORM 10-QSB FOR QUARTER ENDED June 30, 2005

| Exhibit | Description |
|----------------|--|
| 31.1 | Certification of CEO and CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of CEO and CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
