IMAGE SENSING SYSTEMS INC
Form 10QSB
October 30, 2003

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 September 30, 2003

[_] 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 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, 3,240,677 shares as of October 16, 2003.

IMAGE SENSING SYSTEMS, INC.

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PART I. FINANCIAL INFORMATION

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 "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 the Company's 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:

- lack of market acceptance of our products;
- budget constraints by governmental entities that purchase our

products;

- dependence on third parties for manufacturing and marketing our products;
- continuing ability of our licensee to pay royalties owed;
- our inability to diversify our product offerings;
- revenue fluctuations caused by our dependence on sales to governmental entities;
- failure to secure adequate protection for our intellectual property rights;
- failure to respond to evolving industry standards and technological changes;
- our inability to properly manage a growth in revenue and/or production requirements;
- our inability to meet our future additional capital requirements;
- our inability to retain key scientific and technical personnel;
- control of our voting stock by insiders; and
- conditions beyond our control such as war, terrorist attacks, severe acute respiratory syndrome (SARS) epidemic and economic recession.

We caution that the forward-looking statements made in this report or in other announcements made by the Company are further qualified by the factors set forth in the Cautionary Statement included as Exhibit 99.1 to this Quarterly Report.

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

IMAGE SENSING SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2003	December 31, 2002
ASSETS	(Unaudited)	(Note)

Current assets:		
Cash and cash equivalents	$4,386,000	$2,625,000
Accounts receivable	2,091,000	1,417,000
Inventories	318,000	174,000
Prepaid expenses	140,000	123,000
Deferred income taxes	267,000	267,000
Total current assets	7,202,000	4,606,000
Property and equipment, net	122,000	167,000
Other assets:		
Capitalized software development costs, net	743,000	937,000
Goodwill	1,050,000	1,050,000
Other	29,000	29,000
	1,822,000	2,016,000
Total assets	$9,146,000	$6,789,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 593,000	$ 412,000
Due to former shareholders of subsidiary	-	450,000
Accrued compensation	569,000	546,000
Income taxes payable	778,000	104,000
Deferred revenue	5,000	13,000
Total current liabilities	1,945,000	1,525,000
Deferred income taxes	141,000	141,000
Shareholders' equity:		
Common stock	32,000	32,000
Additional paid-in capital	4,895,000	4,717,000
Retained earnings	2,133,000	374,000
	7,060,000	5,123,000
Total liabilities and shareholders' equity	$9,146,000	$6,789,000

Note: The balance sheet at December 31, 2002 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

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

	Three-Month Periods Ended September 30		Nine-Month Peri September	
	2003	2002	2003	
REVENUE:				
Product sales	$ 840,000	$ 594,000	$2,299,000	$1
Royalties	1,829,000	1,405,000	4,518,000	3
Consulting services	-	36,000	5,000	
	2,669,000	2,035,000	6,822,000	5
COSTS OF REVENUE:				
Product sales	397,000	275,000	1,015,000	
Royalties	83,000	77,000	210,000	
Consulting services	-	39,000	2,000	
	480,000	391,000	1,227,000	1
Gross profit	2,189,000	1,644,000	5,595,000	4
OPERATING EXPENSES:				
Selling, marketing and product support	599,000	703,000	1,697,000	1
General and administrative	396,000	267,000	962,000	
Research and development	162,000	113,000	507,000	
Restructuring	-	-	-	
	1,157,000	1,083,000	3,166,000	3
Income from operations	1,032,000	561,000	2,429,000	
Other income (expense), net	14,000	7,000	14,000	
Income before income taxes	1,046,000	568,000	2,443,000	
Income taxes	365,000	14,000	684,000	
Net income	681,000	554,000	$1,759,000	$
Net income per common share:				
Basic	$ 0.21	$ 0.18	$ 0.55	$
Diluted	$ 0.19	$ 0.17	$ 0.51	$
Weighted average number of common shares outstanding:				
Basic	3,236,000	3,153,000	3,199,000	3
Diluted	3,678,000	3,260,000	3,482,000	3

See accompanying notes

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

	Nine-Month Periods Ended September 30	
	2003	2002
OPERATING ACTIVITIES:		
Net income	$ 1,759,000	$ 890,000
Adjustments to reconcile net income to net cash provided by operating activities	363,000	22,000
Net cash provided by operating activities	2,122,000	912,000
INVESTING ACTIVITIES:		
Purchase of property and equipment	(56,000)	(51,000)
Proceeds from sale of equipment	-	40,000
Purchase of minority interest of Flow Traffic	-	(314,000)
Net cash used in investing activities	(56,000)	(325,000)
FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	145,000	1,000
Payment to former shareholders of subsidiary	(450,000)	-
Net cash (used in) provided by financing activities	(305,000)	1,000.00
Increase in cash and cash equivalents	1,761,000	588,000
Cash and cash equivalents, beginning of period	2,625,000	1,199,000
Cash and cash equivalents, end of period	$ 4,386,000	$ 1,787,000
SUPPLEMENTAL CASH FLOW INFORMATION:		
Notes payable and deferred payment portion of acquisition of minority interest of Flow Traffic, Ltd.		$ 750,000

See accompanying notes

IMAGE SENSING SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
September 30, 2003

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 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 for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ended September 30, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2002.

Certain reclassifications have been made in the 2002 condensed consolidated financial statements to conform to the 2003 presentation.

Note B: Net Income Per Share

The following table sets forth the computations of basic and diluted net income per share (in thousands, except per share information):

	Three-Month Periods Ended September 30		Nine-month Periods Ended September 30	
	2003	2002	2003	2002
Numerator:				
Net income	$ 681	$ 554	$1,759	$ 890
Denominator:				
Shares used in basic net income per share calculation:	3,236	3,153	3,199	3,153
Effect of diluted securities:				
Employee and director stock options	442	107	283	44
Shares used in diluted net income per share calculations	3,678	3,260	3,482	3,197
Basic net income per share	$ .21	$ .18	$ .55	$ .28
Diluted net income per share	$ .19	$ .17	$ .51	$ .28

Options to purchase 46,000 and 565,860 shares of common stock with a weighted average exercise price of $7.87 and $2.58 per share were outstanding at September 30, 2003 and 2002, respectively, but were not included in the computation of diluted net income per share because the exercise price exceeded the average market price of the common shares during the period.

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." Except for performance based stock options, 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 FASB Statement No. 123, "Accounting for Stock-Based Compensation" using the assumptions described below (in thousands, except per share information):

	Three-Month Periods Ended September 30,		Nine-month Periods Ended September 30,	
	2003	2002	2003	2002
Net income, as reported	$ 681	$ 554	$ 1,759	$ 890
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects	63	67	189	355
Pro-forma net income	618	487	1,570	535
Net income per share:				
Basic -- as reported	$ .21	$ .18	$ .55	$ .28
Basic -- pro forma	$ .19	$ .15	$ .49	$ .17
Diluted -- as reported	$ .19	$ .17	$ .51	$ .28
Diluted -- pro forma	$ .17	$ .15	$ .44	$ .17

For purposes of the pro forma information 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 136% in 2003 and in 2002; risk-free interest rate of 4.25% in 2003 and in 2002; and expected life of 10 years for all years presented.

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Note D: New Accounting Pronouncements

In December 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 148, "Accounting for Stock-Based Compensation--Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of Accounting Principles Board ("APB") Opinion No. 28, Interim Financial Reporting, to require pro-forma disclosure in interim financial statements by companies that elect to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25. The Company continues to use the intrinsic value method of accounting for stock-based compensation. As a result, the transition provisions will not have an effect on the Company's consolidated financial statements.

In November 2002, the FASB issued FASB Interpretation No. 45 (FIN 45), Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 addresses the disclosure requirements of a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. FIN 45 also requires a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The disclosure requirements of FIN 45 were effective for the Company beginning with its year ended December 31, 2002. The liability recognition requirements will be applicable prospectively to all guarantees issued or modified after December 31, 2002. This pronouncement is not anticipated to have a material effect on the Company's consolidated financial position or results of operations.

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities. FIN 46 is an interpretation of Accounting Research Bulletin No. 51, Consolidated Financial Statements, and addresses consolidation by business enterprises of variable interest entities. FIN 46 applies immediately to variable interest entities created or obtained after January 31, 2003 and it applies in the first fiscal year or interim period ending after December 15, 2003, to variable interest entities in which an enterprise holds a variable interest that is acquired before February 1, 2003. This pronouncement is currently not anticipated to have a material effect on the Company's consolidated financial position or results of operations.

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. Statement 150 changes the classification in the statement of financial position of certain common financial instruments from either equity or mezzanine presentation to liabilities and requires an issuer of those financial statements to recognize changes in fair value or redemption amount, as applicable, in earnings. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of Statement 150 did not have an impact on the Company's financial position or results of operations.

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

Results 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 system. The majority of our revenue is derived from royalties received from Econolite Control Products, Inc., our North American and Latin American distribution partner, based on its sales of traffic control products which use our technology. A secondary source of revenue comes from direct sales, which are primarily to customers in Europe and Asia.

Our critical accounting policies, including the assumptions and judgments underlying them, are disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations in Form 10-KSB for the fiscal year ended December 31, 2002. These policies have been consistently applied in all material respects and address such matters as revenue recognition, goodwill and income tax accounting. While the estimates and judgments associated with the application of these policies may be affected by different assumptions or conditions, we believe the estimates and judgments associated with the reported amounts are appropriate under the circumstances.

Results of Operations (Comparison of Three-and Nine-month Periods Ended September 30, 2003 and 2002):

Revenues for the third quarter of 2003 were $2,669,000, up 31% from $2,035,000 for the same period a year ago. The increase in revenues for the third quarter was due primarily to a 41% increase in product sales over the comparable period in 2002 and a 30% increase in royalty revenue compared to the third quarter of 2002. The increase in sales revenue was due primarily to large product orders shipped to customers in Asia and Europe in the third quarter. The largest orders in Europe were for products introduced within the past year. Royalty revenue for the third quarter of 2003 increased primarily due to a large sale of Autoscope Solo products by Econolite in their southwest territory.

Revenues for the nine-month period ended September 30, 2003, were $6,822,000, an increase of 16% from $5,881,000 a year ago. A 26% increase in product sales and a 14% increase in royalty revenue from Econolite for the current period over the comparable nine-month period in 2002 were the primary reasons for the increase in revenues. These increases were offset by the decrease in consulting services from $108,000 in the comparable period of 2002 to $5,000 in the current nine-month period ended September 30, 2003

Gross profits for the third quarter of 2003 were $2,189,000, or 82% of revenue, compared to $1,644,000, or 81% of revenue, for the same period a year ago. Gross profits for the nine-month period ended September 30, 2003 were $5,595,000, or 82% of revenue, compared to $4,716,000 or 80% of revenue a year ago. The slight increase in gross profit margin for the third quarter and nine-month period ended September 30, 2003, was due primarily to the decrease in revenue from consulting services which had a lower margin than either product sales or royalty revenue. We do not expect that our cost of product sales relative to product sales or royalty costs relative to royalty revenue will change appreciably during the balance of 2003.

Operating expenses were $1,157,000 for the third quarter of 2003, an increase of 7% from $1,083,000 for the comparable period a year ago. The slight increase is due primarily to the addition of sales and service personnel in Asia and the United States. For the nine-month period ended September 30, 2003, operating costs were $3,166,000 compared to $3,824,000 for the comparable period of 2002. The decrease was due primarily to severance and other restructuring costs totaling $474,000 incurred in the first and second quarters of 2002, which did not recur in 2003. Employment cost savings from the restructuring also contributed to the decrease in operating expenses for the nine-month period.

Research and development expenses were $162,000 in the third quarter of 2003 compared to $113,000 for the same period a year ago, while R & D expenses were $507,000 for the nine-month period ended September 30, 2003 compared to $471,000 for the comparable period in 2002. The increase in the third quarter of 2003 and the nine-month period ended September 30, 2003 over the comparable periods in 2002 was due primarily to increased activity in developing communication protocols and other software upgrades.

Income taxes for the third quarter and first half of 2003 are not comparable to the same periods in 2002 when much of the federal tax expense was offset by net operating loss carryforwards. In 2003 we expect to recognize the benefit of net operating loss and research and development tax credit carryforwards not previously recognized, which will reduce our income tax expense below the 35% statutory level. As of September 30, 2003, we have net operating loss carryforwards for income tax purposes of $372,000 and research and development tax credits carryforwards of $321,000 that expire in the years 2007 through 2020.

Liquidity and Capital Resources:

Cash and cash equivalents increased by $1,761,000 for the nine-month period ended September 30, 2003 compared to an increase in cash and cash equivalents of $588,000 for the same period a year ago. In the nine-month period ended September 30, 2003, cash was provided primarily from operating activities, offset in part by payments to former shareholders of our subsidiary, Flow Traffic Ltd. For the same period a year ago we had made a $314,000 initial payment for the acquisition of the minority interest in Flow Traffic Ltd.

At September 30, 2003, we had $4,386,000 in cash and cash equivalents along with an available revolving line of credit with a bank of $500,000. Management believes that our cash and investment position, anticipated cash flows from operations, and funds available through our

bank line of credit will be sufficient to meet cash and working capital requirements for current operations for the foreseeable future.

New Accounting Pronouncements:

In December 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 148, "Accounting for Stock-Based Compensation--Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of Accounting Principles Board ("APB") Opinion No. 28, Interim Financial Reporting, to require pro-forma disclosure in interim financial statements by companies that elect to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25. The Company continues to use the intrinsic value method of accounting for stock-based compensation. As a result, the transition provisions will not have an effect on the Company's consolidated financial statements.

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In January 2003, the FASB issued FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities. FIN 46 is an interpretation of Accounting Research Bulletin No. 51, Consolidated Financial Statements, and addresses consolidation by business enterprises of variable interest entities. FIN 46 applies immediately to variable interest entities created or obtained after January 31, 2003 and it applies in the first fiscal year or interim period ending after December 15, 2003, to variable interest entities in which an enterprise holds a variable interest that is acquired before February 1, 2003. This pronouncement is currently not anticipated to have a material effect on the Company's consolidated financial position or results of operations.

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. Statement 150 changes the classification in the statement of financial position of certain common financial instruments from either equity or mezzanine presentation to liabilities and requires an issuer of those financial statements to recognize changes in fair value or redemption amount, as applicable, in earnings. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption

of Statement 150 did not have an impact on the Company's financial position or results of operations.

Item 3. Disclosure 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 subsidiary) 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.

PART II: OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

The following exhibits are furnished as part of this quarterly report on Form 10-QSB for the quarterly period ended September 30, 2003.

Exhibit Number	Description
10.1	Addendum to Consulting Agreement, effective May 1, 2002 between ISS and Arthur J. Bourgeois
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated October 27, 2003.
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated October 27, 2003.
32.1	Chief Executive Officer Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated October 27, 2003.

32.2	Chief Financial Officer Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated October 27, 2003.
99.1	Cautionary Statement, incorporated herein by reference to Exhibit 99.1 to the Company's Form 10-KSB for the fiscal year ended December 31, 2002.

(b) Reports on Form 8-K

On August 11, 2003, we furnished a Current Report on Form 8-K disclosing a financial press release dated July 22, 2003.

SIGNATURES

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

Image Sensing Systems, Inc.

Date: October 27, 2003

/s/ James Murdakes

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

Date: October 27, 2003

/s/ Arthur J. Bourgeois

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

EXHIBIT INDEX TO FORM 10-QSB

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