

ELECTRONIC SYSTEMS TECHNOLOGY INC

Form 10-Q

November 03, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended **September 30, 2014**

OR

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

From \_\_\_\_\_ to \_\_\_\_\_

**ELECTRONIC SYSTEMS TECHNOLOGY, INC.**

(Exact name of registrant as specified in its charter)

**Washington**

(State or other jurisdiction of incorporation)

**000-27793**

(Commission File Number)

**91-1238077**

(IRS Employer Identification No.)

**415 N. Quay St. Bldg B1 Kennewick WA**

(Address of principal executive offices)

**99336**

(Zip Code)

(509) 735-9092

(Registrant's telephone number, including area code)

N/A

(Former name, former address & former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all documents and reports required to be filed by Sections 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 filings for the past 90 days. YES x NO ..

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company.

Large accelerated filer

..

Accelerated filer

..

Non-accelerated filer

.. (Do not check if a smaller reporting company)

Smaller reporting company

x

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of September 30, 2014, the number of the Company's shares of common stock par value \$0.001, outstanding was 5,158,667.

**ELECTRONIC SYSTEMS TECHNOLOGY, INC.**

**FORM 10-Q**

**September 30, 2014**

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**PART I****FINANCIAL INFORMATION****Item 1. Financial Statements.****ELECTRONIC SYSTEMS TECHNOLOGY, INC.****BALANCE SHEETS**

September 30, 2014

December 31, 2013

(Unaudited)

**ASSETS**

## Current assets

|  |            |            |
|--|------------|------------|
| Cash and cash equivalents                      | \$ 952,484 | \$ 896,580 |
| Short term certificates of deposit investments | 1,058,000  | 1,414,000  |
| Accounts receivable                            | 134,034    | 72,783     |
| Inventories                                    | 715,650    | 625,692    |
| Accrued interest                               | 6,444      | 2,947      |
| Prepaid insurance                              | 7,392      | 11,389     |
| Prepaid expenses                               | 22,145     | 24,298     |
| Total current assets                           | 2,896,149  | 3,047,689  |

|   |        |        |
|---|--------|--------|
| Property and equipment, net of depreciation | 88,455 | 31,372 |
|---|--------|--------|

|                           |                     |                     |
|---------------------------|---------------------|---------------------|
| Deposits                  | -                   | 13,083              |
| Deferred income tax asset | 41,100              | 36,600              |
| <b>Total assets</b>       | <b>\$ 3,025,704</b> | <b>\$ 3,128,744</b> |

**LIABILITIES & STOCKHOLDERS' EQUITY**

## Current liabilities

|                           |          |          |
|---------------------------|----------|----------|
| Accounts payable          | \$ 7,823 | \$ 8,669 |
| Accrued liabilities       | 39,069   | 50,332   |
| Refundable deposits       | 276      | 4,910    |
| Total current liabilities | 47,168   | 63,911   |

|                               |               |               |
|-------------------------------|---------------|---------------|
| Deferred income tax liability | 3,400         | 5,100         |
| <b>Total liabilities</b>      | <b>50,568</b> | <b>69,011</b> |

## Stockholders' equity

|  |                     |                     |
|--|---------------------|---------------------|
| Common stock, \$0.001 par value 50,000,000 shares authorized 5,158,667 shares issued and outstanding | 5,159               | 5,159               |
| Additional paid-in capital   | 1,007,861           | 1,005,616           |
| Retained earnings  | 1,962,116           | 2,048,958           |
| Total stockholders' equity   | 2,975,136           | 3,059,733           |
| <b>Total liabilities and stockholders' equity</b>  | <b>\$ 3,025,704</b> | <b>\$ 3,128,744</b> |

(See "Notes to Financial Statements")



**ELECTRONIC SYSTEMS TECHNOLOGY, INC.**  
**STATEMENTS OF OPERATIONS**

|  | Three Months<br>Ended September<br>30, 2014 | (Unaudited)<br>Three Months<br>Ended<br>September 30,<br>2013 | Nine Months<br>Ended<br>September 30,<br>2014 | Nine Months<br>Ended<br>September 30,<br>2013 |
|--|---|---|---|---|
| <b>SALES, NET</b>  | \$ 355,651                                  | \$ 533,573  | \$ 1,287,436                                  | \$ 1,394,209                                  |
| <b>SITE SUPPORT</b>  | 24,756                                      | 40,934  | 125,057                                       | 87,318  |
| <b>COST OF SALES</b>   | (190,127)                                   | (255,174)   | (648,055)                                     | (665,919)                                     |
| <b>GROSS PROFIT</b>  | 190,280                                     | 319,333   | 764,438                                       | 815,608                                       |
| <b>OPERATING EXPENSES</b>  |   |   |   |   |
| General and administrative   | 67,284                                      | 55,517  | 225,073                                       | 210,635                                       |
| Research and development   | 80,798                                      | 64,114  | 205,440                                       | 189,589                                       |
| Marketing  | 111,456                                     | 114,188   | 342,381                                       | 353,091                                       |
| Customer service   | 29,699                                      | 26,261  | 88,404  | 82,945  |
| <b>TOTAL OPERATING EXPENSES</b>                                    | 289,237                                     | 260,080   | 861,298                                       | 836,260                                       |
| <b>OPERATING INCOME (LOSS)</b>                                     | (98,956)                                    | 59,254  | (96,859)                                      | (20,652)                                      |
| <b>OTHER INCOME</b>  |   |   |   |   |
| Interest income  | 2,492                                       | 1,941   | 8,017   | 5,806   |
| <b>TOTAL OTHER INCOME</b>  | 2,492                                       | 1,941   | 8,017   | 5,806   |
| <b>NET INCOME (LOSS) BEFORE INCOME TAX</b>                         | (96,464)                                    | 61,195  | (88,842)                                      | (14,846)                                      |
| Benefit (provision) for income tax                                 | 2,660                                       | (9,239)   | 2,000   | 14,900  |
| <b>NET INCOME (LOSS)</b>   | \$ (93,806)                                 | \$ 51,956   | \$ (86,842)                                   | \$ 54   |
| Basic and diluted income   |   |   |   |   |
| (loss) per share   | \$ (0.02)                                   | \$ 0.01   | \$ (0.02)                                     | \$ Nil  |
| Weighted average shares used in computing income (loss) per share: |   |   |   |   |

|                   |           |           |           |           |
|-------------------|-----------|-----------|-----------|-----------|
| Basic and diluted | 5,158,667 | 5,158,667 | 5,158,667 | 5,158,667 |
|-------------------|-----------|-----------|-----------|-----------|

(See "Notes to Financial Statements")

**ELECTRONIC SYSTEMS TECHNOLOGY, INC.**  
**STATEMENTS OF CASH FLOWS**

|   | (Unaudited)                             |   |
|---|---|---|
|   | Nine Months Ended<br>September 30, 2014 | Nine Months Ended<br>September 30, 2013 |
| <b>CASH FLOWS PROVIDED (USED) BY OPERATING ACTIVITIES:</b>    |   |   |
| Net income (loss)   | \$ (86,842)                             | \$ 54                                   |
| Noncash items included in net income (loss):                  |   |   |
| Depreciation  | 11,476                                  | 10,096                                  |
| Deferred income taxes   | (6,200)                                 | (14,900)                                |
| Share based compensation                                      | 2,245                                   | 1,713                                   |
| Changes in operating assets and liabilities:                  |   |   |
| Account receivable  | (61,251)                                | (14,272)                                |
| Inventories   | (89,958)                                | (102,198)                               |
| Accrued interest  | (3,496)                                 | (1,027)                                 |
| Prepaid insurance   | 3,997                                   | (4,900)                                 |
| Prepaid expenses  | 2,153                                   | (9,636)                                 |
| Deposits  | 13,083                                  | --                                      |
| Accounts payable  | (846)                                   | 5,694                                   |
| Accrued liabilities   | (11,263)                                | 926                                     |
| Refundable deposits   | (4,635)                                 | (2,035)                                 |
| <b>NET CASH FLOWS USED BY OPERATING ACTIVITIES</b>            | <b>(231,537)</b>                        | <b>(130,485)</b>                        |
| <b>CASH FLOWS PROVIDED (USED) BY INVESTING ACTIVITIES</b>     |   |   |
| Short term certificates of deposit investments redeemed       | 356,000                                 | (138,000)                               |
| Purchases of property and equipment                           | (68,560)                                | (1,640)                                 |
| <b>NET CASH FLOWS PROVIDED (USED) BY INVESTING ACTIVITIES</b> | <b>287,440</b>                          | <b>(139,640)</b>                        |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>   |   |   |
| Cash and cash equivalents at beginning of period              | 896,580                                 | 818,497                                 |
| Cash and cash equivalents at ending of period                 | \$ 952,484                              | \$ 548,372                              |

(See "Notes to Financial Statements")



**ELECTRONIC SYSTEMS TECHNOLOGY, INC.****NOTES TO FINANCIAL STATEMENTS**

(Unaudited)

**NOTE 1 - BASIS OF PRESENTATION**

The financial statements of Electronic Systems Technology, Inc. (the "Company"), presented in this Form 10Q are unaudited and reflect, in the opinion of Management, a fair presentation of operations for the three month and nine month periods ended September 30, 2014 and September 30, 2013. All adjustments of a normal recurring nature and necessary for a fair presentation of the results for the periods covered have been made. Certain information and footnote disclosure normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the applicable rules and regulations of the Securities and Exchange Commission. In preparation of the financial statements, certain amounts and balances have been reformatted from previously filed reports to conform to the format of this quarterly presentation. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's Form 10K for the year ended December 31, 2013 as filed with Securities and Exchange Commission.

The results of operations for the three and nine months ended September 30, 2014 and September 30, 2013, are not necessarily indicative of the results expected for the full fiscal year or for any other fiscal period.

**NOTE 2 - INVENTORIES**

Inventories are stated at lower of direct cost or market with cost determined using the FIFO (first in, first out) method. Inventories consist of the following:

|                  | September 30, | December 31, |
|------------------|---------------|--------------|
|                  | 2014          | 2013         |
| Parts            | \$ 281,679    | \$217,567    |
| Work in progress | 261,633       | 83,620       |
| Finished goods   | 172,338       | 324,505      |
|                  | \$ 715,650    | \$625,692    |

**NOTE 3 INCOME (LOSS) PER SHARE**

Basic income (loss) per share excludes dilution and is computed by dividing income (loss) available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted income (loss) per share reflects potential dilution occurring if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company. At September 30, 2014 the Company had 440,000 outstanding stock options that could have a dilutive effect on future periods. However, at September 30, 2014 the effect of stock options on diluted earnings per share would be anti-dilutive.

**NOTE 4 - STOCK OPTIONS:**

As of September 30, 2014, the Company had 440,000 outstanding stock options, which have been granted periodically to individual employees and directors with no less than three years of continuous tenure with the Company. On February 28, 2014, additional stock options to purchase shares of the Company's common stock were granted to individual employees and directors. The options granted on February 28, 2014 totaled 175,000 shares under option and have an exercise price of \$0.41 per share.

**NOTE 5 - RELATED PARTY TRANSACTIONS**

For the three and nine-month periods ended September 30, 2014, services in the amounts of \$26,074 and \$53,780, respectively, were contracted with Manufacturing Services, Inc. ( MSI ), a company of which Melvin H. Brown is a former owner and is currently a member of the Board of Directors of Electronic Systems Technology Inc. For the three and nine-month periods ended September 30, 2013 the contracted services with MSI were \$28,685 and \$82,527, respectively. The Company owed accounts payable to MSI at September 30, 2014 and December 31, 2013 of \$5,261 and \$10, respectively.

**NOTE 6 - SEGMENT REPORTING**

Segment information is prepared on the same basis that the Company's management reviews financial information for operational decision making purposes. The Company has two reportable segments, domestic and foreign, based on the geographic location of the customers. Both segments sell radio modem products (requiring an FCC license or license free Ethernet products), related accessories for radio modem products for industrial automation projects, and mobile data computer products. The foreign segment sells the Company's products and services outside the United States.

During the quarter ended September 30, 2014, Domestic customers represented approximately 97% of total net revenues. Foreign customers represented approximately 3% of total net revenues. During the quarter ended September 30, 2014, sales to two customers that comprised more than 10% of the Company's sales revenues Customer A and Customer B sales were 15.5% and 11.5% respectively. Revenues from foreign countries during the third quarter of 2014 consist primarily of revenues from product sales to Mexico and Peru.

During the first nine months of 2014, Domestic customers represented approximately 86% of total net revenues. Foreign customers represented approximately 14% of total net revenues. During the nine month period ended September 30, 2014, sales to one customer was greater than 10%, Customer A, of the Company's sales revenues. Revenues from foreign countries during the nine month period ended 2014 consist primarily of revenues from product sales to Peru and Hungary.

Management evaluates performance based on net revenues and operating expenses. Where applicable, portions of the administrative function expenses are allocated between the operating segments. The operating segments share the same manufacturing and distributing facilities. Costs of operating the manufacturing plant, equipment, inventory, and accounts receivable are allocated directly to each segment.

Summary financial information for the two reportable segments for the third quarter and first nine months of 2014 and 2013 is as follows:

|   | <u>Domestic</u> | <u>Foreign</u> | <u>Total</u> |
|---|-----------------|----------------|--------------|
| <b><u>Three months ended September 30, 2014</u></b> |                 |                |              |
| Total sales   | \$ 367,657      | \$ 12,750      | \$ 380,407   |
| Total other income                                  | 2,492           | -              | 2,492        |
| Income (loss) before tax                            | (78,833)        | (17,631)       | (96,464)     |

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|                           |           |     |           |
|---------------------------|-----------|-----|-----------|
| Depreciation/amortization | 5,989     | -   | 5,989     |
| Identifiable assets       | 3,025,567 | 137 | 3,025,704 |
| Net capital expenditures  | 27,547    | -   | 27,547    |

**Three months ended September 30, 2013**

|                           |            |           |            |
|---------------------------|------------|-----------|------------|
| Total sales               | \$ 479,644 | \$ 94,863 | \$ 574,507 |
| Total other income        | 1,941      | -         | 1,941      |
| Income (loss) before tax  | 43,412     | 17,783    | 61,195     |
| Depreciation/amortization | 3,411      | -         | 3,411      |
| Identifiable assets       | 2,995,733  | 3,242     | 2,998,975  |
| Net capital expenditures  | -          | -         | -          |

**Nine months ended September 30, 2014**

|                           |              |            |              |
|---------------------------|--------------|------------|--------------|
| Total sales               | \$ 1,207,925 | \$ 204,568 | \$ 1,412,493 |
| Total other income        | 8,017        | -          | 8,017        |
| Income (loss) before tax  | (141,725)    | 52,883     | (88,842)     |
| Depreciation/amortization | 11,476       | -          | 11,476       |
| Identifiable assets       | 3,025,567    | 137        | 3,025,704    |
| Net capital expenditures  | 68,560       | -          | 68,560       |

**Nine Months ended September 30, 2013**

|                           |              |            |              |
|---------------------------|--------------|------------|--------------|
| Total sales               | \$ 1,129,268 | \$ 352,259 | \$ 1,481,527 |
| Total other income        | 5,806        | -          | 5,806        |
| Income (loss) before tax  | (91,248)     | 76,402     | (14,846)     |
| Depreciation/amortization | 10,096       | -          | 10,096       |
| Identifiable assets       | 2,995,733    | 3,242      | 2,998,975    |
| Net capital expenditures  | 1,640        | -          | 1,640        |



**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATION**

*Management's discussion and analysis is intended to be read in conjunction with the Company's unaudited financial statements and the integral notes thereto for the quarter ended September 30, 2013. The following statements may be forward looking in nature and actual results may differ materially.*

**A. Results of Operations**

**REVENUES:**

Total revenues from the sale of the Company's ESTeem wireless modem products and services decreased to \$380,407 for the third quarter of 2014, compared to \$574,507 for the third quarter of 2013. Gross revenues, which include interest income, decreased to \$382,899 for the quarter ended September 30, 2014, from \$576,448 for the same quarter of 2013. Year to date sales decreased to \$1,412,493 as of September 30, 2014 as compared to \$1,481,527 as of September 30, 2013. Year to date gross revenues decreased to \$1,420,510 as of September 30, 2014 compared to \$1,487,333 as of September 30, 2013. Management believes the decrease in quarterly and year to date sales revenues is due to decreased core products and continuing economic concerns in foreign markets.

The Company's revenues have historically fluctuated from quarter to quarter due to timing factors such as customer order placement and product shipments to customers, as well as customer buying trends, and changes in the general economic environment. The procurement process regarding plant and project automation, or project development, which usually surrounds the decision to purchase ESTeem products, can be lengthy. This procurement process may involve bid activities unrelated to the ESTeem products, such as additional systems and subcontract work, as well as capital budget considerations on the part of the customer. Because of the complexity of this procurement process, forecasts in regard to the Company's revenues become difficult to predict.

A percentage breakdown of EST's Domestic and Export Sales, for the third quarter of 2014 and 2013 are as follows:

|                | For the third quarter of |      |
|----------------|--------------------------|------|
|                | 2014                     | 2013 |
| Domestic Sales | 97%                      | 83%  |
| Export Sales   | 3%                       | 17%  |

**OPERATING SEGMENTS:**

Segment information is prepared on the same basis that the Company's Management reviews financial information for operational decision-making purposes. The Company's operating segment information is contained in Financial Statements, Notes to Financial Statements, Note 6 Segment Reporting.

**Domestic Revenues**

During the quarter ended September 30, 2014, the Company's domestic operations represented 97% of the Company's total sales revenues. Domestic operations sell ESTeem modem products, accessories and service primarily through domestic resellers, as well as directly to end users of the Company's products. Domestic sales revenues decreased to \$367,657 for the quarter ended September 30, 2014, compared to \$479,944 for the quarter ended September 30, 2013.

Management believes the decrease in sales revenues is due to decreased domestic sales for water/waste water and mining industrial automation projects during the first nine months of 2014. During the quarter ended September 30, 2014, two customers, comprised more than 10% of the Company's sales revenues.

Domestic segment operating loss was \$78,833 for the quarter ended September 30, 2014 as compared with a segment net operating income of \$43,412 for the same quarter of 2013, due to decreased sales revenues for the segment during the third quarter of 2014.

For the nine-month period ended September 30, 2014, the Company's domestic operations represented 86% of the Company's total sales revenues. Year to date domestic sales revenues increased to \$1,207,925 as of September 30, 2014 compared to \$1,129,268 for the same period of 2013. Management believes the increase in year to date sales revenues is due to increased engineering services and core product sales during the first nine months of 2014.

Year to date domestic segment operating loss was \$141,725 for the period ended September 30, 2014 as compared with a segment operating loss of \$91,248 for the same period of 2013, due to increased expenses the first nine months of 2014.

#### Foreign Revenues

The Company's foreign operating segment represented 3% of the Company's total net revenues for the quarter ended September 30, 2014. The foreign operating segment is based wholly in the United States and maintains no assets outside of the United States. The foreign operating segment sells ESTeem modem products, accessories and service primarily through foreign resellers, as well as directly to end customers of the Company's products located outside the United States.

During the quarter ended September 30, 2014, the Company had \$12,750 in foreign export sales, amounting to 3% of total net revenues of the Company for the quarter, compared with foreign export sales of \$94,863 for the same quarter of 2013. Management believes the decrease in foreign sales revenues was due to one-time end of life purchase last year. Revenues from foreign countries during the third quarter of 2014 consist primarily of revenues from product sales to Mexico and Peru. No foreign sales to a single customer comprised 10% or more of the Company's product sales for the quarter ended September 30, 2014. Products purchased by foreign customers were used primarily in industrial automation applications. We believe the majority of foreign export sales are the results of the Company's Latin American sales staff, EST foreign reseller activity, and the Company's internet website presence.

Operating loss for the foreign segment was \$17,631 for the quarter ended September 30, 2014 as compared with a net operating profit of \$17,783 for the same period of 2013, due to increased manufacturing over-head and lower sales for the segment during the third quarter of 2014.

For the nine-month period ended September 30, 2014, the Company had \$204,568 in foreign export sales, amounting to 14% of total sales revenues of the Company for the period, compared with foreign export sales of \$352,259 for the same period of 2013. Management believes the decrease in foreign sales revenues is due to lower than anticipated foreign sales revenues from projects in Hungary and Croatia during the first nine months of 2014.

Year to date foreign segment operating income was \$52,883 for the period ended September 30, 2014 as compared with a segment operating income of \$76,402 for the same period of 2013, due to decreased sales for the segment during the first nine months of 2014.

#### **BACKLOG:**

The Corporation had a sales order backlog of approximately \$12,274 as of September 30, 2014. The Company's customers generally place orders on an "as needed basis". Shipment for most of the Company's products is generally made within 1 to 15 working days after receipt of customer orders, with the exception of ongoing, scheduled projects, and custom designed equipment.

**COST OF SALES:**

Cost of sales percentage for the third quarter of 2014 and 2013 was 47% and 41%, respectively. The cost of sales increase for the third quarter of 2014 is the result of the product mix for items sold during the and manufacturing overhead that was not leveraged, when compared with the same period of 2013.

**OPERATING EXPENSES:**

Operating expenses for the third quarter of 2014 increased \$29,157 from the third quarter of 2013. The following is an outline of operating expenses:

| For the quarter ended:     | September 30, 2014 | September 30, 2013 | Increase (Decrease) |
|----------------------------|--------------------|--------------------|---------------------|
| General and Administrative | \$ 67,284          | \$ 55,517          | \$ 11,767           |
| Research/Development       | 80,798             | 64,114             | 16,684              |
| Marketing                  | 111,456            | 114,188            | (2,732)             |
| Customer Service           | 29,699             | 26,261             | 3,438               |
| Total Operating Expenses   | \$ 289,237         | \$ 260,080         | \$ 29,157           |

**GENERAL AND ADMINISTRATIVE:**

During the third quarter of 2014, General and Administrative expenses increased \$11,767 to \$67,284 from the same quarter of 2013, due increased payroll, taxes and benefits.

**RESEARCH AND DEVELOPMENT:**

Research and Development expenses increased \$16,684 to \$80,798 during the third quarter of 2014, when compared with the same period in 2013 due to increased subcontracted engineering expertise and payroll.

**MARKETING:**

During the third quarter of 2014, marketing expenses decreased \$2,732 to \$111,456 from the same period in 2013, due to decreased travel to Latin America.

**CUSTOMER SERVICE:**

Customer service expenses during the third quarter of 2014 increased \$3,438 to \$29,699 when compared with the same quarter of 2013 due to increased department related wages during the period.

**INTEREST AND DIVIDEND INCOME:**

The Corporation earned \$2,492 in interest and dividend income during the quarter ended September 30, 2014. Sources of this income were money market accounts and certificates of deposit.

**STOCK OPTIONS:**

As of September 30, 2014, the Company had 440,000 outstanding stock options. The options granted on February 28, 2014(see Note 4) may be exercised any time during the period from February 28, 2014 through February 28, 2017. The Company's Form 8-K filed March 6, 2014, is incorporated herein by reference. All outstanding stock options must be exercised within 90 days after termination of employment.

The fair value of each option award was estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2014 and 2013:

|   | 2014   | 2013   |
|---|--------|--------|
| Dividend yield                          | 0.00%  | 0.00%  |
| Expected volatility                     | 75%    | 73%    |
| Risk-free interest rate                 | 0.68%  | 0.38%  |
| Expected term (in years)                | 3      | 3      |
| Estimated fair value per option granted | \$0.20 | \$0.15 |

The Company uses historical data to estimate option exercise rates. The option exercise rate for option grants in 2005 through 2013 was 6.43%.

A summary of option activity during the nine months ended September 30, 2014, is as follows:

|                                   | Number      | Weighted-Average Exercise Price Per Share |
|-----------------------------------|-------------|---|
|                                   | Outstanding |   |
| Outstanding at December 31, 2013  | 525,000     | \$0.27                                    |
| Granted                           | 175,000     | 0.41                                      |
| Exercised                         | --          | --  |
| Expired                           | (260,000)   | 0.42                                      |
| Outstanding at September 30, 2014 | 440,000     | 0.39                                      |

In February 2014, the Company issued 175,000 options with an estimated fair value per option of \$0.20 resulting in a stock based compensation value of \$34,930. After the stock based compensation value was adjusted for the historical option forfeiture rate of 93.6%, a stock based compensation expense was charged against income for 2014 of \$2,245. At September 30, 2014 the intrinsic value of outstanding stock options was approximately \$10,300.

**NET INCOME (LOSS):**

The Company had a net loss of \$93,806 for the third quarter of 2014, compared to net income of \$51,956 for the same quarter of 2013. For the nine-month period ended September 30, 2014, the Company recorded a net loss of \$86,842 compared with net income of \$54 for the same period of 2013. The reduction in the Company's net profit is the result of decreased sales revenues, increased payroll and engineering services during the third quarter of 2014.

**B. Financial Condition, Liquidity and Capital Resources**

The Corporation's current asset to current liabilities ratio at September 30, 2014 was 61.4:1 compared to 47.7:1 at December 31, 2013. At September 30, 2014, the Company had cash and cash equivalents of \$952,484; compared to cash and cash equivalent holdings of \$896,580 at December 31, 2013. The Company had certificates of deposit investments in the amount of \$1,058,000 as of September 30, 2014 as compared to \$1,414,000 as of December 31, 2013.

Accounts receivable increased to \$134,034 as of September 30, 2014, from December 31, 2013 levels of \$72,783, due to sales revenue timing differences between the third quarter of 2014 and year-end 2013. Inventories increased to \$715,650 as of September 30, 2014, from December 31, 2013 levels of \$625,692, due primarily to inventory purchases for the production of the new ESTeem 210 and 195 products. The Company's fixed assets, net of depreciation, increased to \$88,455 as of September 30, 2014, from December 31, 2013 levels of \$31,372. The increase is primarily due to the acquisition of software during the quarter ended September 30, 2014.

As of September 30, 2014, the Company's accounts payable balance was \$7,823 as compared with \$8,669 at December 31, 2013, and reflects amounts owed for inventory items, contracted services, and state tax liabilities. Accrued liabilities as of September 30, 2014 were \$39,069, compared with \$50,332 at December 31, 2013, and reflect items such as accrued vacation benefits and payroll tax liability.

In Management's opinion, the Company's cash and cash equivalent reserves, and working capital at September 30, 2014 is sufficient to satisfy requirements for operations, capital expenditures, and other expenditures as may arise during the remainder of 2014, and the ensuing next twelve months.

The Company did not declare or issue any cash dividends during 2013 or 2014.

**FORWARD LOOKING STATEMENTS:** *The above discussion may contain forward looking statements that involve a number of risks and uncertainties. In addition to the factors discussed above, among other factors that could cause actual results to differ materially are the following: competitive factors such as rival wireless architectures and price pressures; availability of third party component products at reasonable prices; inventory risks due to shifts in market demand and/or price erosion of purchased components; change in product mix, and risk factors that are listed in the Company's reports and registration statements filed with the Securities and Exchange Commission.*

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

Not applicable

**Item 4. Controls and Procedures.**

The Company's Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. The Company's internal control over financial reporting is a process to provide reasonable assurance regarding the reliability of our financial reporting for external purposes in accordance with accounting principles generally accepted in the United States of America. Internal control over financial reporting includes maintaining records that in reasonable detail accurately and fairly reflect our transactions; providing reasonable assurance that transactions are recorded as necessary for preparation of our financial statements; providing reasonable assurance that receipts and expenditures of Company assets are made in accordance with Management authorization; and providing reasonable assurance that unauthorized acquisition, use or disposition of Company assets that could have a material effect on our financial statements would be prevented or detected on a timely basis. Because of its inherent limitations, internal control over financial reporting is not intended to provide absolute assurance that a misstatement of our financial statements would be prevented or detected.



### **Controls and Procedures (cont.)**

An evaluation has been performed under the supervision and with the participation of our Management, including our Chief Executive Officer and Principal Accounting Officer, of the effectiveness of the design and the operation of our "disclosure controls and procedures" (as such term is defined in Rules 13a-15(e) under the Securities Exchange Act of 1934) as of September 30, 2014. Based on this evaluation, our Chief Executive Officer and Principal Accounting Officer have determined that there was a material weakness affecting our internal control over financial reporting and, as a result of that weakness, our disclosure controls and procedures were not effective as of September 30, 2014.

The material weakness is as follows:

We did not maintain effective controls to ensure appropriate segregation of duties as the same officer and employee was responsible for the initiating and recording of transactions, thereby creating segregation of duties weaknesses. Due to the (1) significance of segregation of duties to the preparation of reliable financial statements; (2) the significance of potential misstatement that could have resulted due to the deficient controls; and, (3) the absence of sufficient other mitigating controls; we determined that this control deficiency resulted in more than a remote likelihood that a material misstatement or lack of disclosure within the annual or interim financial statements will not be prevented or detected.

Management has evaluated and continues to evaluate, avenues for mitigating our internal controls weaknesses, but mitigating controls have been deemed to be impractical and prohibitively costly due to the size of our organization at the current time. Management does not foresee implementing a cost effective method of mitigating our internal control weaknesses in the near term. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of simple error or mistake. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks.

### **Changes in internal control over financial reporting.**

There have been no changes during the quarter ended September 30, 2014 in the Company's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, internal controls over financial reporting.



**PART II**

**OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company is not involved in any material current of pending legal proceedings

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosure**

Not Applicable

**Item 5. Other Information**

None

**Item 6. Exhibits**

**E X H I B I T  
NUMBER**

**DESCRIPTION**

|         |  |
|---------|--|
| 31.1    | <u>Section 302 Certification, CEO</u>                  |
| 31.2    | <u>Section 302 Certification, CFO</u>                  |
| 32.1    | <u>Section 906 Certification, CEO</u>                  |
| 32.2    | <u>Section 906 Certification, CFO</u>                  |
| 101.INS | XBRL Instance Document                                 |
| 101.SCH | XBRL Taxonomy Extension Schema Document                |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document        |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |



**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ELECTRONIC SYSTEMS TECHNOLOGY, INC.

Date: October 31, 2014

/s/ T.L. KIRCHNER  
Name: T.L. Kirchner  
Title: Director/President

(Chief Executive Officer)

Date: October 31, 2014

/s/ Michael W. Eller  
Name: Michael Eller  
Title: Vice President

(Principal Accounting Officer)

