DEFENSE INDUSTRIES INTERNATIONAL INC
Form 10QSB
August 21, 2006

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

x Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended June 30, 2006

o Transition report under Section 13 or 15(d) of the Exchange Act for the transition period from ___ to ___

Commission file number: 0-30105

Defense Industries International, Inc.

(Exact Name of Small Business Issuer as Specified in Its Charter)

Nevada	84-1421483
(State of Incorporation)	(I.R.S. Employer Identification No.)

8 Brussels St. Sderot, P.O. Box 779, Ashkelon 78101, Israel

(Address of Principal Executive Offices)

(011) 972-8-689-1611

(Issuer's Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year,
if Changed Since Last Report)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

APPLICABLE ONLY TO CORPORATE ISSUERS

As of August 11, 2006 the Issuer had 28,793,198 shares of Common Stock, $.0001 par value per share, outstanding.

Transitional Small Business Disclosure Format (check one):

Yes o No x

DEFENSE INDUSTRIES INTERNATIONAL, INC. AND SUBSIDIARIES

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PART I FINANCIAL INFORMATION

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Item 1.

DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES

CONDENSED CONSOLIDATED INTERIM BALANCE SHEETS

ASSETS

	June 30, 2006 (Unaudited)	December 31, 2005
CURRENT ASSETS		
Cash and cash equivalents	$ 1,280,352	$ 1,581,967
Accounts receivable, net of allowance for doubtful accounts of $180,984 and $133,631, respectively	1,833,884	1,669,808
Accounts receivable - related parties, net of allowance for doubtful accounts of $101,192 and $95,489, respectively	238,354	320,250
Inventories	3,096,778	2,921,998
Trading securities	754,947	739,339
Deferred taxes	95,958	72,255
Other current assets	629,717	646,731
Total Current Assets	7,929,990	7,952,348
PROPERTY, PLANT AND EQUIPMENT, NET	2,275,929	2,270,455
OTHER ASSETS		
Funds in respect of employee rights upon retirement	402,010	382,988
Deferred taxes, long-term	5,552	10,119
Intangible assets, net	96,103	102,499

	June 30, 2006 (Unaudited)	December 31, 2005
Total Other Assets	503,665	495,606
TOTAL ASSETS	$ 10,709,584	$ 10,718,409

The accompanying notes are an integral part of the condensed consolidated financial statements.

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DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARIES

CONDENSED CONSOLIDATED INTERIM BALANCE SHEETS

LIABILITIES AND SHAREHOLDERS EQUITY

	June 30, 2006 (Unaudited)	December 31, 2005
CURRENT LIABILITIES		
Accounts payable	$ 987,292	$ 933,770
Short-term debt	1,217,834	961,738
Current portion of long-term debts	898,854	834,397
Common stock to be issued	40,000	40,000
Other current liabilities	527,336	564,038
Total Current Liabilities	3,671,316	3,333,943
LONG-TERM LIABILITIES		
Long-term portion of debts	1,003,083	712,940
Liability for employee rights upon retirement	301,079	272,190
Common stock to be issued	80,000	120,000
Embedded derivatives at fair value	128,417	166,777
Minority interest	806,340	889,086
Total long-term Liabilities	2,318,919	2,160,993
TOTAL LIABILITIES	5,990,235	5,494,936
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY		
Preferred stock, $.0001 par value, 50,000,000 shares authorized, none issued and outstanding	--	--
Common stock, $.0001 par value, 250,000,000 shares authorized, 28,793,198 issued and outstanding	2,879	2,730
Additional paid-in capital	2,552,738	2,512,887
Retained earnings	2,417,097	3,122,243

	June 30, 2006 (Unaudited)	December 31, 2005
Accumulated other comprehensive loss	(253,365)	(414,387)
Total Shareholders' Equity	4,719,349	5,223,473
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 10,709,584	$ 10,718,409

The accompanying notes are an integral part of the condensed consolidated financial statements.

DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES

CONDENSED CONSOLIDATED INTERIM STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)
(UNAUDITED)

	For the Three Months Ended June 30, 2006	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2006	For the Six Months Ended June 30, 2005
NET REVENUES	$ 1,831,027	$ 3,907,691	$ 3,664,398	$ 7,592,171
COST OF SALES	1,613,383	2,733,221	3,137,856	5,762,604
GROSS PROFIT	217,644	1,174,470	526,542	1,829,567
OPERATING EXPENSES				
Selling	82,386	234,729	218,075	378,810
General and administrative	612,397	560,951	1,006,647	958,047
Total Operating Expenses	694,783	795,680	1,224,722	1,336,857
INCOME (LOSS) FROM OPERATIONS	(477,139)	378,790	(698,180)	492,710
OTHER INCOME (EXPENSES)				
Financial income (expenses), net	(150,708)	8,732	(158,091)	(35,437)
Gain on fair value adjustment to embedded derivatives	9,142	---	38,360	---
Other income (expenses), net	(16,199)	(15,514)	14,089	64,712
Total Other Income (expenses)	(157,765)	(6,782)	(105,642)	29,275

	For the Three Months Ended June 30, 2006	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2006	For the Six Months Ended June 30, 2005
INCOME (LOSS) BEFORE INCOME TAXES	(634,904)	372,008	(803,822)	521,985
Income tax (expenses) benefit	18,686	(133,015)	3,464	(182,029)
Income (loss) before minority interest	(616,218)	238,993	(800,358)	339,956
Minority interest income (loss)	67,082	(33,880)	95,212	(51,605)
NET INCOME (LOSS)	(549,136)	205,113	(705,146)	288,351
OTHER COMPREHENSIVE INCOME (LOSS)				
Foreign currency translation gain (loss), net of minority interest portion	257,320	(193,283)	161,022	(234,567)
Other comprehensive income (loss) before tax	257,320	(193,283)	161,022	(234,567)
Income tax (expenses) benefit related to items of other comprehensive income (loss)	(77,804)	69,393	(41,317)	86,072
TOTAL OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX	179,516	(123,890)	119,705	(148,495)
COMPREHENSIVE INCOME (LOSS)	$ (369,620)	$ 81,223	$ (585,441)	$ 139,856
Net income (loss) per share - basic and diluted	$ (0.01)	$ 0.01	$ (0.02)	$ 0.01
Weighted average number of shares outstanding - basic and diluted	27,689,553	25,375,929	27,498,954	25,363,094

The accompanying notes are an integral part of the condensed consolidated financial statements.

DEFENSE INDUSTRIES INTERNATIONAL, INC.
AND SUBSIDIARY COMPANIES

CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED JUNE 30, 2006 AND 2005

	For The Six Months Ended June 30, 2006	For The Six Months Ended June 30, 2005

	For The Six Months Ended June 30, 2006	For The Six Months Ended June 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (705,146)	$ 288,351
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Depreciation and amortization	211,669	170,944
Gain from sale of property, plant and equipment	---	(17,774)
Provision for doubtful accounts	53,056	18,232
Deferred private placement cost	---	(100,000)
Gain on fair value adjustment to embedded derivatives	(38,360)	---
Net realized and unrealized gain on trading securities	(7,055)	(46,940)
Minority interest in income (loss) of subsidiary	(95,212)	51,605
Increase in deferred taxes	(19,136)	(21,661)
Increase in accounts receivable	(135,235)	(740,157)
decrease in other assets	17,014	206,487
(Increase) decrease in inventories	(174,780)	267,568
Increase in accounts payable	53,521	18,550
Decrease in other liabilities	(36,702)	(15,567)
Increase (decrease) in liability for employee rights upon retirement	28,889	(28,436)

	Number of Shares	Net Value at December 31, 2002
Donald K. Schwanz	12,000	$ 93,000
Vinod M. Khilnani	9,200	$ 71,300
Donald R. Schroeder	16,215	$ 41,966
H. Tyler Buchanan	8,000	$ 62,000
Philip G. Semprevio	0	$ 0
James L. Cummins	15,215	$ 34,216

As of December 31, 2002, Mr. Cummins and Mr. Schroeder each held 10,800 shares of restricted stock subject to payment of a purchase price of $12.50 per share upon lapse of the restrictions. The closing price of CTS common stock on the New York Stock Exchange on December 31, 2002, was $7.75 per share.

(4) The table below shows the components of the All Other Compensation column for 2002:

	CTS Match Under 401(k) Plan	Imputed Income On Term Life Insurance	Other Compensation as Described Below	Total
Donald K. Schwanz	$ 0	$ 4,902	$ 0	$ 4,902
Vinod M. Khilnani	$ 5,423	0	$ 0	$ 5,423

Donald R. Schroeder	$ 6,000	$ 2,622	$ 0	$ 8,622
H. Tyler Buchanan	$ 4,428	$ 2,622	$ 0	$ 7,050
Philip G. Semprevio	$ 6,000	$ 454	$ 73,160	$ 79,614
James L. Cummins	$ 6,000	$ 1,445	$ 0	$ 7,445

Mr. Semprevio received $73,160 in severance compensation following his resignation on September 27, 2002.

(5) Mr. Schwanz was employed by CTS as President and Chief Operating Officer on January 17, 2001.

(6) Reflects cash payments in connection with the lapse of transfer restrictions on restricted shares.

(7) Includes payment of $54,422 in relocation expense reimbursement.

(8) Mr. Khilnani was employed by CTS as Senior Vice President and Chief Financial Officer on May 7, 2001.

(9) Includes $115,678 in relocation expense reimbursement.

(10) Includes $8,870 which represents the difference between the CTS book value and the Kelly Blue Book private party value of the vehicle which Mr. Buchanan purchased from CTS and a perquisite allowance of $10,800.

(11) Mr. Buchanan was elected an officer of CTS on August 18, 2000. His salary for the period from his election through December 31, 2000 was $72,854. The restricted stock grants and option grants he received during 2000 were made prior to his election as an officer.

(12) Mr. Semprevio resigned from his position as Executive Vice President effective September 27, 2002.

(13) Includes $8,790 which represents the difference between the CTS book value and the Kelly Blue Book private party value of the vehicle which Mr. Cummins purchased from CTS and a perquisite allowance of $10,350.

Employment Agreement With Donald K. Schwanz. Mr. Schwanz has an employment agreement with CTS which provides that for five years beginning on October 1, 2001, (the Term), Mr. Schwanz will be employed by CTS as President and Chief Executive Officer, at an initial annual salary of $630,000. During the Term of the agreement, if Mr. Schwanz s employment is terminated as a result of his death or disability, for good reason (as defined) or by CTS without cause (as defined), Mr. Schwanz will receive severance benefits equal to his then current annual salary for the remainder of the Term, plus an annual bonus for each year remaining in the Term equal to the largest cash and stock bonus that he received for any year during the Term, but no less than $330,000. In addition, if Mr. Schwanz s employment is terminated by Mr. Schwanz for good reason or by CTS without cause, Mr. Schwanz may instead receive a lump sum equal to 3 1/3 times the sum of his then current annual salary and the largest cash and stock bonus that he received for any year during the Term, but no less than $330,000. Any payments to Mr. Schwanz upon a change in control are increased to compensate Mr. Schwanz for any excise tax payable by him pursuant to Section 280G of the Internal Revenue Code of 1986, as amended. The payments and benefits to Mr. Schwanz under his employment agreement are reduced automatically by any corresponding payments or benefits under his severance agreement described below.

Mr. Schwanz s employment agreement also provides that for every year of service he accrues after June 30, 2002, an extra year will be credited to him under the CTS Corporation Salaried Employees Pension Plan and/or the CTS Corporation Supplemental Executive Retirement Plan, thereby enhancing the pension benefits which would have otherwise accrued to him under such Plans.

Change in Control Severance Agreements. Each of the active Named Executive Officers has executed a severance agreement with CTS, which becomes operative only upon a change in control of CTS. The term of each agreement is automatically extended each January 1 unless notice is given otherwise. Severance benefits are provided if within three years of a change in control, a covered executive terminates his employment for good reason (as defined) or his employment is terminated for any reason other than cause (as defined), disability or death. Severance benefits include: (i) a lump sum equal to three times the sum of the greater of base salary at the time of the change in control or average base salary over the three years prior to termination plus the greater of average incentive pay over the three years prior to the change in control or target incentive pay for the year in which the change in control occurred; (ii) continued participation for 36 months following termination in welfare benefit plans and similar benefit programs; (iii) a lump sum payment equal to the increase in actuarial value of the benefits under CTS qualified and supplemental retirement plans that the executive would have received had he remained employed; (iv) a lump sum payment ($105,000 for Mr. Schwanz and $67,500 for the other Named Executive Officers) in lieu of any perquisites the executive would otherwise have been provided; (v) outplacement services; (vi) reimbursement of legal, tax and estate planning expense related to the severance agreement; (vii) reimbursement of relocation expenses incurred during the 36 month period following termination; (viii) a lump sum payment equal to target incentive pay for the year in which the termination occurs, prorated based on actual service during the year; and (ix) accelerated vesting, exercise rights and lapse of restrictions on equity based compensation awards. In addition, if any payments made to a covered executive are subject to excise tax under Section 4999 of the Internal Revenue Code, CTS will make an additional payment to put the executive in the same after-tax position as if no excise tax had been imposed.

STOCK OPTIONS

The following table reflects information about stock options awarded to the Named Executive Officers in 2002. These stock options are exercisable in four substantially equal annual installments commencing on July 31, 2003 in accord with the terms set forth in the stock option agreements. Upon termination of employment due to death, total and permanent disability or a change in control of CTS (as defined), the option would become fully vested on an accelerated basis and would be exercisable anytime before its expiration. Upon termination of employment due to qualified retirement (as defined), the option would continue to vest on its schedule and would be exercisable anytime before its expiration. Upon termination of employment for any other reason, the option would be exercisable within the three month period following the termination date, but only to the extent vested as of the termination date.

Option Grants in Last Fiscal Year

	Individual Grants				Potential Realizable Value at Assumed Annual Rates Of Stock Price Appreciation for Option Term (1)	
Name	Securities Underlying Options Granted	% of Total Options Granted to Employees In 2002	Exercise Price ($)/Share	Expiration Date	5%	10%
Donald K. Schwanz	60,000	14.3%	$ 7.70	7-30-2012	$ 290,549	$ 736,309
Vinod M. Khilnani	15,000	3.6%	$ 7.70	7-30-2012	$ 72,637	$ 184,077
Donald R. Schroeder	15,000	3.6%	$ 7.70	7-30-2012	$ 72,637	$ 184,077
H. Tyler Buchanan	12,000	2.9%	$ 7.70	7-30-2012	$ 58,110	$ 147,262
Philip G. Semprevio(2)	10,000	2.4%	$ 7.70	7-30-2012		
James L. Cummins	12,000	2.9%	$ 7.70	7-30-2012	$ 58,110	$ 147,262

(1) Potential realizable value is determined by assuming an initial value equal to the option price per share, the market closing price for CTS common stock on the date of grant, and applying the stated annual appreciation rate compounded annually for the remaining term of the option, subtracting the exercise price and multiplying the remainder by the number of shares subject to options granted. Actual gains, if any, on stock option exercises are dependent on the future performance of the common stock and overall stock market conditions.

(2) Mr. Semprevio s options terminated upon his resignation.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR

AND FISCAL YEAR-END OPTION VALUES

Name	Shares Acquired On Exercise (#)	Value Realized ($)	Number of Securities Underlying Unexercised Options at Fiscal Year End (#)		Value of Unexercised In-the-Money Options at Fiscal Year End ($)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Donald K. Schwanz	0	0	21,500	223,500		$ 3,000
Vinod M. Khilnani	0	0	5,000	30,000		$ 750
Donald R. Schroeder	0	0	11,000	26,000		$ 750
H. Tyler Buchanan	0	0	14,300	21,700		$ 600
Philip G. Semprevio	0	0	0	0		
James L. Cummins	0	0	9,600	19,400		$ 600

PENSION PLAN

The following table shows the estimated annual retirement benefits payable to a covered participant in the CTS Corporation Salaried Employees Pension Plan. The benefit formula is calculated as 1.25% of highest average monthly pay during any three calendar years of a participant s last ten calendar years of service, multiplied by a participant s credited service. Covered compensation is essentially equal to the salary and bonus columns in the Summary Compensation Table, together with the cash payments received in connection with the lapse of transfer restrictions on restricted shares as described in footnote (2) to the Summary Compensation Table. These benefits are not subject to any deduction for social security or other offsets.

Compensation	Years of Service				
	15	20	25	30	35
$ 200,000	$ 37,500	$ 50,000	$ 62,500	$ 75,000	$ 87,500
$ 300,000	$ 56,250	$ 75,000	$ 93,750	$ 112,500	$ 131,250
$ 400,000	$ 75,000	$ 100,000	$ 125,000	$ 150,000	$ 175,000
$ 600,000	$ 112,500	$ 150,000	$ 187,500	$ 225,000	$ 262,500
$ 800,000	$ 150,000	$ 200,000	$ 250,000	$ 300,000	$ 350,000
$ 1,000,000	$ 187,500	$ 250,000	$ 312,500	$ 375,000	$ 437,500
$ 1,200,000	$ 225,000	$ 300,000	$ 375,000	$ 450,000	$ 525,000

$	1,400,000	$	262,500	$	350,000	$	437,500	$	525,000	$	612,500

The years of service credited to the Named Executive Officers as of December 31, 2002 are: Donald K. Schwanz 2.56 years; Vinod M. Khilnani 1.78 years; Donald R. Schroeder 30.44 years; H. Tyler Buchanan 25.78 years; Philip G. Semprevio 7.78 years; and James L. Cummins 25.78 years.

Section 415 of the Internal Revenue Code generally places a limit of $160,000 on the amount of annual pension benefits that may be paid at age 65 from a plan like that of CTS. The Code also places a $12,000 limit, subject to adjustment by the Internal Revenue Service, on annual contributions by an employee to the CTS Corporation Retirement Savings Plan. Under a supplemental benefit provided for by this plan and an unfunded plan adopted in 1996, however, CTS will make payments as permitted by the Code to certain participants in CTS pension plan in an amount equal to the difference, if any, between the benefits that would have been payable under this plan without regard to the limitations imposed by the Code and the actual benefits payable under the plan as described in the above chart.

In addition, as described on page 12 under the heading Employment Agreement with Donald K. Schwanz , the unfunded supplemental retirement plan may be used to further enhance retirement benefits in special situations, beyond those set out in the above chart. Mr. Schwanz s Employment Agreement will, under certain circumstances, provide him with annual retirement benefits approximately equal to two times those reflected in the above chart.

REPORT OF THE AUDIT COMMITTEE

The Audit Committee acts pursuant to its written charter adopted by the Board of Directors, a copy of which is attached hereto as Appendix A. All members of the CTS Audit Committee are independent as defined in Section 303.01(B)(2)(a) and (3) of the New York Stock Exchange listing standards.

The CTS Audit Committee has reviewed and discussed with CTS management and PricewaterhouseCoopers LLP (PwC), CTS independent auditor, the audited consolidated financial statements of the Company for 2002; has discussed with PwC the matters required to be discussed by Statement on Auditing Standards No. 61; has received from the independent auditor the written disclosures and letter required by Independence Standards Board Standard No. 1; and has discussed with the independent auditor the auditor s independence. Based on the review and discussions described above, the Audit Committee recommended to CTS Board of Directors that the financial statements be included in CTS Annual Report on Form 10-K for the fiscal year ended December 31, 2002, for filing with the Securities and Exchange Commission.

CTS CORPORATION 2002 AUDIT COMMITTEE

Gerald H. Frieling, Jr., Chairman
Walter S. Catlow, Member
Michael A. Henning, Vice Chairman
Lawrence J. Ciancia, Member

REPORT OF THE COMPENSATION COMMITTEE

The Committee s Responsibilities: The Compensation Committee of the Board has responsibility for setting and administering CTS executive compensation policies. The Committee is composed entirely of non-employee, outside directors. Reports of the Committee s actions and decisions are presented to the full Board. The purpose of this report is to summarize the principles, specific program objectives and other factors considered by the Committee in reaching its determinations regarding executive compensation.

Compensation Philosophy: The Committee has implemented executive compensation programs which are intended to:

Encourage strong financial and operational performance of CTS;

Link compensation to the interests of shareholders;

Emphasize performance-based compensation;

Provide a competitive level of total compensation necessary to attract and retain talented and experienced executives.

Compensation Methodology: The Committee believes that CTS executive compensation programs reflect this philosophy and provide executives with strong incentives to maximize CTS performance and enhance shareholder value. The executive compensation programs consist of both annual and long-term components and include performance-based and equity-based components. Each year the Committee reviews market data and assesses CTS competitive position in the area of executive compensation. CTS also retains independent compensation and benefits consultants to assist in evaluating executive compensation programs. The use of independent consultants provides additional assurance that CTS programs are reasonable and appropriate.

Components of Compensation:

Base Salary: Annual base salary is designed to compensate CTS executives for their qualifications, responsibilities and performance. CTS objective is to compensate executives within the mid-level of the range of base salaries paid for similar positions at similar companies.

Annual Incentives: CTS has maintained an annual management incentive plan for a number of years which provides cash compensation incentives based on the financial performance of CTS. Under the 2002 Management Incentive Plan, specific financial objectives based on CTS Earnings Per Share (EPS) and/or the contribution to EPS of specific business units were established by the Compensation Committee. For 2002, CTS did not achieve the established EPS target. Although certain business units achieved their established contribution to EPS targets, none of the executive officers qualified for a bonus under the terms of the Plan.

Long-Term, Stock-Based Compensation: CTS uses two forms of long-term, stock-based incentives, restricted stock grants and stock options, under shareholder approved plans. The Committee believes that stock ownership and stock-based compensation are valuable tools for motivating employees to improve the long-term performance of CTS. We also believe that they are the best way to tie a significant amount of an executive s potential income to enhanced shareholder value. CTS stock compensation plans have change of control provisions under which, upon a change of control of CTS, benefits thereunder accelerate and vest immediately.

Stock options are generally awarded on an annual basis by the Compensation Committee at fair market value and vest over a four-year period. During 2002, options for a total of 124,000 shares were granted to the Named Executive Officers, as described in the chart entitled Option Grants in Last Fiscal Year on page 13 of this proxy statement. The number of shares previously awarded to the Named Executive Officers, their market value, vesting schedules and related bonuses, are set forth in the Summary Compensation Table on pages 10 and 11 of this proxy statement. Restricted stock grants are used selectively to provide incentives to key employees who contribute or are expected to contribute materially to the success of CTS. In 2002, restricted stock grants were made to six of the Named Executive Officers, as described in the Summary Compensation Table on pages 10 and 11 of this proxy statement.

Compensation for the Chief Executive Officer (CEO): In September 2001, Donald K. Schwanz entered into an employment agreement to serve as Chief Executive Officer of CTS, the terms of which are summarized on page 12 of this proxy statement. As described above under the Base Salary Component of Compensation, CTS strives to establish the base salary of the CEO at approximately the fiftieth percentile of CEO base salaries paid by similarly situated companies. Use of CEO comparative compensation data supplied by Towers Perrin led to the establishment of Mr. Schwanz s base salary at $630,000. Mr. Schwanz s base salary is subject to annual review by the Board of Directors. The Board made no adjustment to Mr. Schwanz s base salary for the year 2002. Mr. Schwanz did not receive a bonus under the 2002 Management Incentive Plan because CTS did not achieve the established financial targets under the Plan. Mr. Schwanz received stock options and restricted stock grants in 2002 as described in this proxy statement in the Option Grants in Last Fiscal Year chart on page 13 and the Summary Compensation Table on pages 10 and 11.

Deductibility of Certain Executive Compensation: Federal income tax law caps at $1,000,000 the deductible compensation per year for each of the Named Executive Officers in the proxy statement, subject to certain exceptions. In developing and implementing executive compensation policies and programs, the Compensation Committee considers whether particular payments and awards are deductible for federal income tax purposes, along with other relevant factors. Consistent with this policy, the Committee has taken what it believes to be appropriate steps to maximize the deductibility of executive compensation. While it is the general intention of the Committee to meet the requirements for deductibility, the Committee may approve payment of non-deductible compensation from time to time if circumstances warrant. The Committee will continue to review and monitor its policy with respect to the deductibility of compensation.

CTS CORPORATION 2002 COMPENSATION COMMITTEE

Walter S. Catlow, Chairman
Thomas G. Cody, Member
Roger R. Hemminghaus, Member
Robert A. Profusek, Member

INDEPENDENT PUBLIC ACCOUNTANTS

The fees paid to PwC for services rendered in connection with the 2002 annual audit and quarterly reviews of CTS financial statements were $633,000. Fees paid to PwC for other services during fiscal 2002 aggregated $375,000. Other services included tax-related services of $135,000, employee benefit plan assistance services of $210,000 and other accounting related services of $30,000. The Audit Committee has considered whether the provision of these services is compatible with maintaining PwC s auditor independence. No financial information systems design and implementation services were provided by PwC to CTS.

Audit Fees	All Other Fees
$633,000	$ 375,000

PwC representatives will attend the Annual Meeting, to be available to respond to appropriate questions by shareholders and to have the opportunity to make statements, if they desire.

STOCK PERFORMANCE GRAPH

Comparison of Five-Year Cumulative Return

The following graph compares the cumulative total shareholder return on CTS common stock with the Standard & Poor s 500 Stock Index and the Standard & Poor s 500 Information Technology Stock Index for the years 1998 through 2002. The graph assumes that $100 was invested on December 31, 1997 in each of CTS common stock, the S&P 500 Stock Index and the S&P 500 Information Technology Stock Index.

Company/Index	Base Period 1997	1998	1999	2000	2001	2002
CTS Corp	$ 100	$ 137.19	$ 476.86	$ 231.12	$ 101.54	$ 50.23
S&P 500	$ 100	$ 128.58	$ 155.63	$ 141.46	$ 124.65	$ 97.10
S&P 500 Information Technology	$ 100	$ 178.14	$ 318.42	$ 188.18	$ 139.50	$ 87.31

2002 Annual Report on S.E.C. Form 10-K

Upon the written request of a CTS shareholder owning shares of common stock on the Record Date addressed to Richard G. Cutter, Secretary of CTS Corporation, 905 West Boulevard North, Elkhart, Indiana 46514, CTS will provide to such shareholder, without charge, a copy of its 2002 Annual Report on Form 10-K, including the financial statements and financial statement schedules. The report is also available on CTS website at www.ctscorp.com.

By Order of the Board of Directors,

Richard G. Cutter
Secretary

Elkhart, Indiana
March 17, 2003

Appendix A

CTS CORPORATION

BOARD OF DIRECTORS
AUDIT COMMITTEE CHARTER

PURPOSE:

The purposes of the Audit Committee are to (a) assist the Board of Directors in fulfilling the Board s oversight responsibilities with respect to (i) the integrity of the Company s financial statements, (ii) the Company s compliance with legal and regulatory requirements, (iii) the independent auditors qualifications and independence, and (iv) the performance of the independent auditors and the Company s internal audit function; and (b) oversee the preparation of the Committee s report, made pursuant to the Securities Exchange Act of 1934 (the Exchange Act), to be included in the Company s annual proxy statement (the Audit Committee Report).

COMPOSITION:

The Committee shall be solely comprised of a minimum of three (3) and a maximum of five (5) independent members of the Board whose qualifications shall be as follows:

1) Each Committee member shall meet the independence criteria of (a) the rules of the New York Stock Exchange, Inc., as such requirements are interpreted by the Board in its business judgment and (b) Section 301 of the Sarbanes-Oxley Act of 2002 (the Act) and any rules promulgated thereunder by the Securities and Exchange Commission (SEC).

2) Each Committee member shall be financially literate or shall become financially literate within a reasonable period of time after his or her appointment to the Committee. Additionally, at least one member of the Committee shall have accounting or related financial management expertise and shall meet the criteria of a financial expert within the meaning of Section 407 of the Act and any rules promulgated thereunder by the SEC. The Board shall determine, in its business judgment and upon the recommendation of the Nominating and Governance Committee, whether a member is financially literate and whether at least one member has the requisite accounting or financial expertise and meets the financial expert criteria.

3) Each Committee member shall only receive, as compensation from the Company, director s fees (which includes all forms of compensation paid to directors of the Company for service as a director or member of a Board Committee).

4) Each Committee member shall serve on no more than two audit committees of public companies unless the Board of Directors has made an affirmative determination that such service would not detract from that Committee member s ability to give adequate time to the Committee.

The Board shall appoint the members and the Chairman of the Committee based on nominations made by the Company s Nominating and Governance Committee. Committee members shall serve at the pleasure of the Board and for such term or terms as the Board may determine.

RESPONSIBILITIES AND AUTHORITY:

1) *Retain Independent Auditors:* Have the sole authority to (a) retain and terminate the Company s independent auditors (b) approve all audit engagement fees, terms and services, and (c) approve all non-audit engagements with the Company s independent auditors. Such authority shall be exercised in a manner consistent with the provisions of the Act.

The Chairman of the Committee shall have authority to grant any pre-approvals required by the Act, subject to the Chairman reporting any such pre-approvals to the Committee at its next scheduled meeting.

2) *Review Auditors Quality Control:* At least annually, obtain and review reports concerning all communications required by the Act.

3) *Review Independence of Auditors:* In connection with the retention of the Company s independent auditors, at least annually review the information provided by management and the auditors relating to the independence of the audit firm, including, among other things, information related to the non-audit services provided and expected to be provided by the auditors. The Committee is responsible for (a) ensuring that the independent auditors submit at least annually to the Committee a formal written statement delineating all relationships between the auditors and the Company consistent with Independence Standards Board Standard No. 1, (b) actively engaging in a dialogue with the auditors with respect to any disclosed relationship or services that may impact the objectivity and independence of the auditors and (c) taking appropriate action in response to the auditors report to satisfy itself of the auditors independence. In connection with the Committee s evaluation of the auditors independence, the Committee shall also review and evaluate the lead partner of the independent auditors and take such steps as may be required by law with respect to the regular rotation of the lead audit partner and the reviewing audit partner of the independent auditors.

4) *Set Hiring Policies:* Set hiring policies for employees or former employees of the independent auditors which shall include the restrictions set forth in the Act.

5) *Review Audit Plan:* Review with the independent auditors its plans for, and the scope of its annual audit, and other examinations.

6) *Conduct of Audit:* Discuss with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61 (as amended) relating to the conduct of the audit, as well as any audit problems or difficulties and management s response, including (a) any restriction on audit scope or on access to requested information, (b) any disagreements with management and (c) significant issues discussed with the independent auditors national office. Unresolved disagreements between management and the independent auditors regarding financial reporting shall be decided by the Committee.

7) *Discuss Financial Statements:* Discuss with appropriate officers of the Company and the independent auditors the annual audited and quarterly financial statements of the Company, including (a) the Company s disclosures under Management s Discussion and Analysis of Financial Condition and Results of Operations, and (b) the disclosures regarding internal controls and other matters required to be reported to the Committee by the Act and any rules promulgated thereunder by the SEC.

8) *Discuss Earnings Press Releases:* Discuss earnings press releases (including any use of pro forma or adjusted non-GAAP information).

9) *Review Internal Audit Plans:* Review internal audit plans for and the scope of ongoing audit activities.

10) *Review Internal Audit Reports:* Review the annual report of the audit activities, examinations and results thereof of the internal auditing department.

11) *Review Systems of Internal Accounting Controls:* Review the adequacy of the Company s internal accounting controls, the Company s, auditing organization and personnel, and the Company s policies and compliance procedures with respect to business practices which

shall include the disclosures regarding internal controls and matters required to be reported to the Committee by the Act and any rules promulgated hereunder by the SEC.

12) *Review Recommendations of Independent Auditors:* Review with the senior internal auditing executive and the appropriate members of management recommendations made by the independent auditors and the senior internal auditing executive, as well as such other matters, if any, as such persons or other officers of the Company may desire to bring to the attention of the Committee.

13) *Review Audit Results:* Review with the independent auditors (A) the report of their annual audit, or proposed report of their annual audit, (B) the accompanying management letter, if any, (C) the reports of their reviews of the Company s interim financial statements conducted in accordance with Statement on Auditing Standards No. 71, and (D) the reports of the results of such other examinations outside of the course of the independent auditors normal audit procedures that the independent auditors may from time to time undertake. The foregoing shall include the reports required by the Act and, as appropriate, (a) a review of major issues regarding (i) accounting principles and financial statement presentations, including any significant changes in the Company s selection or application of accounting principles and (ii) the adequacy of the Company s internal controls and any special audit steps adopted in light of material control deficiencies, (b) a review of analyses prepared by management and/or the independent auditors setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements and (c) a review of the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the Company.

14) *Exchange Act:* Obtain from the independent auditors assurance that they will inform Company management concerning any information indicating that an illegal act has or may have occurred that could have a material effect on the Company s financial statements and insure that such information has been communicated by management to the Audit Committee.

15) *Review Risk Management Policies:* Review policies and procedures with respect to risk assessment and risk management to oversee the internal controls utilized by management in handling the Company s exposure to risk. The Committee should discuss the Company s major financial risk exposures and the steps management has taken to monitor and control these exposures.

16) *Obtain Reports Regarding Conformity With Legal Requirements and the Company s Code of Ethics:* Review with management, the general counsel, the Company s senior internal auditing executive and the independent auditor that the Company and its subsidiary/foreign affiliated entities are in conformity with applicable legal requirements and the Company s Code of Ethics. Advise the Board with respect to the Company s policies and procedures regarding compliance with applicable laws and regulations and with the Company s Code of Ethics.

17) *Discuss With General Counsel Matters Regarding Financial Statements or Compliance Policies:* Discuss with the Company s General Counsel legal matters that may have a material impact on the financial statements or the Company s compliance policies.

18) *Review Other Matters:* Review such other matters in relation to the accounting, auditing and financial reporting practices and procedures of the Company as the Committee may, in its own discretion, deem desirable in connection with the review functions described above.

19) *Board Reports:* Report its activities regularly to the Board in such manner and at such times as the Committee and the Board deem appropriate, but in no event less than once a year. Such report shall include the Committee s conclusions with respect to its evaluation of the independent auditors.

MEETINGS OF THE COMMITTEE:

The Committee shall meet in person or telephonically at least quarterly, or more frequently as it may determine necessary, to comply with its responsibilities as set forth herein. The Chairman of the Committee shall, in consultation with the other members of the Committee, the Company s independent auditors and the appropriate officers of the Company, be responsible for calling meetings of the Committee, establishing agenda therefor and supervising the conduct thereof. The Committee may also take any action permitted hereunder by unanimous written consent.

The Committee may request any officer or employee of the Company or the Company s outside legal counsel or independent auditors to attend a meeting of the Committee or to meet with any members of, or consultants to, the Committee. It is expected that the Committee shall routinely work with and through management to fulfil its roles and responsibilities except as required or prohibited by law. However, the Committee shall meet periodically in separate private sessions with management, the independent auditors, and the internal auditors to discuss such matters as either party deems appropriate. Additionally the Committee may elect to meet in separate private session with any other party they deem appropriate for private discussions.

RESOURCES AND AUTHORITY OF THE COMMITTEE:

The Committee shall have the resources and authority appropriate to discharge its responsibilities and carry out its duties as required by law, including the authority to engage outside auditors for special audits, reviews and other procedures and to engage independent counsel and other advisors, experts or consultants. The Audit Committee may also, to the extent it deems necessary or appropriate, meet with the Company s investment bankers or financial analysts who follow the Company.

AUDIT COMMITTEE REPORT:

The Committee shall prepare, with the assistance of management, the independent auditors and outside resources (as deemed necessary), the Audit Committee Report.

ANNUAL REVIEW OF CHARTER:

The Committee shall conduct and review with the Board annually an evaluation of this Charter and recommend any changes to the Board. The Charter evaluation shall be conducted by the Committee in such manner as the Committee, in its business judgment, deems appropriate.

ANNUAL PERFORMANCE EVALUATION:

The Committee shall conduct and review with the Board annually an evaluation of the Committee s performance with respect to the requirements of this Charter. This evaluation shall also set forth the goals and objectives of the Committee for the upcoming year. The performance evaluation shall be conducted by the Committee in such manner as the Committee, in its business judgment, deems appropriate.

CTS CORPORATION

C/O EQUISERVE TRUST COMPANY N.A.
P.O. BOX 8694
EDISON, NJ 08818-8694

Voter Control Number

Your vote is important. Please vote immediately.

Vote-by-Internet		Vote-by-Telephone
1. Log on to the Internet and go to http://www.eproxyvote.com/cts	OR	1. Call toll-free 1-877-PRX-VOTE (1-877-779-8683)
2. Enter your Voter Control Number listed above and follow the easy steps outlined on the secured website.		2. Enter your Voter Control Number listed above and follow the easy recorded instructions.

If you vote over the Internet or by telephone, please do not mail your card.

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x Please mark votes as in this example.

CTS CORPORATION

1. Election of Directors
   Nominees: (01) W.S Catlow, (02) L.J. Ciancia, (03) T.G. Cody, (04) G.H. Frieling, Jr., (05) R.R. Hemminghaus, (06) M.A. Henning, (07) R.A. Profusek, (08) D.K. Schwanz

2. In their discretion, the Proxies are authorized to vote upon such other business as may properly come before the meeting, or any adjournment thereof.

FOR ALL o o WITHHELD FROM ALL

NOMINEES NOMINEES

o ______________________________

For all nominees except as noted above

This Proxy, when properly executed, will be voted in the manner directed herein by the undersigned shareholder.

Please be sure to sign and date this Proxy.

Mark box at right if an address change or comment has been noted on the reverse side of this card. o

Please sign exactly as name appears at left. When shares are held by joint tenants, both should sign. When signing as attorney, executor, administrator, trustee or guardian, please give full title as such. If a corporation, please sign in full corporate name by president or other authorized officer. If a partnership, please sign in partnership name by authorized person.

Signature:	______________	Date:	______________	Signature:	______________	Date:	______________

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CTS CORPORATION

905 West Boulevard North, Elkhart, Indiana 46514

2003 Annual Meeting of Shareholders

This Proxy is Solicited on Behalf of the Board of Directors

The undersigned, having received the Notice of Annual Meeting of Shareholders and the Proxy Statement hereby appoints Donald K. Schwanz and Richard G. Cutter as proxies, each with the power to appoint his or her substitute, and hereby authorizes them to represent and to vote, as designated on the reverse side, all of the shares of Common Stock of CTS Corporation held of record by the undersigned on March 7, 2003, at the Annual Meeting of Shareholders originally convened on May 1, 2003 and at any adjournment thereof.

This Proxy, when properly executed, will be voted in the manner directed herein by the undersigned shareholder.

PLEASE VOTE, DATE AND SIGN ON REVERSE AND RETURN PROMPTLY IN THE ENCLOSED ENVELOPE.

Please sign exactly as name appears hereon. When shares are held by joint tenants, both should sign. When signing as attorney, executor, administrator, trustee or guardian, please give full title as such. If a corporation, please sign in full corporate name by president or other authorized officer. If a partnership, please sign in partnership name by authorized person.

HAS YOUR ADDRESS CHANGED?

DO YOU HAVE ANY COMMENTS?