

IMAGE SENSING SYSTEMS INC
Form 10-Q
August 11, 2015
Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

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

For the quarterly period ended June 30, 2015

OR

**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 55104
(Address of principal executive offices) (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

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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 August 1, 2015
Common Stock, \$0.01 par value per share	5,013,663 shares

IMAGE SENSING SYSTEMS, INC.

TABLE OF CONTENTS

<u>PART I. FINANCIAL INFORMATION</u>	3
<u>Item 1. Financial Statements (unaudited)</u>	3
<u>Condensed Consolidated Balance Sheets</u>	3
<u>Condensed Consolidated Statements of Operations</u>	4
<u>Condensed Consolidated Statements of Comprehensive Income (Loss)</u>	5
<u>Condensed Consolidated Statements of Cash Flows</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	17
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	25
<u>Item 4. Controls and Procedures</u>	25
<u>PART II. OTHER INFORMATION</u>	26
<u>Item 1. Legal Proceedings</u>	26
<u>Item 1A. Risk Factors</u>	26
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	26
<u>Item 3. Defaults Upon Senior Securities</u>	26
<u>Item 4. Mine Safety Disclosures</u>	26
<u>Item 5. Other Information</u>	26
<u>Item 6. Exhibits</u>	26
<u>SIGNATURES</u>	27
<u>EXHIBIT INDEX</u>	28

Table of Contents**PART I. FINANCIAL INFORMATION**

Item 1. Financial Statements

Image Sensing Systems, Inc.

Condensed Consolidated Balance Sheets

(Unaudited)

(in thousands)

	June 30, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$575	\$2,656
Accounts receivable, net of allowance for doubtful accounts of \$106 and \$516, respectively	5,102	4,219
Inventories	2,204	2,234
Prepaid expenses and other current assets	648	871
Total current assets	8,529	9,980
Property and equipment:		
Furniture and fixtures	651	620
Leasehold improvements	575	556
Equipment	3,925	3,964
	5,151	5,140
Accumulated depreciation	4,410	4,279
	741	861
Intangible assets, net	3,228	3,987
Deferred income taxes	61	62
TOTAL ASSETS	\$12,559	\$14,890
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$3,145	\$3,315
Warranty and other current liabilities	2,623	2,783
Accrued restructuring	—	216
Total current liabilities	5,768	6,314

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Deferred income taxes	166	165
Other long-term liabilities	80	91
Shareholders' equity		
Preferred stock, \$.01 par value; 5,000,000 shares authorized, none issued or outstanding	—	—
Common stock, \$.01 par value; 20,000,000 shares authorized, 5,013,663 and 4,995,963 issued and outstanding, respectively	50	49
Additional paid-in capital	23,698	23,547
Accumulated other comprehensive loss	(177)	(158)
Accumulated deficit	(17,026)	(15,118)
Total shareholders' equity	6,545	8,320
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$12,559	\$ 14,890

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

Image Sensing Systems, Inc.

Condensed Consolidated Statements of Operations

(Unaudited)

(in thousands, except per share data)

	Three-Month Periods Ended June 30,		Six-Month Periods Ended June 30,	
	2015	2014	2015	2014
Revenue:				
Product sales	\$2,572	\$2,651	\$4,900	\$4,549
Royalties	2,609	3,287	4,620	5,711
	5,181	5,938	9,520	10,260
Cost of revenue:				
Product sales	977	1,675	1,996	2,880
	977	1,675	1,996	2,880
Gross profit	4,204	4,263	7,524	7,380
Operating expenses:				
Selling, marketing and product support	1,322	2,471	2,737	5,191
General and administrative	1,390	1,498	2,762	2,870
Research and development	1,123	1,423	2,200	3,239
Amortization of intangible assets	382	393	763	782
Sale of business unit	751	—	857	—
Restructuring	—	—	119	460
Investigation matter	—	36	—	152
	4,968	5,821	9,438	12,694
Loss from operations	(764)	(1,558)	(1,914)	(5,314)
Other, net	30	15	29	14
Loss before income taxes	(734)	(1,543)	(1,885)	(5,300)
Income tax expense (benefit)	8	(10)	24	(10)
Net loss	\$(742)	\$(1,533)	\$(1,909)	\$(5,290)
Net loss per share:				
Basic	\$(0.15)	\$(0.31)	\$(0.38)	\$(1.06)
Diluted	\$(0.15)	\$(0.31)	\$(0.38)	\$(1.06)
Weighted average number of common shares outstanding:				
Basic	5,008	4,980	5,003	4,978
Diluted	5,008	4,980	5,003	4,978

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

Image Sensing Systems, Inc.

Condensed Consolidated Statements of Comprehensive Income (Loss)

(in thousands)

	Three-Month Periods Ended		Six-Month Periods Ended	
	June 30,		June 30,	
	2015	2014	2015	2014
Loss before income taxes	\$(742)	\$(1,533)	\$(1,909)	\$(5,290)
Other comprehensive income (loss):				
Foreign currency translation adjustment	158	184	(19)	215
Comprehensive loss	\$(584)	\$(1,349)	\$(1,928)	\$(5,075)

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

Image Sensing Systems, Inc.

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(in thousands)

	Six-Month Periods Ended June 30,	
	2015	2014
Operating activities:		
Net loss	\$(1,909)	\$(5,290)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depreciation	173	298
Amortization	763	782
Stock-based compensation	151	186
Loss on disposal of assets	4	—
Changes in operating assets and liabilities:		
Accounts receivable, net	(883)	266
Inventories	30	20
Prepaid expenses and current assets	223	173
Accounts payable	(170)	801
Accrued expenses and other liabilities	(382)	(820)
Net cash used for operating activities	(2,000)	(3,584)
Investing activities:		
Purchases of property and equipment	(62)	(196)
Sales and maturities of marketable securities	—	2,639
Capitalized software development costs	—	(42)
Net cash provided by (used for) investing activities	(62)	2,401
Effect of exchange rate on changes on cash	(19)	195
Decrease in cash and cash equivalents	(2,081)	(988)
Cash and cash equivalents at beginning of period	2,656	3,564
Cash and cash equivalents at end of period	\$575	\$2,576

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

IMAGE SENSING SYSTEMS, INC.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

June 30, 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 and six-month periods ended June 30, 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.

Table of Contents

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 June 30, 2015 and December 31, 2014, we determined there was no impairment of intangible assets. At both June 30, 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.

On July 9, 2015, FASB affirmed its proposal to defer the effective date of ASU 2014-09 for all entities by one year. As a result, public business entities, certain not-for-profit entities, and certain employee benefit plans will apply the new revenue standard to annual reporting periods beginning after December 15, 2017. All other entities will apply the new revenue standard to annual reporting periods beginning after December 15, 2018. Additionally, FASB affirmed its proposal to permit all entities to apply ASU 2014-09 early, but not before the original effective date for public business entities, certain not-for-profit entities, and certain employee benefit plans (that is, annual periods beginning after December 15, 2016). Entities choosing to implement early will apply the new revenue standard to all interim reporting periods within the year of adoption.

Table of Contents

The Company is currently determining its implementation approach and assessing the impact of ASU 2014-09 on the condensed consolidated financial statements.

Note C: Fair Value Measurements

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):

	June 30, 2015	December 31, 2014
Components	\$1,742	\$ 1,760
Finished goods	462	474
	\$2,204	\$ 2,234

9

Table of ContentsNote E: Intangible Assets

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

	June 30, 2015			Weighted Average Useful Life (in Years)
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value	
Developed technology	\$8,121	(6,219)	\$1,902	2.2
Trade names	3,267	(2,495)	772	3.0
Other intangible assets	1,796	(1,242)	554	1.7
Total	\$13,184	\$(9,956)	\$3,228	2.2

	December 31, 2014			Weighted Average Useful Life (in Years)
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value	
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

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 June 30, 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.

Table of Contents

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

	Six-Month Periods Ended June 30,	
	2015	2014
Beginning balance	\$966	\$934
Warranty provisions	59	53
Warranty claims	(103)	(173)
Adjustments to preexisting warranties	(151)	(81)
Ending balance	\$771	\$733

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 operating income. 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 June 30, 2015 and 2014 was \$76,000 and \$99,000, respectively. Stock-based compensation expense included in general and administrative expense for the six-month periods ended June 30, 2015 and 2014 was \$151,000 and \$186,000, respectively. At June 30, 2015, a total of 392,140 shares were available for grant under the Company's stock option and incentive plan.

Stock Options

A summary of the option activity for the first six 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	(3,000)	\$ 9.22	—	\$ —
Forfeited	(54,000)	\$ 5.57	—	\$ —
Options outstanding at June 30, 2015	347,000	\$ 5.88	6.9	\$ 37,000
Options exercisable at June 30, 2015	155,750	\$ 7.23	5.2	\$ —

There were no options exercised during the three-month and six-month periods ended June 30, 2015 and June 30, 2014. As of June 30, 2015, there was \$347,000 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 2.3 years.

Table of Contents*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 June 30, 2015, there were stock awards issued for 7,860 shares with a weighted-average grant date fair value of \$3.18. For the six months ended June 30, 2015, there were stock awards issued for 17,700 shares with a weighted-average grant date fair value of \$2.82.

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 351,000 and 343,000 weighted common shares have been excluded from the diluted weighted shares outstanding for the three-month periods ended June 30, 2015 and 2014, respectively, and 557,000 and 337,000 weighted common shares have been excluded from the diluted weighted shares outstanding for the six-month periods ended June 30, 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		Six-Month Periods Ended	
	June 30, 2015	2014	June 30, 2015	2014
Numerator:				
Net loss	\$ (742)	\$ (1,533)	\$ (1,909)	\$ (5,290)
Denominator:				
Weighted average common shares outstanding	5,008	4,980	5,003	4,978
Dilutive potential common shares	—	—	—	—
Shares used in diluted net loss per common share calculations	5,008	4,980	5,003	4,978
Basic net loss per common share	\$ (0.15)	\$ (0.31)	\$ (0.38)	\$ (1.06)
Diluted net loss per common share	\$ (0.15)	\$ (0.31)	\$ (0.38)	\$ (1.06)

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. RTMS® 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. Until July 9, 2015, Autoscope® license plate recognition was our LPR product line. All segment revenues are derived from external customers. As described in Note M to these Notes to the Condensed Consolidated Financial Statements, effective on July 9, 2015, we sold our LPR business.

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.

Table of Contents

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

	Three Months Ended June 30,							
	Intersection		Highway		LPR		Total	
	2015	2014	2015	2014	2015	2014	2015	2014
Revenue	\$3,189	\$3,625	\$1,218	\$1,094	\$774	\$1,219	\$5,181	\$5,938
Gross profit	2,768	3,242	783	488	653	533	4,204	4,263
Amortization of intangible assets	—	—	122	121	260	272	382	393
Intangible assets	—	—	210	698	3,018	5,065	3,228	5,763

	Six Months Ended June 30,							
	Intersection		Highway		LPR		Total	
	2015	2014	2015	2014	2015	2014	2015	2014
Revenue	\$5,350	\$5,808	\$2,284	\$2,169	\$1,886	\$2,283	\$9,520	\$10,260
Gross profit	4,828	5,347	1,363	1,166	1,333	867	7,524	7,380
Amortization of intangible assets	—	—	244	244	519	538	763	782
Intangible assets	—	—	210	698	3,018	5,065	3,228	5,763

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 six months of 2015 related to employee terminations.

The following table shows the restructuring activity for 2015 (in thousands):

Termination Benefits	Facility Costs and Contract Termination	Total
---------------------------------	--	--------------

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Balance at January 1, 2015	\$ 190	\$ 26	\$216
Charges	119	—	119
Payments/settlements	(295)	(8)	(303)
Balance at March 31, 2015	\$ 14	\$ 18	\$32
Payments/settlements	(14)	(18)	(32)
Balance at June 30, 2015	\$ —	\$ —	\$—

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 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
Payments/settlements	(15)	(223)	(238)
Balance at June 30, 2014	\$ —	\$ —	\$—

Table of Contents

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.

Table of Contents

Note M: Subsequent Events

On July 9, 2015, we announced the sale of our LPR business to TagMaster A.B. (“TagMaster”) located in Stockholm, Sweden, for the purchase price of \$4.2 million in cash. As of July 9, 2015, the LPR business, including all products and solutions, transitioned to TagMaster. We have included a pro forma statement of operations as if the disposition occurred on April 1, 2015.

The following unaudited pro forma statement of operations gives effect to the disposition of the Image Sensing Systems LPR business segment and any associated transaction costs incurred in the second quarter as if the disposition occurred on April 1, 2015. The pro forma adjustments, described in the related notes, are based on the best available information and certain assumptions that ISS management believes are reasonable.

The unaudited consolidated pro forma statement of operations is presented for illustrative purposes only and does not purport to be indicative of the operating results that would have occurred if the transaction described above had occurred as presented in such statement. For example, this financial information does not reflect any potential earnings or other impacts from the use of the proceeds from the disposition or cost reductions previously allocated corporate costs and potential subsequent restructuring charges.

Table of Contents**Image Sensing Systems, Inc.****Unaudited Pro Forma Consolidated Statement of Operations for the three months Ended June 30, 2015****(in thousands, except per share data)**

	Image Sensing Systems Consolidated Historical	Pro Forma Adjustments LPR Disposition		Image Sensing Systems Pro Forma Consolidated
Consolidated Statement of Operations Data:				
Revenue:				
Product sales	\$ 2,572	\$ 774	(a)	\$ 1,798
Royalties	2,609	—		2,609
	5,181	774		4,407
Cost of revenue:				
Product sales	977	121	(a)	856
	977	121		856
Gross profit	4,204	653		3,551
Operating expenses:				
Selling, marketing and product support	1,322	466	(b)	856
General and administrative	1,390	410	(b)	980
Research and development	1,123	164	(b)	959
Amortization of intangible assets	382	259	(b)	123
LPR business unit sale costs	751	751	(c)	—
	4,968	2,050		2,918
Income (Loss) from operations	(764)	(1,397)		633
Other expense, net	30	—		30
Loss before income taxes	(734)	(1,397)		663
Income tax expense	8	—		8
Net income (loss)	\$ (742)	\$ (1,397)		\$ 655
Net loss per share:				
Basic	\$ (0.15)	\$ (0.28)		\$ 0.13
Diluted	\$ (0.15)	\$ (0.28)		\$ 0.13
Weighted average number of common shares outstanding:				
Basic	5,008	5,008		5,008
Diluted	5,008	5,008		5,008

Notes:

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- (a) Represents the decrease of LPR revenue and cost of sales as if the divestiture occurred on April 1, 2015.
- (b) Represents the pro forma decrease of operating cost as if the LPR divestiture occurred on April 1, 2015.
- (c) Represents the LPR business unit sale costs.

Table of Contents

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, RTMS® Detection System and, until July 9, 2015, 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. Until July 9, 2015, we sold 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.

RTMS® Radar Business Model Change. From July 24, 2012 until July 14, 2014, our RTMS 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 RTMS® radar product line in these regions transitioned from Econolite to the Company.

Sale of LPR Business. On July 9, 2015, we closed the sale of our LPR business to TagMaster A.B. (“TagMaster”) for the purchase price of \$4.2 million in cash under the Share and Asset Sale and Purchase Agreement dated July 9, 2015 (the “SAPA”) by and among Image Sensing Systems, Inc.; Image Sensing Systems EMEA Limited, our wholly-owned subsidiary (“ISS EMEA”); and TagMaster. We incurred \$751,000 and \$857,000 in costs related to the sale in the three month and six month periods ended June 30, 2015, respectively, which were included in operating costs. We described the sale of the LPR business unit in our Current Reports on Form 8-K filed with the Securities and Exchange Commission on July 10, 2015 and July 15, 2015.

A copy of the SAPA is filed as Exhibit 2.1 to this Quarterly Report on Form 10-Q. The representations, warranties and covenants of each of Image Sensing Systems, Inc., ISS EMEA and TagMaster contained in the SAPA have been made solely for the benefit of the parties to the SAPA. In addition, such representations, warranties and covenants have been made only for purposes of the SAPA; may have been qualified by confidential disclosures made by the parties in connection with the SAPA; are subject to materiality qualifications contained in the SAPA that may differ from what may be viewed as material by investors; were made only as of the date of the SAPA or such other date as is specified in the SAPA; and have been included in the SAPA for the purpose of allocating risk between the contracting parties rather than establishing matters as facts. Accordingly, the SAPA is included as an exhibit to this Quarterly Report on Form 10-Q only to provide investors with information regarding its terms and not to provide investors with any other factual information regarding the parties to the SAPA or their respective businesses. Investors should not rely on the representations, warranties and covenants or any descriptions thereof as characterizations of the actual state of facts or condition of the parties to the SAPA or any of their respective subsidiaries or affiliates. Moreover, information concerning the subject matter of the representations and warranties may change after the date of the SAPA, which subsequent information may or may not be fully reflected in the public disclosures by the parties or their subsidiaries. The SAPA should not be read alone but should instead be read in conjunction with any other information regarding the parties that is or will be contained in, or incorporated by reference into, the Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and other reports and documents that the parties file with the Securities and Exchange Commission.

Table of Contents

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

• 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 RTMS® 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 RTMS® radar (before July 24, 2012 and after July 14, 2014) and LPR systems in the United States, Mexico, Canada and the Caribbean (until July 9, 2015) 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 RTMS® 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.

Table of Contents

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 and 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.

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

	Three-Month Periods Ended June 30, 2015 2014		Six-Month Periods Ended June 30, 2015 2014	
Loss from operations	\$ (764)	\$ (1,558)	\$ (1,914)	\$ (5,314)
Adjustments to reconcile to non-GAAP net loss				
Amortization of intangible assets	382	393	763	782
Depreciation	85	145	173	298
Sale of business unit	751	—	857	—
Restructuring charges	—	—	119	460
Investigation matter	—	36	—	152
Non-GAAP net income (loss)	\$ 454	\$ (984)	\$ (2)	\$ (3,622)

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. As of June 30, 2015, we operated 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 RTMS® is our radar product line, and revenue consists of sales to external customers. Radar products are normally sold in the Highway segment. Until July 9, 2015, Autoscope® license plate recognition was our LPR product line. All segment revenues are derived from external customers. As described elsewhere in this Quarterly Report on 10-Q, effective on July 9, 2015, we sold our LPR business. As a result of business model changes and modifications in how we manage our business, we may reevaluate our segment definitions in the future.

Table of Contents

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

	Three Months Ended June 30,							
	Intersection		Highway		LPR		Total	
	2015	2014	2015	2014	2015	2014	2015	2014
Revenue	\$3,189	\$3,625	\$1,218	\$1,094	\$774	\$1,219	\$5,181	\$5,938
Gross profit	2,768	3,242	783	488	653	533	4,204	4,263
Amortization of intangible assets	—	—	122	121	260	272	382	393
Intangible assets	—	—	210	698	3,018	5,065	3,228	5,763

	Six Months Ended June 30,							
	Intersection		Highway		LPR		Total	
	2015	2014	2015	2014	2015	2014	2015	2014
Revenue	\$5,350	\$5,808	\$2,284	\$2,169	\$1,886	\$2,283	\$9,520	\$10,260
Gross profit	4,828	5,347	1,363	1,166	1,333	867	7,524	7,380
Amortization of intangible assets	—	—	244	244	519	538	763	782
Intangible assets	—	—	210	698	3,018	5,065	3,228	5,763

Table of Contents**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 profit on product sales and royalties as a percentage of product sales and royalties, respectively.

	Three-Month Periods Ended June 30,		Quarter Over Quarter Change
	2015	2014	Change
Product sales	49.6 %	44.6 %	(3.0)%
Royalties	50.4	55.4	(20.6)
Total revenue	100.0	100.0	(12.7)
Gross profit - product sales	62.0	36.8	63.4
Gross profit - royalties	100.0	100.0	(20.6)
Selling, marketing and product support	25.5	41.6	(46.5)
General and administrative	26.8	25.2	(7.2)
Research and development	21.7	24.0	(21.1)
Amortization of intangible assets	7.4	6.6	(2.8)
Sale of business unit	14.5	—	—
Investigation matter	—	0.6	(100.0)
Loss from operations	(14.7)	(26.2)	(51.0)
Income tax expense (benefit)	0.2	(0.2)	(180.0)
Net loss	(14.3)	(25.8)	(51.6)

	Six-Month Periods Ended		Period Over Period Change
	2015	2014	Change
Product sales	51.5 %	44.3 %	7.7 %
Royalties	48.5	55.7	(19.1)
Total revenue	100.0	100.0	(7.2)
Gross profit - product sales	59.3	36.7	74.0
Gross profit - royalties	100.0	100.0	(19.1)
Selling, marketing and product support	28.8	50.6	(47.3)
General and administrative	29.0	28.0	(3.8)
Research and development	23.1	31.6	(32.1)
Amortization of intangible assets	8.0	7.6	(2.4)
Sale of business unit	9.0	—	—
Restructuring	1.3	4.5	(74.1)
Investigation matter	—	1.5	(100.0)
Loss from operations	(20.1)	(51.8)	(64.0)
Income tax expense (benefit)	0.3	(0.1)	(340.0)

Total revenue decreased to \$5.2 million in the three month period ended June 30, 2015 from \$5.9 million in the same period in 2014, a decrease of 12.7%, and to \$9.5 million in the first half of 2015 from \$10.3 million in the first half of 2014, a decrease of 7.2%. Royalty income decreased to \$2.6 million in the second quarter of 2015 from \$3.3 million in the second quarter of 2014, a decrease of 20.6%, and decreased to \$4.6 million in the first half of 2015 from \$5.7 million in the first half of 2014, a decrease of 19.1%. The decrease in royalties was the result of a decrease in Autoscope® video system sales under the Econolite agreement and the transition of RTMS® radar product sales from Econolite to the Company. Autoscope® video royalties were lower in the three months ended June 30, 2015 compared to the three months ended June 30, 2014 as a result of lower unit volume.

Table of Contents

Product sales decreased to \$2.6 million in the second quarter of 2015 from \$2.7 million in the second quarter of 2014, a decrease of 3.0%, and increased to \$4.9 million in the first half of 2015 from \$4.5 million in the same period in 2014, an increase of 7.7%. The increase in product sales was mainly due to higher sales volume of RTMS® radar sales in North America due to the previously discussed radar transition, partially offset by lower sales volume in Asia.

Revenue for the Intersection segment decreased to \$3.2 million in the three-month period ended June 30, 2015 from \$3.6 million in the three-month period ended June 30, 2014, a decrease of 12.0%. Revenue for the Intersection segment decreased to \$5.3 million in the first six months of 2015 from \$5.8 million in the first six months of 2014, a decrease of 7.9%. The decrease in revenue for the Intersection segment was mainly due to lower sales volume.

Revenue for the Highway segment increased to \$1.2 million in the three-month period ended June 30, 2015 from \$1.1 million in the three-month period ended June 30, 2014, an increase of 11.3%. Revenue for the Highway segment increased to \$2.3 million in the first six months of 2015 from \$2.2 million in the first six months of 2014, an increase of 5.3%. The nominal increase in revenue for the Highway segment was due mainly to the transition of North American Highway sales from Econolite back to Image Sensing Systems in the third quarter of 2014. This transition resulted in the direct sale of product sales to customers instead of a royalty from Econolite.

Revenue for the LPR segment decreased to \$774,000 in the period ended June 30, 2015 from \$1.2 million in the same period for 2014, a decrease of 36.5%, and decreased to \$1.9 million in the first half of 2015 from \$2.3 million in the first half of 2014, a decrease of 17.3%. The decrease in revenue for the LPR segment is due to lower sales volume.

Gross profit for product sales increased to 62.0% in the three months ended June 30, 2015 from 36.8% in the three months ended June 30, 2014 and increased to 59.3% in the first six months of 2015 from 36.7% in the first six months of 2014. Gross profit for the LPR product line has 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 \$1.3 million or 25.5% of total revenue in the second quarter of 2015 from \$2.5 million or 41.6% of total revenue in the second quarter of 2014, and decreased to \$2.8 million or 28.8% of total revenue in the first six months of 2015 from \$5.2 million or 50.6% of total revenue in the first six months of 2014. Our selling, marketing and product support expense decreased mainly due to cost reductions, 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 decreased to \$1.4 million or 26.8% of total revenue for the three months ended June 30, 2015 from \$1.5 million or 25.2% of total revenue for the three months ended June 30, 2014, and decreased to \$2.8 million or 29.0% of total revenue for the first half of 2015 from \$2.9 million or 28.0% of total revenue in the first half of 2014. Overall we anticipate that annual general and administrative expenses will decrease in 2015 as compared to 2014.

Research and development expense decreased to \$1.1 million or 21.7% of total revenue in the three-month period ended June 30, 2015 from \$1.5 million or 24.0% of total revenue in the three-month period ended June 30, 2014, and decreased to \$2.2 million or 23.1% of total revenue in the first six months of 2015 from \$3.2 million or 31.6% of total revenue in the first six months of 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 \$382,000 in the second quarter of 2015 and \$763,000 in the first half of 2015 compared to \$393,000 in the second quarter of 2014 and \$782,000 in the first half of 2014. This 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.

In the three-month and six-month periods ended June 30, 2015, we incurred \$751,000 and \$857,000, respectively, in costs related to the sale of our LPR business unit. We incurred no such costs in the first quarter or first half of 2014.

Table of Contents

We recorded income tax expense of \$8,000, or 1.1% of pretax loss, for the three months ended June 30, 2015, and income tax expense of \$24,000, or 1.3% of pretax loss, for the six months ended June 30, 2015. We recorded an income tax benefit of \$10,000 for the three and six months ended June 30, 2014. Certain jurisdictions have net operating loss carry forwards.

Liquidity and Capital Resources

At June 30, 2015, we had \$575,000 in cash and cash equivalents compared to \$2.7 million in cash and cash equivalents at December 31, 2014. On July 9, 2015, we closed on the sale of our LPR business unit for the purchase price of \$4.2 million in cash. We plan to use the cash from the sale to strengthen our balance sheet and invest in our Autoscope video detection and RTMS® radar detection products and solutions. 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 \$2.0 million in the first six months of 2015 compared to cash used in operating activities of \$3.6 million in the same period in 2014. The primary reason for the decrease in cash was the loss for the first six 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 used in investing activities was \$62,000 for the first half of 2015 compared to cash provided by investing activities of \$2.4 million in the same period in 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 June 30, 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 June 30, 2015, the cash received from the sale of our LPR business unit on July 9, 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.

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 and six months ended June 30, 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.

Table of Contents

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 “anticipates,” or 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;

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.

Table of Contents

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.

Table of Contents

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 June 30, 2015:

Exhibit Number	Description
2.1	Share and Asset Sale and Purchase Agreement dated as of July 9, 2015 among Image Sensing Systems, Inc., Image Sensing Systems EMEA Limited and TagMaster AB (“SAPA”). (Pursuant to Item 601(b)(2) of Regulation S-K under the Securities Act of 1933 and the Securities Exchange Act of 1934, certain schedules to the SAPA have not been filed, and the SAPA briefly identifies the contents of these schedules. Image Sensing Systems, Inc. hereby agrees to furnish supplementally a copy of any omitted schedules to the Securities and Exchange Commission upon its request.)*
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 June 30, 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).

* Portions of this exhibit are treated as confidential pursuant to a request for confidential treatment filed by Image Sensing Systems, Inc. with the Securities and Exchange Commission.

Table of Contents

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: August 11, 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)

Table of Contents

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