

NORTECH SYSTEMS INC
Form 10-Q
August 04, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from _____ to _____

NORTECH SYSTEMS INCORPORATED

Commission file number 0-13257

State of Incorporation: Minnesota

IRS Employer Identification No. 41-1681094

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

Telephone number: (952) 345-2277

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 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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

Non-accelerated Filer

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

Number of shares of \$.01 par value common stock outstanding at August 1, 2006 - 2,648,729

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PART 1

ITEM 1. FINANCIAL STATEMENTS

**NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
JUNE 30, 2006 AND DECEMBER 31, 2005**

| | JUNE 30 2006 (Unaudited) | DECEMBER 31 2005 |
|--|--------------------------------|---------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and Cash Equivalents | \$ 696,113 | \$ 840,123 |
| Accounts Receivable, Less Allowance for Uncollectible Accounts of \$502,000 and \$297,000, respectively | 14,125,648 | 14,447,612 |
| Inventories: | | |
| Raw Materials | 11,284,582 | 10,616,894 |
| Work In Process | 4,644,964 | 4,423,892 |
| Finished Goods | 2,641,561 | 2,027,118 |
| Reserves | (1,416,850) | (1,218,434) |
| Total Inventories | 17,154,257 | 15,849,470 |
| Prepaid Expenses | 426,201 | 466,083 |
| Deferred Income Tax Assets | 1,092,000 | 912,000 |
| Total Current Assets | 33,494,219 | 32,515,288 |
| Property and Equipment | | |
| Land | 300,000 | 151,800 |
| Building and Leasehold Improvements | 5,857,619 | 4,819,919 |
| Manufacturing Equipment | 8,904,069 | 7,662,699 |
| Office and Other Equipment | 3,378,725 | 3,413,968 |
| Construction in Progress | 84,520 | 502,374 |
| Total Property and Equipment | 18,524,933 | 16,550,760 |
| Accumulated Depreciation | (10,100,815) | (9,868,536) |
| Net Property and Equipment | 8,424,118 | 6,682,224 |
| Other Assets | | |
| Finite Life Intangibles | 91,716 | 209,307 |
| Goodwill | 75,006 | 75,006 |
| Deferred Income Tax Assets | 263,000 | 179,000 |
| Restricted Cash | 427,500 | |
| Deposits | 7,726 | 7,726 |
| Total Other Assets | 864,948 | 471,039 |
| Total Assets | \$ 42,783,285 | \$ 39,668,551 |

See Accompanying Condensed Notes to Consolidated Financial Statements

**NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
JUNE 30, 2006 AND DECEMBER 31, 2005**

| | JUNE 30 2006 (Unaudited) | DECEMBER 31 2005 |
|--|---|-----------------------------|
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current Liabilities | | |
| Bank Note Payable | \$ 6,103,984 | \$ 4,228,234 |
| Current Maturities of Notes Payable | 1,741,179 | 1,207,305 |
| Current Maturities of Bonds Payable | 130,000 | - |
| Checks Written in Excess of Bank Balance | | 1,200,000 |
| Accounts Payable | 9,769,395 | 9,902,998 |
| Accrued Payroll and Commissions | 3,096,978 | 2,849,472 |
| Accrued Health and Dental Claims | 400,000 | 271,104 |
| Income Taxes Payable | 112,808 | 317,487 |
| Other Accrued Liabilities | 229,272 | 324,360 |
| Total Current Liabilities | 21,583,616 | 20,300,960 |
| Long-Term Liabilities | | |
| Notes Payable (Net of Current Maturities) | 2,609,258 | 2,714,227 |
| Bonds Payable (Net of Current Maturities) | 1,310,000 | |
| Total Long-Term Liabilities | 3,919,258 | 2,714,227 |
| Total Liabilities | 25,502,874 | 23,015,187 |
| 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: 2,648,729 and 2,618,197 Shares Issued and Outstanding at June 30, 2006 and December 31, 2005, respectively | 26,487 | 26,182 |
| Additional Paid-In Capital | 14,380,732 | 14,306,602 |
| Accumulated Other Comprehensive Loss | (41,033) | (21,032) |
| Retained Earnings | 2,664,225 | 2,091,612 |
| Total Shareholders Equity | 17,280,411 | 16,653,364 |
| Total Liabilities and Shareholders Equity | \$ 42,783,285 | \$ 39,668,551 |

See Accompanying Condensed Notes to Consolidated Financial Statements

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
JUNE 30, 2006 AND 2005
(UNAUDITED)

| | THREE MONTHS ENDED | |
|--|---------------------------|---------------|
| | JUNE 30 | |
| | 2006 | 2005 |
| Net Sales | \$ 26,173,559 | \$ 20,562,916 |
| Cost of Goods Sold | 22,759,919 | 17,974,470 |
| Gross Profit | 3,413,640 | 2,588,446 |
| Operating Expenses: | | |
| Selling Expenses | 1,127,525 | 936,709 |
| General and Administrative Expenses | 1,658,616 | 1,275,942 |
| Total Operating Expenses | 2,786,141 | 2,212,651 |
| Income From Operations | 627,499 | 375,795 |
| Other Income (Expense) | | |
| Interest Income | 669 | 415 |
| Miscellaneous Expense, net | 9,283 | (8,849) |
| Interest Expense | (190,786) | (161,400) |
| Total Other Expense | (180,834) | (169,834) |
| Income Before Income Taxes | 446,665 | 205,961 |
| Income Tax Expense | 138,000 | 67,000 |
| Net Income | \$ 308,665 | \$ 138,961 |
| Earnings Per Common Share: | | |
| Basic | \$ 0.12 | \$ 0.05 |
| Weighted Average Number of Common Shares Outstanding Used for Basic Earnings Per Common Share | 2,619,281 | 2,582,222 |
| Diluted | \$ 0.11 | \$ 0.05 |
| Weighted Average Number of Common Shares Outstanding Plus Dilutive Common Stock Options | 2,682,244 | 2,610,040 |

See Accompanying Condensed Notes to Consolidated Financial Statements

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
JUNE 30, 2006 AND 2005
(UNAUDITED)

| | SIX MONTHS ENDED | |
|--|------------------|---------------|
| | JUNE 30 2006 | 2005 |
| Net Sales | \$ 52,191,178 | \$ 39,630,418 |
| Cost of Goods Sold | 45,618,787 | 34,677,439 |
| Gross Profit | 6,572,391 | 4,952,979 |
| Operating Expenses: | | |
| Selling Expenses | 2,248,176 | 1,801,937 |
| General and Administrative Expenses | 3,095,746 | 2,459,914 |
| Total Operating Expenses | 5,343,922 | 4,261,851 |
| Income From Operations | 1,228,469 | 691,128 |
| Other Income (Expense) | | |
| Interest Income | 1,002 | 779 |
| Miscellaneous Expense, net | 14,346 | (14,522) |
| Interest Expense | (366,204) | (302,532) |
| Total Other Expense | (350,856) | (316,275) |
| Income Before Income Taxes | 877,613 | 374,853 |
| Income Tax Expense | 305,000 | 137,000 |
| Net Income | \$ 572,613 | \$ 237,853 |
| Earnings Per Common Share: | | |
| Basic | \$ 0.22 | \$ 0.09 |
| Weighted Average Number of Common Shares Outstanding Used for Basic Earnings Per Common Share | 2,618,742 | 2,582,185 |
| Diluted | \$ 0.21 | \$ 0.09 |
| Weighted Average Number of Common Shares Outstanding Plus Dilutive Common Stock Options | 2,683,587 | 2,609,879 |

See Accompanying Condensed Notes to Consolidated Financial Statements

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
JUNE 30, 2006 AND 2005
(UNAUDITED)

| | SIX MONTHS ENDED | |
|--|------------------|--------------|
| | JUNE 30 2006 | 2005 |
| Cash Flows From Operating Activities | | |
| Net Income | \$ 572,613 | \$ 237,853 |
| Adjustments to Reconcile Net Income to Net Cash | | |
| Provided by Operating Activities: | | |
| Depreciation | 662,953 | 586,264 |
| Amortization | 196,964 | 196,980 |
| Compensation on restricted stock and stock option grants | 66,207 | |
| Deferred Taxes | (264,000) | (203,000) |
| (Gain) Loss on Disposal of Assets | 867 | |
| Foreign Currency Transaction Gain | (6,210) | 14,254 |
| Changes in Current Operating Items: | | |
| Accounts Receivable | 314,227 | (1,012,556) |
| Inventories | (1,304,787) | (974,287) |
| Prepaid Expenses and Other Assets | 39,127 | 105,100 |
| Income Taxes Payable | (204,017) | 325,253 |
| Accounts Payable | (130,674) | 1,890,104 |
| Accrued Payroll and Commissions | 255,826 | (14,519) |
| Accrued Health and Dental Claims | 128,896 | 120,626 |
| Other Accrued Liabilities | (95,088) | 253,164 |
| Net Cash Provided by Operating Activities | 232,904 | 1,525,236 |
| Cash Flows from Investing Activities: | | |
| Proceeds from Sale of Assets | 275 | |
| Restricted Cash | (427,500) | |
| Purchase of Property and Equipment | (2,421,637) | (482,778) |
| Net Cash Used in Investing Activities | (2,848,862) | (482,778) |
| Cash Flows from Financing Activities: | | |
| Net Change in Line of Credit | 1,875,750 | (595,823) |
| Proceeds from Notes Payable | 1,100,926 | |
| Proceeds from Bonds Payable | 1,440,000 | |
| Payments on Notes Payable | (672,021) | (509,419) |
| Payments for Bond Issue Costs | (79,373) | |
| Issuance of Stock | 8,228 | 606 |
| Checks in Excess of Bank Balance | (1,200,000) | 64,000 |
| Net Cash Provided by (Used in) Financing Activities | 2,473,510 | (1,040,636) |
| Effect of Exchange Rate Changes on Cash | (1,562) | (9,357) |
| Net Decrease in Cash and Cash Equivalents | (144,010) | (7,535) |
| Cash and Cash Equivalents - Beginning | 840,123 | 555,783 |
| Cash and Cash Equivalents - Ending | \$ 696,113 | \$ 548,248 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the period for interest | \$ 363,153 | \$ 161,533 |

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| | | | |
|--|---------|---------|----|
| Cash paid during the period for income taxes | 771,000 | | |
| Supplemental schedule of noncash financing activity: | | | |
| Issuance of Common Stock on a restricted basis | \$ | 212,040 | \$ |

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 accounting principles generally accepted in the United States of America (GAAP) for interim financial information and in accordance with 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. These statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2005. 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. Actual results could differ from those estimates.

Cash and Cash Equivalents

For purposes of reporting cash flows, we consider cash equivalents to be short-term, highly liquid interest-bearing accounts readily convertible to cash. The carrying amount approximates fair value.

Restricted Cash

At June 30, 2006, restricted cash of \$427,500 is to be used for the purchase of equipment at the Blue Earth, Minnesota facility as required by the Industrial Revenue Bond agreement into which we entered on June 28, 2006 to purchase the Blue Earth, Minnesota facility, see Note 5.

Stock Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123R, *Share-Based Payment: An Amendment of FASB Statement No. 123*, (SFAS 123R) which requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS 123R is effective for financial statements issued for annual reporting periods that begin after June 15, 2005. In adopting SFAS 123R, we used the modified prospective transition method, as of January 1, 2006, the first day of our fiscal year 2006.

Under the modified prospective transition method, awards that are granted, modified or settled after the date of adoption will be measured and accounted for in accordance with SFAS 123R. Compensation cost for awards granted prior to, but not vested, as of the date SFAS 123R is adopted would be based on the grant date attributes originally used to value those awards for pro forma purposes under SFAS 123. Our condensed consolidated financial statements as of and for the first six months of fiscal 2006 reflect the impact of SFAS 123R. In accordance with the modified prospective transition method, the consolidated financial statements for the prior periods have not been restated to

reflect, and do not include, the impact of SFAS 123R. Share-based compensation expense before income taxes recognized under SFAS 123R for the three months and six months ended June 30, 2006 was \$56,571 and \$66,207, respectively.

Prior to January 1, 2006, we applied Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for options and the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*. Accordingly, no stock-based compensation expense for stock options was recognized in our consolidated statements of income prior to 2006, as the exercise price was equal to the market price of our stock on the date of grant.

On November 15, 2005, our Board of Directors accelerated the vesting of the then outstanding and unvested stock options. Had these vesting periods not been accelerated, under SFAS 123R we would have recognized approximately \$370,000 in cumulative expense spread over five years beginning in fiscal 2006.

Had compensation cost for the our stock option plan been determined pursuant to SFAS 123 in 2005, net income and earnings per common share on a proforma basis would have been as follows:

| | For the Three Months Ended June 30, 2005 | For the Six Months Ended June 30, 2005 |
|--|---|---|
| Net income, as reported | \$ 138,961 | \$ 237,853 |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects | (34,843 |) (65,613 |
| Pro forma net income | \$ 104,118 | \$ 172,240 |
| Earnings per common share: | | |
| Basic as reported | \$ 0.05 | \$ 0.09 |
| Basic pro forma | \$ 0.04 | \$ 0.07 |
| Diluted as reported | \$ 0.05 | \$ 0.09 |
| Diluted pro forma | \$ 0.04 | \$ 0.07 |

SFAS 123R requires companies to estimate the fair value of share-based awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense in the condensed consolidated statement of operations over the requisite service periods. Share-based compensation expense for share-based awards granted prior to, but not yet vested as of December 31, 2005, is based on the grant date fair value estimated in accordance with the provisions of SFAS 123. For options granted subsequent to December 31, 2005, compensation expense is based on the grant date fair value estimated in accordance with SFAS 123R. Because share-based compensation expense is based on awards that are ultimately expected to vest, share-based compensation expense will be reduced to account for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the pro forma information required under SFAS 123 for periods prior to fiscal 2006, we accounted for forfeitures as they occurred.

We have two types of stock-based compensation awards consisting of restricted stock and stock options. Following is a summary of the key terms and methods of valuation for our stock-based compensation awards.

Restricted Stock

On March 7, 2006, 28,500 shares of restricted common stock were granted to our management and directors. This benefit was valued at the market price of the stock on the date of grant. These awards vest over a three-year term and are expensed ratably over the same period. The arrangements do contain an acceleration condition whereby if we attain certain financial measurements, the awards vest in their entirety on December 31, 2006. Total compensation expense related to restricted stock included in the statement of income for the three months and six months ended June 30, 2006 was \$22,075 and \$25,754, respectively. The following is the status of our restricted shares as of June 30, 2006, including changes during the six-month period ended June 30, 2006:

| | Restricted Shares | Weighted- Average Grant Date Fair Value |
|------------------------------|----------------------|--|
| Outstanding January 1, 2006 | | \$ |
| Granted | 28,500 | 7.44 |
| Outstanding June 30, 2006 | 28,500 | \$ 7.44 |
| Exercisable on June 30, 2006 | | |

As of June 30, 2006, there was approximately \$186,000 of unrecognized compensation expense related to unvested restricted stock awards, which we expect to recognize over a weighted average period of 2.50 years.

Stock Options

On March 7, 2006, 73,500 options were granted to our management and directors with the exercise price equaling the closing price of the common shares on that date. To calculate the option-based compensation under SFAS 123R, we used the Black-Scholes option-pricing model, which we had previously used for the valuation of option-based awards for our pro forma information required under SFAS 123 for periods prior to fiscal 2006. Our determination of fair value of option-based awards on the date of grant using the Black-Scholes model is affected by our stock price as well as assumptions regarding a number of subjective variables. These variables include, but are not limited to, our expected stock price volatility over the term of the awards, risk-free interest rate, and the expected life of the options. The risk-free interest rate is based on a treasury instrument whose term is consistent with the expected life of our stock options. The expected volatility, holding period, and forfeitures of options are based on historical experience.

Total compensation expense related to stock options included in our statement of income for the three months and six months ended June 30, 2006 was \$34,496 and \$40,453, respectively. For all grants, the amount of compensation expense to be recognized is adjusted for an estimated forfeiture rate, which is based on historical data.

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Following is the status of our stock option plan as of June 30, 2006, including changes during the six-month period ended June 30, 2006:

| | | Options | Weighted-Average Exercise Price Per Share | Weighted-Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|------------------------------|-----------------|----------|---|--|---------------------------|
| Outstanding | January 1, 2006 | 287,000 | \$ 6.27 | | |
| Granted | | 73,500 | \$ 7.44 | | |
| Exercised | | (2,000) | \$ 4.00 | | |
| Forfeited | | (2,000) | \$ 8.00 | | |
| Outstanding | June 30, 2006 | 356,500 | \$ 6.52 | 6.42 | \$ 243,520 |
| Exercisable on June 30, 2006 | | 283,000 | \$ 6.28 | 5.57 | \$ 261,160 |

As of June 30, 2006, there was approximately \$275,000 of unrecognized compensation expense related to unvested option awards that we expect to recognize over a weighted average period of 2.50 years. SFAS 123R also requires that the tax benefit from the exercise of options be reflected in the statement of cash flows as a cash inflow from financing activities. Prior to the adoption of SFAS 123R, these tax benefits have been reflected as a cash inflow from operations.

Segment Reporting Information

Our results of operations for the three months and six months ended June 30, 2006 and 2005 represent a single segment referred to as Contract Manufacturing. Export sales represented 5% of consolidated net sales for the three-month and six-month periods ended June 30, 2006. Export sales represented 4% of consolidated net sales for the three-month and six-month periods ended June 30, 2005.

Long-lived assets by country are as follows:

| | United States | Mexico | Total |
|----------------------------|---------------|------------|--------------|
| June 30, 2006 | | | |
| Net Property and Equipment | \$ 7,814,371 | \$ 609,747 | \$ 8,424,118 |
| Other Assets | 856,222 | 8,726 | 864,948 |
| December 31, 2005 | | | |
| Net Property and Equipment | \$ 5,995,465 | \$ 686,759 | \$ 6,682,224 |
| Other Assets | 271,529 | 199,510 | 471,039 |

Finite Life Intangible Assets

Finite life intangible assets at June 30, 2006 and December 31, 2005 are as follows:

| | June 30, 2006 | Gross | Accumulated | Net Book |
|---------------------------|----------------------|-----------------|---------------------|-----------------|
| | Estimated | Carrying | Amortization | Value |
| | Lives | Amount | | |
| | (Years) | | | |
| Deferred Bond Issue Costs | 15 | \$ 79,373 | \$ | \$ 79,373 |
| Non-Compete | 4 | 1,526,384 | 1,526,384 | |
| Other Intangibles | 3 | 37,059 | 24,716 | 12,343 |
| Totals | | \$ 1,642,816 | \$ 1,551,100 | \$ 91,716 |

| | December 31, 2005 | Gross | Accumulated | Net Book |
|-------------------|--------------------------|-----------------|---------------------|-----------------|
| | Estimated | Carrying | Amortization | Value |
| | Lives | Amount | | |
| | (Years) | | | |
| Non-Compete | 4 | \$ 1,526,384 | \$ 1,335,600 | \$ 190,784 |
| Other Intangibles | 3 | 37,059 | 18,536 | 18,523 |
| Totals | | \$ 1,563,443 | \$ 1,354,136 | \$ 209,307 |

Amortization expense related to these assets is as follows:

| | |
|--------------------------------|-----------|
| Quarter ended June 30, 2006 | \$ 98,474 |
| Quarter ended June 30, 2005 | 98,490 |
| Six months ended June 30, 2006 | 196,964 |
| Six months ended June 30, 2005 | 196,980 |

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

| | |
|-------------------|----------|
| Remainder of 2006 | \$ 9,000 |
| 2007 | 11,000 |
| 2008 | 5,000 |
| 2009 | 5,000 |
| 2010 | 5,000 |
| Thereafter | 57,000 |

NOTE 2. PRINCIPLES OF CONSOLIDATION

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

NOTE 3. ACCOUNTING PRINCIPLES

In preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States, we must make decisions, which impact the reported amounts and related disclosures. Such decisions include the selection of the appropriate principles to be applied and the

assumptions on which to base accounting estimates. In reaching such decisions, we apply judgment based on our understanding and analysis of the relevant circumstances.

The accounting principles followed in the preparation of the condensed consolidated financial information contained on Form 10-Q are the same as those described in our Annual Report on Form 10-K for the year ended December 31, 2005, except as previously noted herein. Refer to our Annual Report on Form 10-K for detailed information on accounting policies.

NOTE 4. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash and trade accounts receivable. With regard to cash, we maintain our excess cash balances in checking accounts at three financial institutions. We do not require collateral on our receivables. Historically, we have not suffered significant losses with respect to trade accounts receivable.

Two customers accounted for 10% or more of our net sales for the three-month and six-month periods ended June 30, 2006 and 2005. For the three-month periods ended June 30, 2006 and 2005, G.E. Medical and Transportation Divisions accounted for 14% of net sales. For the six-month periods ended June 30, 2006 and 2005, G.E. Medical and Transportation Divisions accounted for 14% and 13% of net sales, respectively. Accounts receivable from G.E. Medical and Transportation Divisions at June 30, 2006 and 2005, represented 13% and 19% of total accounts receivable, respectively. For the three-month periods ended June 30, 2006 and 2005, Northrop Grumman Corp. accounted for 15% and 11% of net sales, respectively. For the six-month periods ended June 30, 2006 and 2005, Northrop Grumman Corp. accounted for 12% and 10% of net sales, respectively. Accounts receivable from Northrop Grumman Corp. at June 30, 2006 and 2005, represented 16% and 14% of total accounts receivable, respectively.

NOTE 5. LONG TERM DEBT

On June 28, 2006, we received \$1.4 million in exchange for an industrial revenue bond with Wells Fargo Bank, N.A. (WFB), where the City of Blue Earth, Minnesota is issuer of the bond. The bond, which matures on June 1, 2021, bears a variable interest rate, which we have exchanged with WFB for a 5-year fixed rate of 4.07%, converting back to a variable rate in 2012. The bond is payable in annual installments per the agreement with WFB. Our first bond principal payment on June 1, 2007 will be \$130,000. The proceeds of the bond were used to purchase the facility in Blue Earth, Minnesota.

On April 28, 2006, we entered into a 6th amendment to our credit agreement with WFB, increasing our line of credit arrangement from \$8 million to \$10 million and extending the maturity dates of the line of credit to April 30, 2008 and our real estate term note to July 30, 2011. The line of credit and other installment debt 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 ratios, and limit the amount of annual capital expenditures. On June 30, 2006, we had an outstanding balance of \$6.1 million under the line of credit and unused availability of \$3.7 million supported by the borrowing base level.

We received \$1.1 million on April 5, 2006 in exchange for the promissory note, payable to WFB bearing an interest rate of 7.3%, payable over 36 monthly installments to March 15, 2009, with collateral comprised of equipment purchases.

NOTE 6. NET INCOME PER COMMON SHARE

The following is a reconciliation of the numerators and the denominators of the basic and diluted per common share computations.

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------|------------------|------------|
| | June 30, 2006 | 2005 | June 30, 2006 | 2005 |
| Basic Earnings Per Common Share | | | | |
| Net income, as reported | \$ 308,665 | \$ 138,961 | \$ 572,613 | \$ 237,853 |
| Weighted average common shares outstanding | 2,619,281 | 2,582,222 | 2,618,742 | 2,582,185 |
| Basis earnings per common share | \$ 0.12 | \$ 0.05 | \$ 0.22 | \$ 0.09 |
| Diluted Earnings Per Common Share | | | | |
| Net income, as reported | \$ 308,665 | \$ 138,961 | \$ 572,613 | \$ 237,853 |
| Weighted average common shares outstanding | 2,619,281 | 2,582,222 | 2,618,742 | 2,582,185 |
| Effect of Stock options | 58,895 | 27,818 | 52,265 | 27,694 |
| Effect of Restricted stock | 4,068 | | 12,580 | |
| Weighted average common shares for diluted earnings per common share | 2,682,244 | 2,610,040 | 2,683,587 | 2,609,879 |
| Diluted earnings per common share | \$ 0.11 | \$ 0.05 | \$ 0.21 | \$ 0.09 |

For the three-month and six-month periods ended June 30, 2006, 1,046 shares and 26,159 shares, respectively, were excluded from the computation of diluted earnings per common share as these shares were antidilutive. For the three-month and six-month periods ended June 30, 2005, 50,263 and 98,240 shares, respectively, were excluded from the computation of diluted earnings per common share as these shares were antidilutive.

NOTE 7. FOREIGN CURRENCY TRANSLATION

Local currency is considered the functional currency for operations outside the United States. Assets and liabilities are translated at period-end exchange rates. Income and expense items are translated at average rates of exchange prevailing during the period. Translation adjustments are recorded as a component of accumulated other comprehensive loss in shareholders' equity. Foreign currency exchange transaction gains and losses attributable to exchange rate movements on intercompany receivables and payables not deemed to be of a long-term investment nature are recorded in miscellaneous income (expense). The Mexican peso is the only foreign currency being translated.

NOTE 8. COMPREHENSIVE INCOME

Comprehensive income is comprised of net income and other comprehensive income (loss). Other comprehensive income (loss) includes gains and losses resulting from foreign currency translations. The details of comprehensive income are as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|------------|------------------------------|------------|
| | 2006 | 2005 | 2006 | 2005 |
| Net Income, as reported | \$ 308,665 | \$ 138,961 | \$ 572,613 | \$ 237,853 |
| Other Comprehensive Income (Loss): Currency Translation Adjustment | (10,746) | 19,738 | (20,001) | 19,738 |
| Comprehensive Income | \$ 297,919 | \$ 158,699 | \$ 552,612 | \$ 257,591 |

NOTE 9. RECENTLY ISSUED ACCOUNTING STANDARDS

In November 2004, the FASB issued Statement No. 151 (SFAS 151), *Inventory Costs – an amendment of ARB No. 43, Chapter 4*. The amendments made by SFAS 151 require that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) be recognized as current-period charges. In addition, SFAS 151 requires the allocation of fixed production overhead to inventory based on the normal capacity of production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We adopted SFAS 151 on January 1, 2006 with no material impact to the consolidated financial statements.

In March 2005, the FASB issued Interpretation No. 47, or FIN 47, which clarifies terminology in FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. FIN 47 clarifies when an entity has sufficient information to reasonably estimate the fair value of an asset retirement obligation. FIN 47 became effective for us in the first quarter of fiscal 2006. The adoption of FIN 47 did not have a material impact on our consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48, or FIN 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement 109*, which clarifies the accounting for uncertainty in tax positions. FIN 48 provides that the tax effects from an uncertain tax position can be recognized in our consolidated financial statements, only if the position is more likely than not to be sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of fiscal 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. We are currently evaluating the impact of adopting FIN 48 on our consolidated financial statements.

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. Markets served include industrial equipment, transportation, medical, military/defense, computer, recreation and food. In Minnesota, we have facilities in Baxter, Bemidji, Blue Earth, Fairmont and Merrifield. We also have facilities in Augusta, Wisconsin, and Monterrey, Mexico.

Summary:

For the quarter ended June 30, 2006, we reported net sales of \$26.2 million, up 27 percent over the \$20.6 million we reported in the same quarter of 2005. For the six months ended June 30, 2006, we reported net sales of \$52.2 million, up 32% over the \$39.6 million we reported for the first six months of 2005. The second quarter gross profit percentage was 13% for both 2006 and 2005. For the first six months of 2006 and 2005, the gross profit percentage was 13% and 12%, respectively. Income from operations for the second quarter of 2006 totaled \$627,499, an increase of 67% above the \$375,795 reported in the second quarter of 2005. For the six months ended June 30, 2006 and 2005, income from operations totaled \$1,228,469 and \$691,128, respectively, a 78% increase from 2005. Net income for the second quarter of 2006 totaled \$308,665, or \$0.11 per diluted common share and was above the \$138,961, or \$0.05 per diluted common share, reported in the second quarter of 2005. Net income for the first six months of 2006 totaled \$572,613, or \$0.21 per diluted common share and was above the \$237,853, or \$0.09 per diluted common share, reported in the first six months of 2005. The increased profit for the three-months and six months ending June 30, 2006 comes primarily from the revenue growth.

(1) Results of Operations:

The following table presents statement of operations data as percentages of total revenues for the periods indicated:

| | Three Months Ended | | Six Months Ended | |
|-------------------------------------|--------------------|-------|------------------|-------|
| | June 30, 2006 | 2005 | June 30, 2006 | 2005 |
| Net Sales | 100 | % 100 | % 100 | % 100 |
| Cost of Good Sold | 87 | % 87 | % 87 | % 88 |
| Gross Profit | 13 | % 13 | % 13 | % 12 |
| Selling Expenses | 5 | % 5 | % 4 | % 4 |
| General and Administrative Expenses | 6 | % 6 | % 6 | % 6 |
| Income from Operations | 2 | % 2 | % 3 | % 2 |
| Other Expenses, Net | 1 | % 1 | % 1 | % 1 |
| Income Tax Expense | 0 | % 0 | % 1 | % 0 |
| Net Income | 1 | % 1 | % 1 | % 1 |

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Net Sales:

We reported net sales of \$26.2 million and \$20.6 million for the second quarter ended June 30, 2006 and 2005, respectively, a 27% increase year over year. The increase in net sales of \$5.6 million for the second quarter is due to increased sales volume in our Aerospace Systems Division of \$3.2 million, our Industrial Electronic Printed Circuit Board Assemblies Division of \$1.6 million and our Commercial Wire and Cable Divisions of \$0.8 million. We reported net sales of \$52.2 million and \$39.6 million for the six months ended June 30, 2006 and 2005, respectively, a 32% increase year over year. The increase in net sales of \$12.6 million for the first six months is due to increased sales volume in our Aerospace Systems Division of \$5.8 million, our Industrial Electronic Printed Circuit Board Assemblies Division of \$4.1 million and our Commercial Wire and Cable Divisions of \$2.7 million. Our 90-day order backlog was approximately \$17.1 million as of June 30, 2006, compared to approximately \$22.1 million at the beginning of the quarter. The majority of the backlog reduction is associated with the increased capacity from our Aerospace Systems Division's expansion into the Blue Earth facility helping to reduce past due orders. We expect, based on the current backlog position, the third quarter of 2006 to have similar sales levels as the second quarter of 2006.

Gross Profit:

Our gross profit for the second quarter of 2006 was \$3.4 million or 13% of net sales compared to gross profit of \$2.6 million or 13% of net sales for the second quarter of 2005. Our gross profit for the first six months of 2006 was \$6.6 million or 13% of net sales compared to gross profit of \$5.0 million or 12% of net sales for the second quarter of 2005. The gross profit improvement for the quarter and first six months of \$0.8 million and \$1.6 million, respectively, was positively impacted by the increased revenue and associated leveraging of fixed costs but did not materialize into improved gross margin percentages due to higher copper and oil based commodity prices, higher energy costs and underutilized plant capacity.

Selling Expense:

We had selling expenses of \$1.1 million or 5% of net sales for the second quarter of 2006 compared to \$0.9 million or 5% of net sales for the second quarter of 2005. For the first six months ended June 30, 2006 and 2005, we had selling expenses of \$2.2 million and \$1.8 million, respectively, representing 4% of net sales. The increase in selling expenses for the quarter and the first six months of \$0.2 million and \$0.4 million resulted from increases in commissions of \$0.1 million and \$0.3 million, respectively, with the remaining increase in our sales infrastructure and expenses. We continue to invest in our sales force and brand in order to maintain a high level of customer service, support the revenue growth and communicate our brand and services to the markets we serve.

General and Administrative Expense:

Our general and administrative expenses were \$1.7 million or 6% of net sales for the second quarter of 2006 and \$1.3 million or 6% of net sales for the second quarter ended June 30, 2005. For the first six months ended June 30, 2006 and 2005, we had general and administrative expenses of \$3.1 million and \$2.5 million, respectively, representing 6% of net sales. The increase in general and administrative expenses for the quarter and for the first six months of \$0.4 million and \$0.6 million, respectively, is attributable to increased personnel expenses to support the growth and the operations.

Other Expense:

Other expenses, net were \$180,834 for the quarter ended June 30, 2006 compared to \$169,834 for the second quarter of 2005. Other expenses, net were \$350,856 for the six months ended June 30, 2006 compared to \$316,275 for the first six months of 2005. Interest expense increased for the three months and six months ended June 30, 2006, by \$29,386 and \$63,672, respectively, which is due to higher interest rates which on average were 1% higher than prior year and increased funded debt levels.

Income Tax:

Income tax expense for the three months ended June 30, 2006 was \$138,000 compared to an income tax expense of \$67,000 for the three months ended June 30, 2005. Income tax expense for the six months ended June 30, 2006 was \$305,000 compared to an income tax expense of \$137,000 for the six months ended June 30, 2005. The effective tax rate for 2006 is expected to approximate 34.6%, comprised of an effective rate of 33.2% for domestic federal and state taxes and 1.4% for foreign taxes. The effective tax rate for 2005 was 33%, comprised of an effective rate of 31.2% for domestic federal and state taxes and 1.8% for foreign taxes. We anticipate additional Research and Development credits to impact the effective domestic tax rate but not to the same levels as in 2005.

(2.) **Liquidity and Capital Resources:**

We have satisfied our liquidity needs over the past several years through revenue generated from operations and an operating line of credit through Wells Fargo Bank, N.A. (WFB). Due to our continued growth and increased working capital requirements in the past several quarters our line of credit arrangement with Wells Fargo Bank was increased from \$8.0 million to \$10.0 million on April 28, 2006 with a maturity date of April 30, 2008. The line of credit and other installment debt 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 ratios, and limit the amount of annual capital expenditures. On June 30, 2006, we had an outstanding balance of \$6.1 million under the line of credit and unused availability of \$3.7 million supported by our borrowing base level.

The following unaudited ratios are not required under the SEC guidelines or accounting principles generally accepted in the United States of America, however, we believe they are meaningful measures and are useful to readers of our financial statements.

Our line of credit is classified as a current liability as of June 30, 2006 and December 31, 2005. At December 31, 2003, the line of credit was classified as a long-term liability. Therefore, in order to present the following ratios as comparable to the prior periods, the line of credit at December 31, 2003 has been included in the current liabilities to compute the ratios below to make the comparisons below more meaningful.

| | June 30, 2006 | December 31, 2005 | December 31, 2004 | December 31, 2003* |
|--|------------------|----------------------|----------------------|-----------------------|
| Current Ratio (Current Assets / Current Liabilities) | 1.55 | 1.60 | 1.65 | 1.80 |
| Working Capital (Current Assets - Current Liabilities) | \$ 11,910,603 | \$ 12,214,328 | \$ 11,749,991 | \$ 10,816,072 |
| Quick Ratio (Cash + Accounts Receivable / Current Liabilities) | 0.69 | 0.75 | 0.77 | 0.81 |
| Accounts Receivable to Working Capital (Average Accounts Receivable/ Working Capital) | 1.20 | 1.14 | 1.03 | 0.85 |
| Inventory to Working Capital (Average Inventory/ Working Capital) | 1.39 | 1.23 | 1.10 | 1.11 |

* Proforma ratios since the line of credit debt has been reclassified to current liabilities as noted in above comments.

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Our working capital of \$11.9 million as of June 30, 2006 was relatively unchanged from the \$12.2 million at December 31, 2005. Working capital changes were an increase in inventory of \$1.3 million, a decrease in Accounts Receivable of \$0.3 million, a decrease in Accounts Payable of \$0.1 million, and the remaining major changes were in current financing activities. We continue to take the necessary actions needed and implement initiatives to improve our working capital position by focusing on lowering inventory levels and collecting accounts receivable within terms.

Net cash provided by operating activities for the six months ended June 30, 2006 was \$0.2 million, which is down from the \$1.5 million of net cash provided by operating activities for the six months ended June 30, 2005. The cash flow from operations for the six months ended June 30, 2006 is the result of net income of \$0.6 million adjusted for noncash depreciation, amortization, loss on the disposal of assets, stock-based compensation expense, foreign currency transaction loss, and the change in deferred taxes, which combined totaled \$0.6 million in net positive adjustments, less the net change in operating assets and liabilities of \$1.0 million. Decreases in Accounts Receivable of \$0.3 million and increases in Inventories of \$1.3 million account for the majority of use of working capital cash in the first six months of 2006. The growth in inventory is associated with the year-to-date revenue increase of 32%.

Net cash used in investing activities of \$2.8 million for the first six months of 2006 is up from \$0.5 million spent on property and equipment purchases in the first six months of 2005. The 2006 major investments are related to the June 28, 2006 purchase of the facility in Blue Earth, Minnesota for \$1.4 million and other property and equipment purchases of \$1.0 million.

Net cash provided by financing activities for the six months ended June 30, 2006 was \$2.5 million, consisting primarily of drawing on the line of credit by \$1.9 million, proceeds from the \$1.1 million equipment note, \$1.4 million from the industrial revenue bond for the Blue Earth purchase, and offset by paying down principal on notes payable of \$0.6 million and reduced checks in excess of bank balance of \$1.2 million.

We believe that our future financing requirements can be met with funds generated from our operating activities and our operating line of credit. Set forth below is information about our long-term contractual obligations outstanding as of June 30, 2006. Refer to the Annual Report on Form 10-K for detailed information on our long-term contractual obligations and commitments.

| | Payments Due by Period | | | |
|--|-------------------------------|---------------------|-------------------|---------------------|
| | Remainder of 2006 | 2 - 3 Yrs | 4 - 5 Yrs | Thereafter |
| Notes Payable | \$ 6,103,984 | \$ | \$ | \$ |
| Long-term Debt | 757,260 | 2,357,222 | 723,178 | 1,952,778 |
| Operating Leases | 166,249 | 361,759 | 184,655 | |
| Equipment Purchase Commitments | 515,000 | | | |
| Total Contractual Obligations and Commitments | \$ 7,542,493 | \$ 2,718,981 | \$ 907,833 | \$ 1,952,778 |

As result of the purchase of the Blue Earth facility on June 28, 2006, we are leasing 45,000 square feet of the building to the previous owner through the remainder of 2006 with an option to renew until March 2007. This sublease income of approximately \$102,000 will effectively reduce our contractual obligations for the remainder of 2006. Included in the equipment purchase commitments is \$427,500 that will be used for the purchase of equipment for the Blue Earth facility as specified in the Industrial Revenue Bond Agreement.

From time to time we enter into purchase commitments with our suppliers under customer purchase order forms. Any significant losses implicit in these contracts would be recognized in accordance with generally accepted accounting principles. At June 30, 2006, no such losses existed.

(3.) Critical Accounting Policies:

Our significant accounting policies and estimates are summarized in the footnotes to the annual consolidated financial statements. Some of the most critical accounting policies and estimates that require us to exercise significant judgment are listed below.

Revenue Recognition:

We recognize revenue upon shipment of products to customers, when title has passed, all contractual obligations have been satisfied and collection of the resulting receivables are reasonably assured. In the normal course of business, we enter into a number of contracts with customers under which we provide engineering services on a per project basis. Revenue for these services is recognized upon completion of the engineering process, usually upon initial shipment of the product. Revenues from repair services are recognized upon shipment of related equipment to customers.

Allowance for Uncollectible Accounts:

We evaluate our allowance for uncollectible accounts on a quarterly basis and review any significant customers with delinquent balances to determine future collectibility. We base our determinations on legal issues (such as bankruptcy status), past history, current financial and credit agency reports, and experience. We reserve accounts deemed to be uncollectible in the quarter in which we make the determination. We maintain additional reserves based on our historical bad debt experience. We believe these estimates may differ from actual results. We believe that, based on past history and credit policies, the net accounts receivable are of good quality.

Inventory Valuation and Reserves:

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 inventory that may have a lower value than stated or in excess of production needs. These estimates may differ from actual results. We have an evaluation process that is used to assess the value of the inventory by part and customer that is slow moving, excess or obsolete. This process is reviewed and evaluated quarterly.

Deferred Income Tax Valuation:

At June 30, 2006 and December 31, 2005, we have recorded U.S. deferred tax assets pertaining to the recognition of future deductible temporary differences. We have not provided any valuation allowance with respect to these assets, as we believe their realization is more likely than not. This determination is primarily based upon our expectation that future U.S. operations will be sufficiently profitable, as well as various tax, business and other planning strategies available to us. We cannot assure you that we will be able to realize this asset or that future valuation allowances will not be required. The failure to utilize this asset would adversely affect our results of operations and financial position.

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Long-Lived and Intangible Asset Impairment:

We evaluate long-lived assets and intangible assets with finite lives for impairment, as well as the related amortization periods, to determine whether adjustments to these amounts or useful lives are required based on current events and circumstances. The evaluation 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 is recorded to reduce the carrying amount to its estimated fair value.

The test for impairment requires us to make several estimates about fair value, most of which are based on projected future cash flows. The estimates associated with the asset impairment tests are considered critical due to the judgments required in determining fair value amounts, including projected future cash flows. Changes in these estimates may result in the recognition of an impairment loss.

Stock-Based Compensation:

We adopted the provisions of SFAS 123R, *Share-Based Payment* on January 1, 2006. SFAS 123R requires us to measure and recognize in our consolidated statements of operations the expense associated with all share-based payment awards made to employees and directors based on estimated fair values. We have two types of stock-based compensation awards consisting of restricted stock and stock options.

Restricted stock is valued at the market price of the stock on the date of grant. These awards vest over a three-year term and are expensed ratably over the same period. The arrangements contain an acceleration condition whereby, if we attain certain financial measurements, the awards vest in their entirety on December 31, 2006.

We utilize the Black-Scholes option valuation model to measure the amount of compensation expense to be recognized for each stock option award. There are several assumptions that must be made when using the Black-Scholes model such as the expected term of each option, the expected volatility of the stock price during the expected term of the option, the expected dividends to be paid and the risk free interest rate expected during the option term. We have reviewed each of these assumptions carefully and we determined our best estimate for these variables. Of these assumptions, the expected term of the option and expected volatility of our common stock are the most difficult to estimate since they are based on the exercise behavior of employees and the expected performance of our stock. An increase in the volatility of our stock will increase the amount of compensation expense on new awards. An increase in the holding period of options will also cause an increase in compensation expense. Dividend yields and risk-free interest rates are less difficult to estimate, but an increase in the dividend yield will cause a decrease in expense and an increase in the risk-free interest rate will increase compensation expense.

Based on a critical assessment of our accounting policies and the underlying judgments and uncertainties affecting the application of those policies, we believe that our consolidated financial statements provide a meaningful and fair perspective of our financial position as of June 30, 2006. This is not to suggest that other general risk factors, such as changes in worldwide economic conditions, fluctuations in foreign currency exchange rates, changes in materials costs, performance of acquired businesses and others, could not adversely impact our consolidated financial position, results of operations and cash flows in future periods.

(4.) Forward-Looking Statements:

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

- **Volatility in the marketplace which may affect market supply and demand for our products;**

- **Increased competition;**

- **Changes in the reliability and efficiency of operating facilities or those of third parties;**

- Risks related to availability of labor;

- Increase in certain raw material costs such as copper;

- Commodity and energy cost instability;

- General economic, financial and business conditions that could affect our financial condition and results of operations.

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 foregoing 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.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to changes in interest rates primarily as a result of our borrowing activities used to maintain liquidity. Our earnings have been affected by recent changes in interest rates on our floating interest rate debt because interest rates have risen over the past year while our utilization on our line of credit has remained stable. Based on our current borrowings, an increase of 100 basis points in prevailing interest rates would increase our annual interest expense by less than \$100,000, which may be offset in part by the interest rate swap agreement entered into in connection with the issuance of bonds at the end of the second quarter.

We are exposed to currency exchange fluctuations related to our Mexico subsidiary; however, the Mexican peso continues to remain fairly stable.

ITEM 4. CONTROLS AND PROCEDURES

The factors identified above are believed to be important factors (but not necessarily all of the important factors) that

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We evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, 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 of June 30, 2006. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and are operating in an effective manner.

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We are currently in the process of reviewing and formalizing our internal controls and procedures for financial reporting in accordance with the Securities and Exchange Commission's rules implementing the internal control reporting requirements included in Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404). Changes have been and will be made to our internal controls over financial reporting as a result of these efforts. We are dedicating significant resources, including senior management time and effort, and incurring substantial costs in connection with its ongoing Section 404 assessment. We are currently documenting and testing internal controls and considering whether any improvements are necessary for maintaining an effective control environment. The evaluation of internal controls is being conducted under the direction of senior management in consultation with an independent third party consulting firm. In addition, senior management is regularly discussing proposed improvements to the control environment with the Audit Committee. We expect to assess controls and procedures on a regular basis and will continue to work to improve controls and procedures and educate and train employees on the existing controls and procedures in connection with the efforts to maintain an effective controls infrastructure.

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PART II

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

We are affected by risks specific to us as well as factors that affect all businesses operating in a global market. The significant factors known to us that could materially adversely affect our business, financial condition, or operating results are described in our most recently filed Annual Report on Form 10-K (Item 1A). There has been no material change in those risk factors.

ITEM 6. EXHIBITS

(a) 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 Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.

32.1 Certification of the Chief Executive Officer and Chief Financial Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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: August 2, 2006

by /s/ Michael J. Degen
Michael J. Degen
President and Chief
Executive Officer

Date: August 2, 2006

by /s/ Richard G. Wasielewski
Richard G. Wasielewski
Chief Financial Officer