

Edgar Filing: IMAGE SENSING SYSTEMS INC - Form 10QSB

IMAGE SENSING SYSTEMS INC  
Form 10QSB  
April 29, 2003

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

FORM 10-QSB

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934

For the quarterly period ended March 31, 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

-----  
(State or other jurisdiction of  
incorporation or organization)

41-1519168

-----  
(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)

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, 3,181,277 shares as of April 17, 2003.

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IMAGE SENSING SYSTEMS, INC.

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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

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cause such differences include, but are not limited to:

- o lack of market acceptance of our products;
- o budget constraints by governmental entities that purchase our products;
- o dependence on third parties for manufacturing and marketing our products;
- o continuing ability of our licensee to pay royalties owed;
- o our inability to diversify our product offerings;
- o revenue fluctuations caused by our dependence on sales to governmental entities;
- o failure to secure adequate protection for our intellectual property rights;
- o failure to respond to evolving industry standards and technological changes;
- o our inability to properly manage a growth in revenue and/or production requirements;
- o our inability to meet our future additional capital requirements;
- o our inability to retain key scientific and technical personnel;
- o control of our voting stock by insiders; and
- o 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.

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### PART I - FINANCIAL INFORMATION

#### Item 1. Financial Statements

IMAGE SENSING SYSTEMS, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

March 31,

December 31,

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	2003 ----- (Unaudited)	2002 ----- (Note)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 2,943,000	\$ 2,625,000
Accounts receivable	1,330,000	1,417,000
Inventories	193,000	174,000
Prepaid expenses	109,000	123,000
Deferred income taxes	267,000	267,000
	-----	-----
Total current assets	4,842,000	4,606,000
Property and equipment, net	174,000	167,000
Other assets:		
Capitalized software development costs, net	872,000	937,000
Goodwill	1,050,000	1,050,000
Other	29,000	29,000
	-----	-----
	1,951,000	2,016,000
	-----	-----
Total assets	\$ 6,967,000	\$ 6,789,000
	=====	=====
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 359,000	\$ 412,000
Due former shareholders of subsidiary	450,000	450,000
Accrued compensation	447,000	546,000
Income taxes payable	171,000	104,000
Deferred revenue	13,000	13,000
	-----	-----
Total current liabilities	1,440,000	1,525,000
Deferred income taxes	141,000	141,000
Shareholders' equity:		
Common stock	32,000	32,000
Additional paid-in capital	4,729,000	4,717,000
Retained earnings	625,000	374,000
	-----	-----
	5,386,000	5,123,000
	-----	-----
Total liabilities and shareholders' equity	\$ 6,967,000	\$ 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

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

	Three-Month Periods Ended March 31	
	2003	2002
REVENUE:		
Product sales	\$ 408,000	\$ 638,000
Royalties	1,143,000	954,000
Consulting services	5,000	18,000
	-----	-----
	1,556,000	1,610,000
COSTS OF REVENUE:		
Product sales	204,000	309,000
Royalties	51,000	47,000
Consulting services	2,000	11,000
	-----	-----
	257,000	367,000
	-----	-----
Gross profit	1,299,000	1,243,000
OPERATING EXPENSES:		
Selling, marketing and product support	513,000	657,000
General and administrative	280,000	313,000
Research and development	183,000	234,000
Restructuring		268,000
	-----	-----
	976,000	1,472,000
	-----	-----
Income (loss) from operations	323,000	(229,000)
Other income, net	3,000	3,000
	-----	-----
Income (loss) before income taxes	326,000	(226,000)
Income taxes	75,000	--
	-----	-----
Net income (loss)	\$ 251,000	\$ (226,000)
	=====	=====
Net income (loss) per common share:		
Basic	\$ 0.08	\$ (0.07)
	=====	=====
Diluted	\$ 0.07	\$ (0.07)
	=====	=====
Weighted average number of common shares outstanding:		
Basic	3,178,000	3,153,000
	=====	=====
Diluted	3,452,000	3,153,000
	=====	=====

See accompanying notes

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

	Three-Month Periods En March 31	
	2003	20
	-----	-----
OPERATING ACTIVITIES:		
Net income (loss)	\$ 251,000	\$ (2
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	94,000	1
	-----	-----
Net cash provided by (used in) operating activities	345,000	(1
INVESTING ACTIVITIES:		
Purchase of property and equipment	(39,000)	
Purchase of minority interest of Flow Traffic		(2
	-----	-----
Net cash used in investing activities	(39,000)	(2
FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	12,000	
	-----	-----
Net cash provided by financing activities	12,000	
	-----	-----
Increase (decrease) in cash and cash equivalents	318,000	(3
Cash and cash equivalents, beginning of period	2,625,000	1,2
	-----	-----
Cash and cash equivalents, end of period	\$ 2,943,000	\$ 8
	=====	=====

See accompanying notes

IMAGE SENSING SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)  
March 31, 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 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, 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 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: Earnings Per Share

The following table sets forth the computations of basic and diluted earnings per share:

	Three Month Period Ended March 31, 2003 -----
Numerator:	
Net income	\$ 251,000 =====
Denominator:	
Shares used in basic earnings per share calculation	3,178,000
Effect of diluted securities:	
Employee and director stock options	274,000 -----
Shares used in diluted earnings per share calculations	3,452,000 =====
Basic earnings per share	\$ 0.08

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Diluted earnings per share	=====	\$ 0.07
	=====	

For the three-month period ended March 31, 2002, stock options would have had an anti-dilutive effect on loss per share. Had net income been achieved, no common share equivalents shares would have been included in the computation of loss per share

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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 (loss), 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 (loss) and net income (loss) 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".

	2003 -----	2002 -----
Net income (loss), as reported	\$ 251,000	\$ (226,000)
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects	(68,000)	(182,000)
	-----	-----
Pro-forma net income (loss)	183,000	\$ (408,000)
	=====	=====
Income (loss) per share:		
Basic - as reported	\$ .08	\$ (.07)
Basic - pro forma	.06	(.13)
Diluted - as reported	\$ .07	\$ (.07)
Diluted - pro forma	.05	(.13)

The fair value of each 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.

Options to purchase 6,000 and 463,260 shares of common stock with a weighted average exercise price of \$7.50 and \$3.24 were outstanding at March 31, 2003 and 2002, but were not included in the computation of diluted net earnings (loss) per share because the exercise price exceeded the average market price of the common shares during the period.



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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

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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 their 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 in the circumstances.

#### Results of Operations (Comparison of Three-Month Periods Ended March 31, 2003 and 2002):

Revenues for the first quarter of 2003 were \$1,556,000, which were down 3% from \$1,610,000 for the same period a year ago. The decrease is attributable primarily to decreased product sales in Europe and Asia which were offset in part by increased royalty income resulting from increased sales of Autoscope products in the United States by Econolite. We do not believe the decrease in international sales represents a downward trend, but we cannot be sure that the war in Iraq or the severe acute respiratory syndrome (SARS) epidemic in Asia may not have an adverse effect on sales revenue for the balance of fiscal 2003.

Gross profits were \$1,299,000 in the first quarter of 2003, or 83% of revenue, compared to \$1,243,000, or 77% of revenue, for the same period a year ago. The margin percentage increase was due to the mix of revenue with higher margin royalty income increasing as a percentage of total revenue as compared to product sales, which have a lower gross profit margin.

Operating expenses were \$976,000 for the first quarter of 2003 compared to \$1,472,000 for the same period a year ago. The decrease is due to the non-recurrence of severance payments and other restructuring costs totaling \$268,000 incurred in the first quarter of 2002, as well as continued cost savings from the restructuring.

Research and development expenses were \$183,000 in the first quarter of 2003 compared to \$234,000 for the same period a year ago. The decrease is due to

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fewer new product development projects in progress in the current quarter and a smaller engineering staff compared to the same period a year ago. We do not expect these expenses to change appreciably in subsequent quarters of 2003.

Other income, net was \$3,000 in the first quarter of 2003, the same as for the comparable period a year ago.

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Income tax expense for the first quarter of 2003 was \$75,000. We expect to eliminate our valuation allowance previously established to offset our net operating loss and research and development tax credit carryforwards and thereby incur less than the 34% statutory income tax rate for the remainder of fiscal 2003. No tax benefit from the loss incurred in the comparable period for the prior year was derived as realization of the operating loss carryforward was not reasonably assured. Accordingly, a valuation allowance was established in 2002 to fully offset the carryforwards.

### Liquidity and Capital Resources:

Cash and cash equivalents increased by \$318,000 for the first quarter of 2003 compared to a decrease in cash and cash equivalents of \$361,000 for the same period a year ago. In the first quarter of 2003, cash was provided primarily from operating activities, offset in part by capital additions. For the same period a year ago we had severance payment obligations of \$268,000 and paid \$250,000 as an initial payment for the acquisition of the minority interest in our subsidiary, Flow Traffic Ltd.

At March 31, 2003, we had \$2,943,000 in cash and cash equivalents along with an available revolving line of credit with a bank of \$50,000, after giving effect to letters of credit issued to the former minority shareholders of Flow Traffic. On April 1, 2003, we paid \$450,000 owed to the former shareholders of Flow Traffic and cancelled the letters of credit, thereby increasing our available line of credit to \$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.

### Item 3. Controls and Procedures

- (a) Evaluation of disclosure controls and procedures. Our chief executive officer and chief financial officer, after evaluating the effectiveness of our "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934 Rules 13a-14(c) and 15d-14(c) as of a date (the "Evaluation Date") within 90 days before the filing date of this quarterly report, have concluded that as of the Evaluation Date, our disclosure controls and procedures were adequate and designed to ensure that material information relating to us and our consolidated subsidiary would be made known to them by others within those entities.
- (b) Changes in internal controls. There were no significant changes in our internal controls or to our knowledge, in other

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factors that could significantly affect our disclosure controls and procedures subsequent to the Evaluation Date.

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### Part II: Other Information

#### Item 6. Exhibits and Reports on Form 8-K

##### (a) Exhibits

The following exhibits are filed as part of this quarterly report on Form 10-QSB for the quarterly period ended March 31, 2003.

Exhibit Number	Description
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.
99.2	Certification of Chief Executive Officer.
99.3	Certification of Chief Financial Officer.

##### (b) Reports on Form 8-K

On January 9, 2003, we filed a Current Report on Form 8-K disclosing a change in our independent accountants.

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### 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.

By:

Dated: April 29, 2003

/s/ James Murdakes

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

Dated: April 29, 2003

/s/ Arthur J. Bourgeois

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

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CERTIFICATION

I, James Murdakes, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Image Sensing Systems, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

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6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: April 29, 2003

/s/ JAMES MURDAKES

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James Murdakes  
Chief Executive Officer

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### CERTIFICATION

I, Arthur J. Bourgeois, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Image Sensing Systems, Inc.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies in the design or operation of

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internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: April 29, 2003

/s/ ARTHUR J. BOURGEOIS

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Arthur J. Bourgeois  
Chief Financial Officer