IMAGE SENSING SYSTEMS INC
Form 10QSB
April 29, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-QSB

[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2005

[_] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT
For the transition period from _________ to _________

Commission file number: 0-26056

IMAGE SENSING SYSTEMS, INC.
(Exact name of small business issuer as specified in its charter)

Minnesota	41-1519168
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

500 SPRUCE TREE CENTRE
1600 UNIVERSITY AVE. W.
ST. PAUL, MN 55104-3825
(Address of principal executive offices)

(651) 603-7700
(Issuer's telephone number)

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

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes [X] No [ ]

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practical date: Common Stock, $.01 par value, 3,547,522 shares as of April 22, 2005.

Transitional Small Business Disclosure Format: Yes [_] No [X]

IMAGE SENSING SYSTEMS, INC.

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

IMAGE SENSING SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2005	December 31, 2004
ASSETS	(Unaudited)	(Note)
Current assets:		
Cash and cash equivalents	$ 1,602,000	$ 1,262,000
Short-term investments	5,450,000	5,000,000
Accounts receivable	1,643,000	2,176,000
Inventories	489,000	404,000

Investment in callable FHLB bonds	2,300,000	2,300,000
Prepaid expenses	91,000	275,000
Deferred income taxes	49,000	49,000
Total current assets	11,624,000	11,466,000
Property and equipment, net	145,000	127,000
Other assets:		
Capitalized software development costs, net	355,000	420,000
Goodwill	1,050,000	1,050,000
	1,405,000	1,470,000
Total assets	$13,174,000	$13,063,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 375,000	$ 402,000
Accrued compensation	346,000	708,000
Income taxes payable	96,000	30,000
Total current liabilites	817,000	1,140,000
Deferred income taxes	144,000	144,000
Shareholders' equity:		
Common stock	35,000	35,000
Additional paid-in capital	6,578,000	6,541,000
Retained earnings	5,600,000	5,203,000
	12,213,000	11,779,000
Total liabilities and shareholders' equity	$13,174,000	$13,063,000

Note: The balance sheet at December 31, 2004 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

See accompanying notes

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IMAGE SENSING SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	Three-Month Periods Ended March 31	
	2005	2004

REVENUE:		
Product sales	$ 430,000	$ 830,000
Royalties	1,697,000	1,243,000
	2,127,000	2,073,000
COSTS OF REVENUE:		
Product sales	183,000	415,000
Royalties	80,000	58,000
	263,000	473,000
Gross profit	1,864,000	1,600,000
OPERATING EXPENSES:		
Selling, marketing and product support	665,000	622,000
General and administrative	320,000	320,000
Research and development	283,000	194,000
	1,268,000	1,136,000
Income from operations	596,000	464,000
Other income, net	44,000	13,000
Income before income taxes	640,000	477,000
Income taxes	243,000	157,000
Net income	$ 397,000	$ 320,000
Net income per common share:		
Basic	$ 0.11	$ 0.10
Diluted	$ 0.10	$ 0.09
Weighted average number of common shares outstanding:		
Basic	3,544,000	3,292,000
Diluted	3,886,000	3,760,000

See accompanying notes

IMAGE SENSING SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW
(UNAUDITED)

	Three-Month Periods Ended March 31	
	2005	2004

OPERATING ACTIVITIES:		
Net income	$ 397,000	$ 320,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	91,000	83,000
Change in operating assets and liabilities	308,000	(495,000)
Net cash provided by (used in) operating activities	796,000	(92,000)
INVESTING ACTIVITIES:		
Purchase of property and equipment	(45,000)	(44,000)
Sale (purchase) of short-term investments	(450,000)	600,000
Purchase of callable FHLB bonds	--	(1,204,000)
Net cash used in investing activities	(495,000)	(648,000)
FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	39,000	37,000
Net cash provided by financing activities	39,000	37,000
Increase (decrease) in cash and cash equivalents	340,000	(703,000)
Cash and cash equivalents, beginning of period	1,262,000	2,034,000
Cash and cash equivalents, end of period	$ 1,602,000	$ 1,331,000

See accompanying notes

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IMAGE SENSING SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited) March 31, 2005

Note A: Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month period ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to the financial statements and footnotes thereto for the year ended December 31, 2004.

Note B: Earnings Per Share

The following table sets forth the computations of basic and diluted earnings per share for the three-month periods ended March 31, 2005 and 2004:

	2005	2004
Numerator:		
Net income	$ 397,000	$ 320,000
Denominator:		
Shares used in basic earnings per share calculation	3,544,000	3,292,000
Effect of diluted securities:		
Employee and director stock options	342,000	468,000
Shares used in diluted earnings per share calculations	3,886,000	3,760,000
Basic earnings per share	$ 0.11	$ 0.10
Diluted earnings per share	$ 0.10	$ 0.09

Note C: Stock Options

Stock options issued to employees are accounted for under the intrinsic value method as prescribed by APB Opinion No. 25, "Accounting for Stock Issued to Employees." No stock-based employee compensation cost is reflected in net income, as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and net income per share if we had applied the fair value method of accounting for stock options under the provisions of Financial Accounting Standards Board (FASB) Statement No. 123, "Accounting for Stock-Based Compensation":

	2005	2004
Net income, as reported	$ 397,000	$ 320,000
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects	(55,000)	(55,000)

Pro-forma net income	$ 342,000	$ 265,000
Income per share:		
Basic - as reported	$ .11	$ .10
Basic - pro forma	$ .10	$ .08
Diluted - as reported	$ .10	$ .09
Diluted - pro forma	$ .09	$ .07

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used: zero dividend yield; expected volatility of 127%; risk-free interest rate of 4.27% and expected life of 10 years for all years presented.

In December 2004, the FASB issued Statement of Financial Accounting Standards Statement No. 123 (revised 2004), Share-Based Payment. This Statement is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, is effective in the first annual period that begins after December 15, 2005 and focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. This Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services and requires that the compensation cost relating to share-based payment transactions be measured on the fair value of the equity or liability instruments issued. Management is currently assessing if the adoption of this Statement will have a material impact on the Company.

Item 2. Management's Discussion and Analysis or Plan of Operations

Overview:

We have developed proprietary machine vision technology that converts real world information into digital electronic signals for processing by computer and have applied it to traffic management problems. Our technology uses standard video and computer equipment, combined with proprietary technology, including complex detection algorithms, computer software, special purpose hardware, and a Microsoft Windows(R)-based graphical user interface that enables standard video cameras to work with the Autoscope(R) Wide Area Video Vehicle Detection System.

Autoscope systems are sold to distributors and end users of traffic management products in North America and Latin America by Econolite Control Products, Inc. (Econolite), our master distributor in those locations. We also sell Autoscope products to distributors and end users in Europe and Asia through our European and Hong Kong subsidiaries, respectively. The Autoscope system is used by traffic managers primarily to improve the flow of vehicle traffic and to enhance safety at intersections, main thoroughfares, freeways and tunnels. Flow Traffic Ltd., our Asian subsidiary, also sells other traffic management products and systems in Asia.

The majority of our revenue is derived from royalties received from Econolite, with a second primary source of revenue produced from direct product sales in Europe and Asia. End users of the Autoscope system throughout the world are generally funded by government agencies responsible for traffic management and/or traffic law enforcement.

Our success is primarily dependent upon (1) continued governmental funding of "Intelligent Transportation Systems", such as machine vision for traffic control; (2) our ability through Econolite and our sales representatives in Europe and Asia, to successfully market the Autoscope System to individual traffic managers and (3) our ability to develop new machine vision products and applications that enhance the traffic manager's ability to cost-effectively improve traffic flow and safety.

Results of Operations: (Comparison of three-month periods ended March 31, 2005 and 2004)

The following table sets forth for the three-month periods ended March 31, 2005 and 2004, certain statements of income data as a percent of total revenue and gross profit on product sales and royalties as a percentage of product sales and royalties, respectively, shown in italics:

	2005	2004
Product sales	20.2%	40.0%
Royalties	79.8	60.0
Total revenue	100.0	100.0
GROSS PROFIT - PRODUCT SALES	57.4	50.0
GROSS PROFIT - ROYALTIES	95.3	95.3
Selling, marketing and product support	31.3	30.0
General and administrative	15.0	15.4
Research and development	13.3	9.4
Income from operations	28.0	22.4
Income taxes	11.4	7.6
Net income	18.7	15.4

Total revenue increased to $2,127,000 in the first quarter of 2005 from $2,073,000 in the first quarter of 2004, an increase of 2.6%. Product sales for 2005 decreased to $430,000, or 20.2% of revenue, from $830,000, or 40.0% of revenue, in 2004. The 48.2% decrease in product sales compared to 2004 was due primarily to the fact that we were transitioning to a new loop detection product in the first quarter of 2005 and had no sales of the product by our Hong Kong subsidiary compared to sales of over $350,000 in the first quarter of 2004. We are currently proposing the new loop detection product on several bid opportunities in Asia and expect sales of the product to begin in the second quarter of 2005. We also were unable to repeat a large order sold in the first quarter of 2004 to a customer in Greece in preparation for the 2004 Olympics in Athens. Royalty income for the first quarter of 2005 increased to $1,697,000, or 79.8% of revenue, from $1,243,000, or 60.0% of revenue, in 2004. The 36.5% increase in royalty income in 2005 resulted primarily from a similar increase in sales volume of the Autoscope Solo Pro product by Econolite.

Gross profits on product sales for the first quarter of 2005 were $247,000, a 40.5% decrease from $415,000 in the comparable quarter of 2004, a result of the decrease in sales in the quarter. Gross profit margins on product sales increased to 57.4%, compared to 50.0% in 2004, due primarily to the mix of product sales with less sales of lower margin camera and loop detection products in 2005 compared to 2004. Gross profit margins on royalty income remained unchanged.

Selling, marketing and product support expenses were $665,000, or 31.3% of revenue, in the first quarter of 2005, compared to $622,000, or 30.0% of revenue, in the comparable quarter of 2004. The increases in both total dollars expended and as a percent of sales resulted primarily from adding sales and support staff for our new branch office in Poland. We do not expect the level of selling, marketing and product support expenses to increase appreciably over the remaining three quarters of 2005. General and administrative expenses were $320,000, or 15.0% of revenue, in

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2005, compared to $320,000, or 15.4% of revenue, in 2004. We do not expect the level of general and administrative expenses to increase appreciably over the remaining three quarters of 2005. Research and development expenses totaled $283,000, or 13.3% of revenue, in 2005 compared to $194,000, or 9.4% of revenue, in 2004. The increase resulted primarily from the allocation of more engineering time to new product development in 2005 compared to 2004. We expect that research and development expenses will continue to increase marginally in 2005 as we complete or advance the development of several new products.

Income from operations in the first quarter of 2005 was $596,000, or 28.0% of revenue, compared to $464,000, or 22.4% of revenue, in the comparable quarter in 2004, an increase of 28.4%. The increase resulted primarily from the 36.5% growth in revenue from royalties offset in part by lower product sales and increased operating expenses as described above.

Income taxes were $243,000 or 38.0% of pretax income in the first quarter of 2005, compared to $157,000 or 32.9% of pretax income in the comparable quarter of 2004. The increase in income taxes was due primarily to having more taxable income in 2005 and the increase in the effective tax rate was due primarily from the losses sustained by our foreign subsidiaries that do not generate tax benefits. We expect the effective income tax rate to decrease to about 34% of pretax income if our foreign subsidiaries become profitable in the remaining quarters of 2005.

Net income was $397,000 in the first quarter of 2005, a 24.1% increase compared to $320,000 in the comparable quarter of 2004, due to the factors discussed above.

Liquidity and Capital Resources:

At March 31, 2005, we had $1,602,000 in cash and cash equivalents, compared to

$1,262,000 at December 31, 2004. We had working capital of $10,807,000, and a ratio of current assets to current liabilities of 14.2 to 1 at March 31, 2005, compared to $10,326,000 and 10.1 to 1, respectively, at the end of 2004. In addition, we increased our short-term investments to $5,450,000 at March 31, 2005 from $5,000,000 at the end of 2004.

Net cash provided by operating activities was $796,000 in the first quarter of 2005, compared to $92,000 net cash used by operating activities in 2004. The primary reason for the change was that we received an unusually large payment on accounts receivable in March 2005 and we used an overpayment on estimated income taxes in 2004 to pay the balance owing for 2004, wherein the first quarter of 2004 we paid over $300,000 in income taxes on the balance owing for 2003. We invested $450,000 of the cash generated from operating activities in short-term tax-exempt bonds and $45,000 in property and equipment.

We have a credit agreement that provides up to $1,000,000 in short-term borrowings at .5% over the prime rate (effective rate of 6.25% at March 31, 2005). Loans would be unsecured except for the bank's right of setoff against checking, savings and other accounts we have with the bank. We had no outstanding borrowings under the credit agreement in 2005 or 2004.

We believe that cash and cash equivalents on hand at March 31, 2005, our $1,000,000 revolving line of credit with Wells Fargo Bank Minnesota, N.A. and cash provided by operating activities

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will satisfy our projected working capital needs, investing activities and other cash requirements in the foreseeable future.

Off-Balance Sheet Arrangements:

We have no off-balance sheet arrangements.

Cautionary Statement:

SAFE HARBOR STATEMENT UNDER THE PRIVATE
SECURITIES LITIGATION REFORM ACT OF 1995

This Quarterly Report on Form 10-QSB 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 discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to:

- dependence on a single product for most of our revenue;
- budget constraints by governmental entities that purchase our products;
- continuing ability of our licensee to pay royalties owed;
- dependence on third parties for manufacturing and marketing

our products;

- dependence on single-source suppliers to meet manufacturing needs;
- failure to secure adequate protection for our intellectual property rights;
- our inability to develop new applications and product enhancements;
- our inability to properly manage a growth in revenue and/or production requirements;
- control of our voting stock by insiders;
- our inability to retain key scientific and technical personnel;
- our inability to achieve and maintain effective internal controls;
- 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 1 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2004.

Item 3. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our 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) or 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")). Based upon that evaluation, the 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 in timely alerting them to the material information relating to us (or our consolidated subsidiaries) required to be included in the reports we file or submit under the Exchange Act.

Changes in Internal Control Over Financial Reporting

During the fiscal quarter covered by this report, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) or 15d-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 6. Exhibits

The following exhibits are filed as part of this quarterly report on Form 10-QSB for the quarterly period ended March 31, 2005.

Exhibit Number	Description
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934
32.1	Chief Executive Officer Certification pursuant to 18 U. S. C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Chief Financial Officer Certification pursuant to 18 U. S. C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

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

Image Sensing Systems, Inc.

By:

Dated: April 29, 2005

/s/ James Murdakes

James Murdakes
Chairman and Chief Executive Officer
(principal executive officer)

Dated: April 29, 2005

/s/ Arthur J. Bourgeois

Arthur J. Bourgeois
Chief Financial Officer
(principal financial and accounting officer)

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EXHIBIT INDEX TO FORM 10-QSB

Exhibit No.	Description
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, dated April 29, 2005.

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32.2	Chief Financial Officer Certification pursuant to 18 U. S. C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated April 29, 2005.