

IMAGE SENSING SYSTEMS INC

Form 10-Q

May 14, 2015

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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 March 31, 2015

OR

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

For the transition period from _____ to _____

Commission file number: 0-26056

Image Sensing Systems, Inc.
(Exact name of registrant as specified in its charter)

Minnesota
(State or other jurisdiction of
incorporation or organization)

41-1519168
(I.R.S. Employer
Identification No.)

500 Spruce Tree Centre
1600 University Avenue West
St. Paul, MN
(Address of principal executive offices)

55104
(Zip Code)

(651) 603-7700
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

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 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 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. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Class	Outstanding at May 1, 2015
Common Stock, \$0.01 par value per share	5,005,803 shares

IMAGE SENSING SYSTEMS, INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Image Sensing Systems, Inc.
Condensed Consolidated Balance Sheets
(Unaudited)
(in thousands)

	March 31, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$884	\$ 2,656
Accounts receivable, net of allowance for doubtful accounts of \$147 and \$516, respectively	4,525	4,219
Inventories	1,980	2,234
Prepaid expenses and other current assets	641	871
Total current assets	8,030	9,980
Property and equipment:		
Furniture and fixtures	619	620
Leasehold improvements	562	556
Equipment	3,886	3,964
	5,067	5,140
Accumulated depreciation	4,282	4,279
	785	861
Intangible assets, net	3,570	3,987
Deferred income taxes	59	62
TOTAL ASSETS	\$12,444	\$ 14,890
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$2,707	\$ 3,315
Warranty and other current liabilities	1,789	2,096
Accrued compensation	604	687
Accrued restructuring	32	216
Total current liabilities	5,132	6,314
Deferred income taxes	157	165
Other long-term liabilities	104	91
Shareholders' equity		

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Preferred stock, \$.01 par value; 5,000,000 shares authorized, none issued or outstanding	—	—
Common stock, \$.01 par value; 20,000,000 shares authorized, 5,005,803 and 4,995,963 issued and outstanding, respectively	49	49
Additional paid-in capital	23,622	23,547
Accumulated other comprehensive loss	(335)	(158)
Accumulated deficit	(16,285)	(15,118)
Total shareholders' equity	7,051	8,320
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$12,444	\$ 14,890

See accompanying notes to the condensed consolidated financial statements.

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Image Sensing Systems, Inc.
Condensed Consolidated Statements of Operations
(Unaudited)
(in thousands, except per share data)

	Three-Month Periods Ended March 31,	
	2015	2014
Revenue:		
Product sales	\$ 2,328	\$ 1,898
Royalties	2,011	2,424
	4,339	4,322
Cost of revenue:		
Product sales	1,019	1,205
	1,019	1,205
Gross profit	3,320	3,117
Operating expenses:		
Selling, marketing and product support	1,415	2,720
General and administrative	1,478	1,372
Research and development	1,077	1,816
Amortization of intangible assets	381	389
Restructuring	119	460
Investigation matter	—	116
	4,470	6,873
Loss from operations	(1,150)	(3,756)
Other, net	(1)	(1)
Loss before income taxes	(1,151)	(3,757)
Income tax expense	16	—
Net loss	\$ (1,167)	\$ (3,757)
Net loss per share:		
Basic	\$ (0.23)	\$ (0.76)
Diluted	\$ (0.23)	\$ (0.76)
Weighted average number of common shares outstanding:		
Basic	4,999	4,976
Diluted	4,999	4,976

See accompanying notes to the condensed consolidated financial statements.

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Image Sensing Systems, Inc.
 Condensed Consolidated Statements of Comprehensive Income (Loss)
 (in thousands)

	Three-Month Periods Ended March 31,	
	2015	2014
Loss before income taxes	\$ (1,167)	\$ (3,757)
Other comprehensive income (loss):		
Foreign currency translation adjustment	(177)	30
Comprehensive loss	\$ (1,344)	\$ (3,727)

See accompanying notes to the condensed consolidated financial statements.

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Image Sensing Systems, Inc.

Condensed Consolidated Statements of Cash Flows
(Unaudited)
(in thousands)

	Three-Month Periods Ended March 31,	
	2015	2014
Operating activities:		
Net loss	\$ (1,167)	\$ (3,757)
Adjustments to reconcile net loss to net cash provided by (used for) operating activities:		
Depreciation	87	153
Amortization	381	389
Stock-based compensation	75	87
Changes in operating assets and liabilities:		
Accounts receivable, net	(306)	967
Inventories	254	218
Prepaid expenses and current assets	233	259
Accounts payable	(608)	(683)
Accrued expenses and other liabilities	(561)	(868)
Net cash used for operating activities	(1,612)	(3,235)
Investing activities:		
Purchases of property and equipment	(28)	(81)
Sales and maturities of marketable securities	—	2,639
Net cash provided by (used for) investing activities	(28)	2,558
Effect of exchange rate on changes on cash	(132)	43
Decrease in cash and cash equivalents	(1,772)	(634)
Cash and cash equivalents at beginning of period	2,656	3,564
Cash and cash equivalents at end of period	\$ 884	\$ 2,930

See accompanying notes to the condensed consolidated financial statements.

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IMAGE SENSING SYSTEMS, INC.
Notes to Condensed Consolidated Financial Statements
(Unaudited)
March 31, 2015

Note A: Basis of Presentation

Image Sensing Systems, Inc. (referred to herein as “we,” the “Company,” “us” and “our”) develops and markets software-based computer enabled detection products for use in traffic, security, police and parking applications. We sell our products primarily to distributors and also receive royalties under a license agreement with a manufacturer/distributor for certain of our products. Our products are used primarily by governmental entities.

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to the Quarterly Report on Form 10-Q, which require the Company to make estimates and assumptions that affect amounts reported. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. It is the opinion of management that the unaudited condensed consolidated financial statements include all adjustments consisting of normal recurring accruals considered necessary for a fair presentation. All significant intercompany balances and transactions have been eliminated.

Operating results for the three-month periods ended March 31, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. The accompanying condensed consolidated financial statements of the Company should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2014 as filed with the SEC.

Summary of Significant Accounting Policies

The Company believes that of its significant accounting policies, the following are particularly important to the portrayal of the Company’s results of operations and financial position and may require the application of a higher level of judgment by the Company’s management and, as a result, are subject to an inherent degree of uncertainty.

Revenue Recognition

We recognize revenue on a sales arrangement when it is realized or realizable and earned, which occurs when all of the following criteria have been met: persuasive evidence of an arrangement exists; delivery and title transfer have occurred or services have been rendered; the sales price is fixed and determinable; collectability is reasonably assured; and all significant obligations to the customer have been fulfilled.

Certain sales may contain multiple elements for revenue recognition purposes. We consider each deliverable that provides value to the customer on a standalone basis as a separable element. Separable elements in these arrangements may include the hardware, software, installation services, training and support. We initially allocate consideration to each separable element using the relative selling price method. Selling prices are determined by us based on either vendor-specific objective evidence (“VSOE”) (the actual selling prices of similar products and services sold on a standalone basis) or, in the absence of VSOE, our best estimate of the selling price. Factors considered by us in determining estimated selling prices for applicable elements generally include overall economic conditions, customer

demand, costs incurred by us to provide the deliverable, as well as our historical pricing practices. Under these arrangements, revenue associated with each delivered element is recognized in an amount equal to the lesser of the consideration initially allocated to the delivered element or the amount for which payment is not deemed contingent upon future delivery of other elements in the arrangement. Under arrangements where special acceptance protocols exist, installation services and training may not be considered separable. Under those circumstances, revenue for the entire arrangement is recognized upon the completion of installation, training and fulfillment of any other significant obligations specific to the terms of the arrangement. Arrangements that do not contain any separable elements are typically recognized when the products are shipped and title has transferred to the customer.

Revenue from arrangements for services such as maintenance, repair, consulting and technical support are recognized either as the service is performed or ratably over the defined contractual period for service maintenance contracts.

Econolite Control Products, Inc. (Econolite) is our licensee that sells certain of our products in the United States, Mexico, Canada and the Caribbean. The royalty of approximately 50% of the gross profit on licensed products is recognized when the products are shipped or delivered by Econolite to its customers.

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We record provisions against sales revenue for estimated returns and allowances in the period when the related revenue is recorded based on historical sales returns and changes in end user demand.

Revenue is recorded net of taxes collected from customers that are remitted to governmental authorities, with the collected taxes recorded as current liabilities until remitted to the relevant government authority.

Inventories

Inventories are primarily electronic components and finished goods and are valued at the lower of cost or market on the first-in, first-out accounting method.

Income Taxes

We record a tax provision for the anticipated tax consequences of the reported results of operations. Deferred tax assets and liabilities are measured using the currently enacted tax rates that apply to taxable income in effect for the years in which those deferred tax assets and liabilities are expected to be realized or settled. We record a valuation allowance to reduce deferred tax assets to the amount that is believed more likely than not to be realized. We believe it is more likely than not that forecasted income, including income that may be generated as a result of certain tax planning strategies, together with the tax effects of the deferred tax liabilities, will be sufficient to fully recover the remaining net realizable value of deferred tax assets. In the event that all or part of the net deferred tax assets are determined not to be realizable in the future, an adjustment to the valuation allowance would be charged to earnings in the period such determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with management's expectations could have a material impact on our financial condition and operating results. We recognize penalties and interest expense related to unrecognized tax benefits in income tax expense.

Intangible Assets

Intangible assets with finite lives are amortized on a straight-line basis over the expected period to be benefited by future cash flows and reviewed for impairment. At both March 31, 2015 and December 31, 2014, we determined there was no impairment of intangible assets. At both March 31, 2015 and December 31, 2014, there were no indefinite-lived intangible assets.

We capitalize certain software development costs related to software to be sold, leased, or otherwise marketed. Capitalized software development costs include purchased materials and services and other costs associated with the development of new products and services. Software development costs are expensed as incurred until technological feasibility has been established, at which time future costs incurred are capitalized until the product is available for general release to the public. A certain amount of judgment and estimation is required to assess when technological feasibility is established, as well as the ongoing assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized software costs, the Company compares expected product performance, utilizing forecasted revenue amounts, to the total costs incurred to date and estimates of additional costs to be incurred. If revised forecasted product revenue is less than, and/or revised forecasted costs are greater than, the previously forecasted amounts, the net realizable value may be lower than previously estimated, which could result in the recognition of an impairment charge in the period in which such a determination is made.

Note B: Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers.” ASU 2014-09 provides new guidance related to how an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, ASU 2014-09 specifies new accounting for costs associated with obtaining or fulfilling contracts with customers and expands the required disclosures related to revenue and cash flows from contracts with customers. This new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, and can be adopted either retrospectively to each prior reporting period presented or as a cumulative-effect adjustment as of the date of adoption, with early application not permitted. The Company is currently determining its implementation approach and assessing the impact of ASU 2014-09 on the condensed consolidated financial statements.

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Note C: Fair Value Measurements and Marketable Securities

The guidance for fair value measurements establishes the authoritative definition of fair value, sets out a framework for measuring fair value and outlines the required disclosures regarding fair value measurements. Fair value is the price that would be received to sell an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. We use a three-tier fair value hierarchy based upon observable and non-observable inputs as follows:

Level 1 – observable inputs such as quoted prices in active markets;

Level 2 – inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and

Level 3 – unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Nonfinancial Assets Measured at Fair Value on a Nonrecurring Basis

Our intangible assets and other long-lived assets are nonfinancial assets that were acquired either as part of a business combination, individually or with a group of other assets. These nonfinancial assets were initially, and have historically been, measured and recognized at amounts equal to the fair value determined as of the date of acquisition.

Financial Instruments not Measured at Fair Value

Certain of our financial instruments are not measured at fair value and are recorded at carrying amounts approximating fair value, based on their short-term nature or variable interest rate. These financial instruments include cash and cash equivalents, accounts receivable, accounts payable and other current assets and liabilities.

Note D: Inventories

Inventories consisted of the following (in thousands):

	March 31, 2015	December 31, 2014
Components	\$ 1,563	\$ 1,760
Finished goods	417	474
	\$ 1,980	\$ 2,234

Note E: Intangible Assets

Intangible assets consisted of the following (dollars in thousands):

	March 31, 2015			Weighted Average Useful Life
	Gross Carrying	Accumulated	Net Carrying	

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	Amount	Amortization	Value	(in Years)
Developed technology	\$ 8,086	\$ (5,918)	\$ 2,168	2.4
Trade names	3,267	(2,431)	836	3.3
Other intangible assets	1,706	(1,140)	566	1.9
Total	\$ 13,059	\$ (9,489)	\$ 3,570	2.4

December 31, 2014

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value	Weighted Average Useful Life (in Years)
Developed technology	\$ 8,114	\$ (5,666)	\$ 2,448	2.6
Trade names	3,267	(2,367)	900	3.5
Other intangible assets	1,777	(1,138)	639	2.2
Total	\$ 13,158	\$ (9,171)	\$ 3,987	2.7

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Note F: Credit Facilities

In May 2014, the Company entered into a credit agreement and related documents with Alliance Bank providing for a revolving line of credit for the Company. The credit agreement and related documents with Alliance Bank (collectively, the “Alliance Credit Agreement”) provide up to a \$5.0 million revolving line of credit. Amounts due under the Alliance Credit Agreement bear interest at a fixed annual rate of 3.95%. Any advances are secured by the Company’s inventories, accounts receivable, cash, marketable securities, and equipment. We are subject to certain covenants under the Alliance Credit Agreement. In March 2015, we entered into an agreement with Alliance Bank amending the Alliance Credit Agreement to extend the maturity date from May 12, 2015 to April 1, 2016. At March 31, 2015, we had no borrowings under the Alliance Credit Agreement, and we were in compliance with all financial covenants.

Prior to May 12, 2014, we had a revolving line of credit with Associated Bank, National Association (“Associated Bank”) that was initially entered into as of May 1, 2008. We requested, and Associated Bank granted, a termination to this credit facility effective on May 12, 2014 in connection with the revolving line of credit from Alliance Bank described above.

Note G: Warranties

We generally provide a standard two-year warranty on product sales. Reserves to honor warranty claims are estimated and recorded at the time of sale based on historical claim information and are analyzed and adjusted periodically based on claim trends.

Warranty liability and related activity consisted of the following (in thousands):

	Three-Month Periods Ended	
	March 31,	
	2015	2014
Beginning balance	\$ 966	\$ 934
Warranty provisions	44	50
Warranty claims	(118)	(81)
Adjustments to preexisting warranties	(24)	(121)
Ending balance	\$ 868	\$ 782

Note H: Stock-Based Compensation

We compensate officers, directors and key employees with stock-based compensation under stock option and incentive plans approved by our shareholders and administered under the supervision of our Board of Directors. Stock option awards are granted at exercise prices equal to the closing price of our stock on the day before the date of grant. Generally, options vest proportionally over periods of three to five years from the dates of the grant, beginning one year from the date of grant, and have a contractual term of nine to ten years.

Performance stock options are time based; however, the final number of awards earned and the related compensation expense is adjusted up or down to the extent the performance target is met. The actual number of shares that will

ultimately vest ranges from 90% to 100% of the targeted amount if the minimum performance target is achieved. For performance stock awards granted in 2015, the performance target is revenue. We evaluate the likelihood of meeting the performance target at each reporting period and adjust compensation expense, on a cumulative basis, based on the expected achievement of each performance target.

Compensation expense, net of estimated forfeitures, is recognized ratably over the vesting period. Stock-based compensation expense included in general and administrative expense for the three-month periods ended March 31, 2015 and 2014 was \$75,000 and \$87,000, respectively. At March 31, 2015, a total of 550,649 shares were available for grant under the Company's stock option and incentive plans.

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Stock Options

A summary of the option activity for the first three months of 2015 is as follows:

	Number of Shares	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Options outstanding at December 31, 2014	354,000	\$6.30	7.0	\$—
Granted	50,000	\$2.73	5.0	\$—
Exercised	—	\$—	—	\$—
Expired	—	\$—	—	\$—
Forfeited	(53,500)	\$5.56	—	\$—
Options outstanding at March 31, 2015	350,500	\$5.91	7.1	\$—
Options exercisable at March 31, 2015	129,000	\$7.75	4.5	\$—

There were no options exercised during the three-month periods ended March 31, 2015 and March 31, 2014. As of March 31, 2015, there was \$398,000 of total unrecognized compensation cost related to non-vested stock options. The weighted average period over which the compensation cost is expected to be recognized is 2.5 years.

Stock Awards

We issue stock awards as a portion of the annual retainer for each director on a quarterly basis. The stock awards are fully vested at the time of issuance. Compensation expense related to stock awards is determined on the grant date based on the publicly quoted fair market value of our common stock and is charged to earnings on the grant date. During the quarter ended March 31, 2015, there were stock awards issued for 9,840 shares with a weighted-average grant date fair value of \$2.54.

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Note I: Loss per Common Share

Net loss per share is computed by dividing net loss by the daily weighted average number of common shares outstanding during the applicable periods. Diluted net loss per share includes the potentially dilutive effect of common shares subject to outstanding stock options using the treasury stock method. Under the treasury stock method, shares subject to certain outstanding stock options have been excluded from the diluted weighted average shares outstanding calculation because the exercise of those options would lead to a net reduction in common shares outstanding. As a result, stock options to acquire 556,989 and 220,555 weighted common shares have been excluded from the diluted weighted shares outstanding for the three-month periods ended March 31, 2015 and 2014, respectively. The potentially dilutive effect of common shares subject to certain outstanding stock options is determined based on net loss. A reconciliation of these amounts is as follows (dollar amounts in thousands except per share data):

	Three-Month Periods Ended March 31,	
	2015	2014
Numerator:		
Net loss	\$(1,167)	\$(3,757)
Denominator:		
Weighted average common shares outstanding	4,999	4,976
Dilutive potential common shares	—	—
Shares used in diluted net loss per common share calculations	4,999	4,976
Basic net loss per common share	\$(0.23)	\$(0.76)
Diluted net loss per common share	\$(0.23)	\$(0.76)

Note J: Segment Information

The Company's Interim Chief Executive Officer and management regularly review financial information for the Company's three discrete operating segments. Based on similarities in the economic characteristics, nature of products and services, production processes, type or class of customer served, method of distribution and regulatory environments, the operating segments have been aggregated for financial statement purposes and categorized into three reportable segments: Intersection, Highway and License Plate Recognition ("LPR"). Autoscope® video is our machine-vision product line, and revenue consists of royalties (all of which are received from Econolite), as well as a portion of international product sales. Video products are normally sold in the Intersection segment. The Autoscope® radar is our radar product line, and revenue consists of international and North American product sales as well as a portion of royalties (all of which are received from Econolite). Radar products are normally sold in the Highway segment. Autoscope® license plate recognition is our LPR product line. All segment revenues are derived from external customers.

Operating expenses and total assets are not allocated to the segments for internal reporting purposes. Due to the changes in how we manage our business, we may reevaluate our segment definitions in the future.

The following tables set forth selected unaudited financial information for each of our reportable segments (in thousands):

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	For the three months ended March 31, 2015			
	Intersection	Highway	LPR	Total
Revenue	\$2,161	\$1,066	\$1,112	\$4,339
Gross profit	2,060	580	680	3,320
Amortization of intangible assets	—	122	259	381
Intangible assets	—	332	3,238	3,570

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	For the three months ended March 31, 2014			
	Intersection	Highway	LPR	Total
Revenue	\$2,183	\$1,075	\$1,064	\$4,322
Gross profit	2,105	678	334	3,117
Amortization of intangible assets	—	122	267	389
Intangible assets	—	820	5,265	6,085

Note K: Restructuring

In the fourth quarter of 2014, the Company implemented restructuring plans to close our offices in Asia. Because of these actions, restructuring charges of approximately \$119,000 were recorded in the first quarter of 2015 related to employee terminations.

The following table shows the restructuring activity for the three months ended March 31, 2015 (in thousands):

	Termination Benefits	Facility Costs and Contract Termination	Total
Balance at January 1, 2015	\$ 190	\$ 26	\$ 216
Charges	119	—	119
Payments/settlements	(295)	(8)	(303)
Balance at March 31, 2015	\$ 14	\$ 18	\$ 32

In the first quarter of 2014, the Company implemented restructuring plans to improve our financial performance in Europe. These plans included the closure of our office in Poland. Because of these actions, restructuring charges of approximately \$460,000 were recorded related primarily to facilities and employee terminations.

The following table shows the restructuring activity for the three months ended March 31, 2014 (in thousands):

	Termination Benefits	Facility Costs and Contract Termination	Total
Balance at January 1, 2014	\$ —	\$ —	\$ —
Charges	60	400	460
Payments/settlements	(45)	(177)	(222)
Balance at March 31, 2014	\$ 15	\$ 223	\$ 238

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Note L: Commitments and Contingencies

Litigation

We are involved from time to time in various legal proceedings arising in the ordinary course of our business, including primarily commercial, product liability, employment and intellectual property claims. In accordance with GAAP, we record a liability in our Consolidated Financial Statements with respect to any of these matters when it is both probable that a liability has been incurred and the amount of the liability can be reasonably estimated. With respect to any currently pending legal proceedings, we have not established an estimated range of reasonably possible additional losses either because we believe that we have valid defenses to claims asserted against us or the proceeding has not advanced to a stage of discovery that would enable us to establish an estimate. We currently do not expect the outcome of these matters to have a material effect on our consolidated results of operations, financial position or cash flows. Litigation, however, is inherently unpredictable, and it is possible that the ultimate outcome of one or more claims asserted against us could adversely impact our results of operations, financial position or cash flows. We expense legal costs as incurred.

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

Overview

General. We provide software based computer enabled detection ("CED") products and solutions that use advanced signal processing software algorithms to detect and monitor objects in a designated field of view. Our technology analyzes signals from a sophisticated sensor and passes the information along to management systems, controllers or directly to users. Our core products, the Autoscope® Video Vehicle Detection System, Autoscope® Radar Detection System and Autoscope® License Plate Recognition ("LPR") System, operate using our proprietary application software in conjunction with video cameras or radar and commonly available electronic components. Our systems are used by traffic managers primarily to improve the flow of vehicle traffic and to enhance safety at intersections, main thoroughfares, freeways and tunnels and by parking and toll managers and law enforcement officials to read license plates for various safety, security, access and enforcement LPR applications.

Autoscope® video systems are sold to distributors and end users of traffic management products in the United States, Mexico, Canada and the Caribbean by Econolite Control Products, Inc. ("Econolite"), our exclusive licensee in these regions. We sell LPR systems to distributors and end users in the United States, Canada and Mexico. We sell all of our systems to distributors and end users in Europe and Asia through our subsidiaries. The majority of our sales are to end users that are funded by government agencies responsible for traffic management or traffic law enforcement.

Autoscope® Radar Business Model Change. From July 24, 2012 until July 14, 2014, our Autoscope® radar systems also were sold by Econolite in the United States, Mexico, Canada and the Caribbean under the same arrangement as Econolite sold our Autoscope® video systems. Effective July 14, 2014, the marketing, manufacturing and distribution of the Autoscope® radar product line in these regions transitioned from Econolite to the Company.

Trends and Challenges in Our Business

We believe the expected growth in our business can be attributed primarily to the following global trends:

worsening traffic caused by increased numbers of vehicles in metropolitan areas without corresponding expansions of road infrastructure and the need to automate safety, security and access applications for automobiles and trucks, which has increased demand for our products;

advances in information technology, which have made our products easier to market and implement;

the continued funding allocations for centralized traffic management services and automated enforcement schemes, which have increased the ability of our primary end users to implement our products; and

general increases in the cost-effectiveness of electronics, which make our products more affordable for end users.

We believe our continued growth primarily depends upon:

continued adoption and governmental funding of intelligent transportation systems ("ITS") and other automated applications for traffic control, safety and enforcement in developed countries;

a propensity by traffic engineers to implement lower cost technology-based solutions rather than civil engineering solutions such as widening roadways;

countries in the developing world adopting above-ground detection technology, such as video or radar, instead of in-pavement loop technology to manage traffic;

the adoption of automatic LPR for law enforcement and homeland security applications in metropolitan areas;

the use of CED to provide solutions to security/surveillance and environmental issues associated with increasing automobile use in metropolitan areas; and

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our ability to develop new products, such as hybrid CED devices incorporating, for example, radar and video technologies, that provide increasingly accurate information and enhance the end users' ability to cost-effectively manage traffic, security/surveillance and environmental issues.

Because the majority of our end users are governmental entities, we are faced with challenges related to potential delays in purchase decisions by those entities and changes in budgetary constraints. These contingencies could result in significant fluctuations in our revenue between periods. The ongoing economic environment in Europe and the United States is further adding to the unpredictability of purchase decisions, creating more delays than usual and decreasing governmental budgets, and it is likely to continue to affect our revenue.

Key Financial Terms and Metrics

Revenue. We derive revenue from two sources: (1) royalties received from Econolite for sales of the Autoscope® video and Autoscope® radar (from July 24, 2012 until July 14, 2014) systems in the United States, Mexico, Canada and the Caribbean and (2) revenue received from the direct sales of our Autoscope® radar (before July 24, 2012 and after July 14, 2014) and LPR systems in the United States, Mexico, Canada and the Caribbean and all of our systems in Europe and Asia. On July 14, 2014, we announced the transfer of North American marketing and manufacturing of the Autoscope® radar product line from Econolite to Image Sensing Systems, ending our royalty agreement with Econolite for radar sales. Autoscope® video royalties are calculated using a profit sharing model where the gross profits on sales of product made through Econolite are shared equally with Econolite. This royalty arrangement has the benefit of decreasing our cost of revenues and our selling, marketing and product support expenses because these costs and expenses are borne primarily by Econolite. Although this royalty model has a positive impact on our gross margin, it also negatively impacts our total revenue, which would be higher if all the sales made by Econolite were made directly by us. The royalty arrangement is exclusive under a long-term agreement.

Cost of Revenue. There is no cost of revenue related to royalties, as virtually all manufacturing, warranty and related costs are incurred by Econolite. Cost of revenue related to product sales consists primarily of the amount charged by our third party contractors to manufacture hardware platforms, which is influenced mainly by the cost of electronic components. The cost of revenue also includes logistics costs, estimated expenses for product warranties, restructuring costs and inventory reserves. The key metric that we follow is achieving certain gross margin percentages on product sales by geographic region and to a lesser extent by product line.

Operating Expenses. Our operating expenses fall into three categories: (1) selling, marketing and product support; (2) general and administrative; and (3) research and development. Selling, marketing and product support expenses consist of various costs related to sales and support of our products, including salaries, benefits and commissions paid to our personnel; commissions paid to third parties; travel, trade show and advertising costs; second-tier technical support for Econolite; and general product support, where applicable. General and administrative expenses consist of certain corporate and administrative functions that support the development and sales of our products and provide an infrastructure to support future growth. These expenses include management, supervisory and staff salaries and benefits, legal and auditing fees, travel, rent and costs associated with being a public company, such as board of director fees, listing fees and annual reporting expenses. Research and development expenses consist mainly of salaries and benefits for our engineers and third party costs for consulting and prototyping. We measure all operating expenses against our annually approved budget, which is developed with achieving a certain operating margin as a key focus. Also included in operating expenses are restructuring costs and non-cash expense for intangible asset amortization.

Non-GAAP Operating Measure. We provide certain non-GAAP financial information as supplemental information to financial measures calculated and presented in accordance with GAAP (Generally Accepted Accounting Principles in the United States). This non-GAAP information excludes the impact of amortizing intangible assets, depreciation, and may exclude other non-recurring items. Management believes that this presentation facilitates the comparison of our current operating results to historical operating results. Management uses this non-GAAP information to evaluate short-term and long-term operating trends in our core operations. Non-GAAP information is not prepared in accordance with GAAP and should not be considered a substitute for or an alternative to GAAP financial measures and may not be computed the same as similarly titled measures used by other companies.

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Reconciliations of GAAP net loss to non-GAAP net loss are as follows (in thousands):

	Three-Month Periods Ended March 31,	
	2015	2014
Loss from operations	\$(1,150)	\$(3,756)
Adjustments to reconcile to non-GAAP net loss		
Amortization of intangible assets	381	389
Depreciation	87	153
Restructuring charges	119	460
Investigation matter	—	116
Non-GAAP net loss	\$(563)	\$(2,638)

Seasonality. Our quarterly revenues and operating results have varied significantly in the past due to the seasonality of our business. Our first quarter generally is the weakest due to weather conditions that make roadway construction more difficult in parts of North America, Europe and northern Asia. We expect such seasonality to continue for the foreseeable future. Additionally, our international revenues regularly contain individually significant sales. This can result in significant variations of revenue between periods. Accordingly, we believe that quarter-to-quarter comparisons of our financial results should not be relied upon as an indication of our future performance. No assurance can be given that we will be able to achieve or maintain profitability on a quarterly or annual basis in the future.

Segments. We currently operate in three reportable segments: Intersection, Highway and LPR. Autoscope® video is our machine-vision product line, and revenue consists of royalties (all of which are received from Econolite), as well as a portion of international product sales. Video products are normally sold in the Intersection segment. The Autoscope® radar is our radar product line, and revenue consists of sales to external customers. Radar products are normally sold in the Highway segment. Autoscope® license plate recognition is our LPR product line. All segment revenues are derived from external customers. As a result of business model changes and modifications in how we manage our business, we may reevaluate our segment definitions in the future.

Financial information by reportable segment for the three-month periods ended March 31, 2015 and 2014 is summarized as follows (in thousands):

	For the three months ended March 31, 2015			
	Intersection	Highway	LPR	Total
Revenue	\$2,161	\$1,066	\$1,112	\$4,339
Gross profit	2,060	580	680	3,320
Amortization of intangible assets	—	122	259	381
Intangible assets	—	332	3,238	3,570

	For the three months ended March 31, 2014			
	Intersection	Highway	LPR	Total

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Revenue	\$2,183	\$1,075	\$1,064	\$4,322
Gross profit	2,105	678	334	3,117
Amortization of intangible assets	—	122	267	389
Intangible assets	—	820	5,265	6,085

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Results of Operations

The following table sets forth, for the periods indicated, certain statements of operations data as a percent of total revenue and gross margin on product sales and royalties as a percentage of product sales and royalties, respectively.

	Three-Month Periods				Quarter	
	Ended		March 31,		Over	
	2015	2014	2015	2014	Change	
Product sales	53.7	43.9	%	%	22.7	%
Royalties	46.3	56.1			(17.0))
Total revenue	100.0	100.0			0.4	
Gross profit - product sales	56.2	36.5			88.9	
Gross profit - royalties	100.0	100.0			(17.0))
Selling, marketing and product support	32.6	62.9			(48.0))
General and administrative	34.1	31.7			7.7	
Research and development	24.8	42.0			(40.7))
Amortization of intangible assets	8.8	9.0			(2.1))
Restructuring	2.7	10.6			(74.1))
Investigation matter	—	2.7			(100.0))
Loss from operations	(26.5)	(86.9)))	(69.4))
Income tax expense (benefit)	0.4	—			-	
Net loss	(26.9)	(86.9)))	(68.9))

Total revenue was \$4.3 million in the three month periods ended March 31, 2015 and 2014. Royalty income decreased to \$2.0 million in the first quarter of 2015 from \$2.4 million in the first quarter of 2014, a decrease of 17.0%. The decrease in royalties was the result of a decrease in Autoscope® video system sales under the Econolite agreement and the transition of Autoscope® radar product sales from Econolite to the Company. Autoscope® video royalties were nominally lower in the three months ended March 31, 2015 compared to the three months ended March 31, 2014 as a result of lower unit volume. Product sales increased to \$2.3 million in the first quarter of 2015 from \$1.9 million in the first quarter of 2014, an increase of 22.7%. The increase in product sales was mainly due to higher sales volume of Autoscope® radar sales in North America due to the previously discussed radar transition, partially offset by lower sales volume in Asia because of the previously announced office closure.

Revenue for the Intersection segment remained consistent at \$2.2 million in the first three months ended March 31, 2015 and 2014.

Revenue for the Highway segment was \$1.1 million in the first quarter of 2015 and 2014

Revenue for the LPR segment was \$1.1 million in the three-month periods ended March 31, 2015 and 2014.

Gross profit for product sales increased to 56.2% in the three months ended March 31, 2015 from 36.5% in the three months ended March 31, 2014. Gross profit for the LPR product line have historically been lower than gross profit for the Intersection and Highway product lines and therefore the mix of the product lines sold in any given period can

result in varying gross profit. Generally, lower sales volumes of Highway or LPR products will reduce gross profit because of fixed manufacturing costs for these products. Additionally, the geographic sales mix of our product sales can influence margins, as product sold in some jurisdictions have lower margins. We anticipate that gross profit for our product sales will be higher in 2015 as compared to 2014, while we expect royalty gross profit will be 100% in 2015.

Selling, marketing and product support expense decreased to \$1.4 million or 32.6% of total revenue in the first three months of 2015 from \$2.7 million or 62.9% of total revenue in the first three months of 2014. Our selling, marketing and product support expense decreased mainly due to cost reductions made during the quarter, which were partially offset by royalties due to Econolite for orders that were received by Econolite but fulfilled by Image Sensing Systems. We anticipate that annual selling, marketing and product support expense will decrease in dollar amount in 2015 as compared to 2014.

General and administrative expense increased to \$1.5 million for the three months ended March 31, 2015 from \$1.4 million for the same period in 2014. General and administrative expense increased as a percentage of revenue to 34.1% in the first quarter of 2015 from 31.7% in the first quarter of 2014. Overall we anticipate that annual general and administrative expenses will decrease in 2015 as compared to 2014.

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Research and development expense decreased to \$1.1 million or 24.8% of total revenue in the three-month period ended March 31, 2015 from \$1.8 million or 42.0% of total revenue in the three-month period ended March 31, 2014. The decrease is primarily driven by investment as it relates to current and anticipated research and development projects in 2015. We anticipate that research and development expense will decrease in 2015 compared to 2014.

In the first quarter of 2014, the Company implemented restructuring plans to improve our financial performance in Europe. These plans included the closure of our office in Poland. Because of these actions, restructuring charges of approximately \$460,000 were recorded related primarily to the closure of facilities and employee terminations. In the fourth quarter of 2014, the Company implemented restructuring plans to close our offices in Asia. Because of these actions, additional restructuring charges of approximately \$119,000 were recorded in the first quarter of 2015. We expect costs related to our Asia office closures to be de minimis in future periods.

Amortization of intangibles was \$381,000 in the first three months of 2015 compared to \$389,000 in the first three months of 2014 and reflects the amortization of intangible assets acquired in acquisitions. Assuming there are no changes to our intangible assets, we anticipate amortization expense will be approximately \$1.5 million in 2015.

We recorded income tax expense of \$16,000, or 1.4% of pretax loss, for the three months ended March 31, 2015. There was no income tax expense recorded for the three months ended March 31, 2014. Certain jurisdictions have net operating loss carry forwards.

Liquidity and Capital Resources

At March 31, 2015, we had \$884,000 in cash and cash equivalents compared to \$2.7 million in cash and cash equivalents at December 31, 2014. Our investment objectives are to preserve principal, maintain liquidity, and achieve the best available return consistent with our primary objectives of safety and liquidity.

Net cash used in operating activities was \$1.6 million in the first three months of 2015 compared to cash used in operating activities of \$3.2 million in the same period in 2014. The primary reason for the decrease in cash was the loss for the first three months of 2015, the timing of the collection of outstanding receivables, as well as timing of the payment of outstanding payables, partially offset by the conversion of inventory. We anticipate that average receivable collection days in 2015 will improve from 2014 but that the improvement will not have a material impact on our liquidity.

Net cash provided by investing activities was \$28,000 for the first three months of 2015 compared to cash provided by investing activities of \$2.6 million in the first three months of 2014. Our planned additions of property and equipment are discretionary, and we do not expect them to exceed historical levels in 2015.

In May 2014, the Company entered into a credit agreement and related documents with Alliance Bank providing for a revolving line of credit for the Company. The credit agreement and related documents with Alliance Bank (collectively, the "Alliance Credit Agreement") provide up to a \$5.0 million revolving line of credit. Amounts due under the Alliance Credit Agreement bear interest at a fixed annual rate of 3.95%. Any advances are secured by the Company's inventories, accounts receivable, cash, marketable securities, and equipment. We are subject to certain covenants under the Alliance Credit Agreement. In March 2015, we entered into an agreement with Alliance Bank amending the Alliance Credit Agreement to extend the maturity date from May 12, 2015 to April 1, 2016. At March 31, 2015, we had no borrowings under the Alliance Credit Agreement, and we were in compliance with all financial

covenants.

Prior to May 12, 2014, we had a revolving line of credit with Associated Bank, National Association (“Associated Bank”) that was initially entered into as of May 1, 2008. We requested, and Associated Bank granted, a termination to this credit facility effective on May 12, 2014 in connection with the revolving line of credit from Alliance Bank described above.

We believe that cash and cash equivalents on hand at March 31, 2015, along with the availability of funds under our revolving line of credit and cash provided by operating activities, will satisfy our projected working capital needs, investing activities, and other cash requirements for the foreseeable future.

Off-Balance Sheet Arrangements

We do not participate in transactions or have relationships or other arrangements with an unconsolidated entity, including special purpose and similar entities, or other off-balance sheet arrangements.

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Critical Accounting Policies

Our significant accounting policies are described in Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2014. The accounting policies used in preparing our interim Condensed Consolidated Financial Statements as of and for the three months ended March 31, 2015 set forth elsewhere in this Quarterly Report on Form 10-Q are the same as those described in our Annual Report on Form 10-K.

Cautionary Statement:

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange of 1934, as amended. Forward-looking statements represent our expectations or beliefs concerning future events and can be identified by the use of forward-looking words such as “expects,” “believes,” “may,” “will,” “should,” “intends,” “plans,” “estimates,” or “ant” other comparable terminology. Forward-looking statements are subject to risks and uncertainties that may cause our actual results to differ materially from the results described in the forward-looking statements. Factors that might cause such differences include, but are not limited to:

our historical dependence on a single product for most of our revenue;

budget constraints by governmental entities that purchase our products, including constraints caused by declining tax revenue;

the continuing ability of Econolite to pay royalties owed;

the mix of and margin on the products we sell;

our dependence on third parties for manufacturing and marketing our products;

our dependence on single-source suppliers to meet manufacturing needs;

our failure to secure adequate protection for our intellectual property rights;

our inability to develop new applications and product enhancements;

the potential disruptive effect on the markets we serve of new and emerging technologies and applications, including vehicle to vehicle communications;

unanticipated delays, costs and expenses inherent in the development and marketing of new products;

our inability to respond to low-cost local competitors in Asia and elsewhere;

our inability to properly manage any growth in revenue and/or production requirements;

the influence over our voting stock by affiliates;

our inability to hire and retain key scientific and technical personnel;

the effects of legal matters in which we may become involved;

our inability to achieve and maintain effective internal controls;

our inability to successfully integrate acquisitions;

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political and economic instability, including continuing volatility in the economic environment of the European Union;

our inability to comply with international regulatory restrictions over hazardous substances and electronic waste; and conditions beyond our control such as war, terrorist attacks, health epidemics and economic recession.

We caution that the forward-looking statements made in this report or in other announcements made by us are further qualified by the risk factors set forth in Item 1A. to our Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our foreign sales and results of operations are subject to the impact of foreign currency fluctuations. From time to time, we enter into currency hedges to attempt to lower our exposure to translation gains and losses as well as to limit the impact of foreign currency translation upon the consolidation of our foreign subsidiaries. A 10% adverse change in foreign currency rates, if we have not properly hedged, could have a material effect on our results of operations or financial position.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Interim Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)). Based upon that evaluation, our Interim Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective.

Changes in Internal Control Over Financial Reporting

During the fiscal quarter covered by this Quarterly Report on Form 10-Q, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

Some of the risk factors to which we and our business are subject are described in the section entitled “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2014. The risks and uncertainties described in our Annual Report are not the only risks we face. Additional risks and uncertainties not presently known to us or that our management currently deems immaterial also may impair our business operations. If any of the risks described were to occur, our business, financial condition, operating results and cash flows could be materially adversely affected.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

The following exhibits are filed as part of this Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2015:

Exhibit Number	Description
31.1	Certification of Interim Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	

Certification of Interim Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

101 The following financial information from the Quarterly Report on Form 10-Q for the quarter ended March 31, 2015, formatted in XBRL (Extensible Business Reporting Language), (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Cash Flows, and (iv) the Notes to Condensed Consolidated Financial Statements (filed herewith).

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SIGNATURES

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

Image Sensing Systems, Inc.

Dated: May 14, 2015

By: /s/ Dale E. Parker
Dale E. Parker
Interim President, Interim Chief Executive
Officer and
Chief Financial Officer
(Interim Principal Executive Officer,
Principal Financial
Officer and Principal Accounting Officer)

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