

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 September 30, 2013

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**

(Address of principal executive offices)

**55104**

(Zip Code)

**(651) 603-7700**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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

Class

Outstanding at November 1, 2013

Common Stock, \$0.01 par value per share

4,971,202 shares

IMAGE SENSING SYSTEMS, INC.

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## PART I. FINANCIAL INFORMATION

### Item 1. Financial Statements (unaudited):

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

	<b>September 30, 2013</b>	<b>December 31, 2012</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 3,691	\$ 8,334
Marketable securities	3,883	4,817
Accounts receivable, net of allowance for doubtful accounts of \$1,025 and \$796, respectively	5,997	6,722
Inventories	4,495	4,485
Prepaid expenses and other current assets	3,973	1,797
Total current assets	22,039	26,155
Property and equipment:		
Furniture and fixtures	502	461
Leasehold improvements	497	471
Equipment	4,637	4,427
	5,636	5,359
Accumulated depreciation	4,088	3,484
	1,548	1,875
Deferred income taxes	4,017	4,017
Intangible assets, net	6,187	6,489
Other assets	300	—
<b>TOTAL ASSETS</b>	<b>\$ 34,091</b>	<b>\$ 38,536</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,779	\$ 2,112
Accrued compensation	839	949
Warranty and other current liabilities	1,884	1,086
Total current liabilities	4,502	4,147
Deferred income taxes	245	241
Other long-term liabilities	168	168
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, 4,971,202 and 4,966,619 issued and outstanding, respectively	50	49
Additional paid-in capital	23,213	23,055
Accumulated other comprehensive income	560	390
Retained earnings	5,353	10,486
Total shareholders' equity	29,176	33,980
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 34,091</b>	<b>\$ 38,536</b>

*See accompanying notes to the condensed consolidated financial statements.*

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

	Three-Month Periods Ended September 30,		Nine-Month Periods Ended September 30,	
	2013	2012	2013	2012
Revenue:				
Product sales	\$ 4,341	\$ 3,403	\$ 10,657	\$ 8,983
Royalties	3,400	3,774	9,167	9,159
	<u>7,741</u>	<u>7,177</u>	<u>19,824</u>	<u>18,142</u>
Cost of revenue:				
Product sales	2,944	1,861	6,511	4,493
Gross profit	<u>4,797</u>	<u>5,316</u>	<u>13,313</u>	<u>13,649</u>
Operating expenses:				
Selling, marketing and product support	2,792	1,567	7,545	5,237
General and administrative	1,464	1,532	4,426	4,072
Research and development	1,651	954	4,138	3,241
Investigation matter	476	—	3,214	—
Amortization of intangible assets	328	409	1,009	1,227
Restructuring	—	—	—	430
Goodwill impairment	—	—	—	3,175
	<u>6,711</u>	<u>4,462</u>	<u>20,332</u>	<u>17,382</u>
Income (loss) from operations	<u>(1,914)</u>	<u>854</u>	<u>(7,019)</u>	<u>(3,733)</u>
Other income (expense), net	<u>1</u>	<u>3</u>	<u>(1)</u>	<u>27</u>
Income (loss) before income taxes	<u>(1,913)</u>	<u>857</u>	<u>(7,020)</u>	<u>(3,706)</u>
Income tax expense (benefit)	<u>22</u>	<u>(132)</u>	<u>(1,887)</u>	<u>(369)</u>
Net income (loss)	<u>\$ (1,935)</u>	<u>\$ 989</u>	<u>\$ (5,133)</u>	<u>\$ (3,337)</u>
Net income (loss) per share:				
Basic	<u>\$ (0.39)</u>	<u>\$ 0.20</u>	<u>\$ (1.04)</u>	<u>\$ (0.68)</u>
Diluted	<u>\$ (0.39)</u>	<u>\$ 0.20</u>	<u>\$ (1.04)</u>	<u>\$ (0.68)</u>
Weighted average number of common shares outstanding:				
Basic	<u>4,970</u>	<u>4,904</u>	<u>4,949</u>	<u>4,878</u>
Diluted	<u>4,970</u>	<u>4,964</u>	<u>4,949</u>	<u>4,878</u>

*See accompanying notes to the condensed consolidated financial statements.*

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

	<b>Three-Month Periods Ended</b>		<b>Nine-Month Periods Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Net income (loss)	\$ (1,935)	\$ 989	\$ (5,133)	\$ (3,337)
Other comprehensive income:				
Foreign currency translation adjustment	476	551	170	478
Comprehensive income (loss)	<u>\$ (1,459)</u>	<u>\$ 1,540</u>	<u>\$ (4,963)</u>	<u>\$ (2,859)</u>

*See accompanying notes to the condensed consolidated financial statements.*

Image Sensing Systems, Inc.  
Condensed Consolidated Statements of Cash Flows  
(Unaudited)  
(in thousands)

	Nine-Month Periods Ended September 30,	
	2013	2012
<b>Operating activities:</b>		
Net loss	\$ (5,133)	\$ (3,337)
Adjustments to reconcile net loss to net cash provided by (used for) operating activities:		
Depreciation	665	551
Amortization	1,009	1,227
Stock-based compensation	149	186
Goodwill impairment	—	3,175
Changes in operating assets and liabilities:		
Accounts receivable, net	725	1,869
Inventories	(10)	1,192
Prepaid expenses and current assets	(2,176)	(233)
Accounts payable	(333)	(1,046)
Accrued liabilities	688	(410)
Net cash provided by (used for) operating activities	(4,416)	3,174
<b>Investing activities:</b>		
Purchases of marketable securities	(5,009)	(6,054)
Sales and maturities of marketable securities	5,943	4,992
Purchase of other investments	(300)	—
Capitalized software development costs	(714)	—
Purchases of property and equipment	(302)	(293)
Net cash used for investing activities	(382)	(1,355)
<b>Financing activities:</b>		
Proceeds from exercise of stock options	9	121
Net cash provided by financing activities	9	121
Effect of exchange rate on changes on cash	146	302
Increase (decrease) in cash and cash equivalents	(4,643)	2,242
Cash and cash equivalents at beginning of period	8,334	5,224
Cash and cash equivalents at end of period	\$ 3,691	\$ 7,466

*See accompanying notes to the condensed consolidated financial statements.*

IMAGE SENSING SYSTEMS, INC.  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
September 30, 2013

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 requires 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 nine-month periods ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. The accompanying 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, 2012 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 has 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 North America, the Caribbean and Latin America. We recognize the royalty of approximately 50% of the gross profit on licensed products when the products are shipped or delivered by Econolite to its customers.

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 our 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.

#### *Goodwill and Intangible Assets*

Goodwill represents the excess of acquisition costs over the fair value of the net assets of businesses acquired. Goodwill is not amortized, but instead tested at least annually for impairment. Goodwill is also tested for impairment as changes in circumstances occur indicating that the carrying value may not be recoverable.

In the second quarter of 2012, the Company experienced a significant and sustained decline in its stock price. The decline resulted in the Company's market capitalization falling significantly below the recorded value of its consolidated net assets. As a result, the Company concluded a triggering event had occurred and performed an impairment test of goodwill for each reporting unit as of the end of the second quarter of 2012. Based on the results of the Company's initial assessment of impairment of its goodwill (step 1), it was determined that the carrying value of each reporting unit exceeded its estimated fair value. Therefore, the Company performed the second step of the impairment assessment to determine the implied fair value of goodwill. In performing the goodwill assessment, the Company used current market capitalization, discounted cash flows and other factors as the best evidence of fair value.

Intangible assets with finite lives are amortized on a straight-line basis over the expected period to be benefited by future undiscounted cash flows and reviewed for impairment. Fair values of intangible assets are primarily determined using discounted cash flow analyses. At both September 30, 2013 and December 31, 2012, we determined there was no impairment of intangible assets.

The Company capitalizes 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. Based on the Company's product development process, technological feasibility is generally established once product and detailed program designs have been completed, uncertainties related to high-risk development issues have been resolved through coding and testing, and the Company has established that the necessary skills, hardware, and software technology are available for production of the product. Once a software product is available for general release to the public, capitalized development costs associated with that product will begin to be amortized to cost of sales over the product's estimated economic life, using the greater of straight-line or a method that results in cost recognition in future periods that is consistent with the anticipated timing of product revenue recognition.

The Company's capitalized software development costs are subject to an ongoing assessment of recoverability, which is impacted by estimates and assumptions of future revenues and expenses for these software products, as well as other factors such as changes in product technologies. Any portion of unamortized capitalized software development costs that are determined to be in excess of net realizable value will be expensed in the period such a determination is made. The Company reached technological feasibility for certain software products and, as a result, capitalized \$255,000 and \$714,000 of software development costs during the three and nine months ended September 30, 2013, respectively.



Once the software products are available for release, the capitalized development costs will begin to be amortized to cost of sales over the products' estimated economic life using the greater of straight-line or a method that results in cost recognition in future periods that is consistent with the anticipated time of product revenue recognition.

#### Note B: Fair Value Measurements and Marketable Securities

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

- Level 1 – observable inputs such as quoted prices in active markets;
- Level 2 – inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and
- Level 3 – unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

#### *Assets and Liabilities that are Measured at Fair Value on a Recurring Basis*

The fair value hierarchy requires the use of observable market data when available. In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Our assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset or liability.

Investments are comprised of high-grade municipal bonds, U.S. government securities and commercial paper and are classified as Level 1 or Level 2, depending on trading frequency and volume and our ability to obtain pricing information on an ongoing basis.

The amortized cost which approximates market value of our available-for-sale securities by major security type were as follows (in thousands):

	<b>September 30, 2013</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Bank certificates of deposit	\$ —	\$ 3,783	\$ —	\$ 3,783
Corporate obligations	100	—	—	100
	<u>\$ 100</u>	<u>\$ 3,783</u>	<u>\$ —</u>	<u>\$ 3,883</u>
	<b>December 31, 2012</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Bank certificates of deposit	\$ —	\$ 2,524	\$ —	\$ 2,524
U.S. government obligations	880	504	—	1,384
Corporate obligations	453	—	—	453
State and municipal bonds	—	456	—	456
	<u>\$ 1,333</u>	<u>\$ 3,484</u>	<u>\$ —</u>	<u>\$ 4,817</u>

The Company evaluates impairment at each reporting period for securities where the fair value of the investment is less than its cost. Unrealized gains and losses on the Company's available-for-sale investments are primarily attributable to general changes in interest rates and market conditions. We do not believe the unrealized losses represent other-than-temporary impairments based on our evaluation of available evidence as of September 30, 2013. The aggregate unrealized gain or loss on available-for-sale investments was immaterial as of September 30, 2013 and December 31, 2012.

Classification of available-for-sale investments as current or noncurrent is dependent upon our intended holding period, the security's maturity date, or both. Contractual maturities were less than one year for all available-for-sale investments as of September 30, 2013. There were no available-for-sale investments with gross unrealized losses that had been in a continuous unrealized loss position for more than 12 months as of September 30, 2013 and December 31, 2012.

Proceeds from maturities or sales of available-for-sale securities were \$2.6 million and \$5.9 million for the three and nine month periods ended September 30, 2013, respectively, and \$1.1 million and \$5.0 million for the three and nine month periods ended September 30, 2012, respectively. Realized gains and losses are determined on the specific identification method. Realized gains and losses related to sales of available-for-sale securities during the three and nine month periods ended September 30, 2013 and 2012 were immaterial and included in other income (expense).

*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.

Periodically, these nonfinancial assets are tested for impairment by comparing their respective carrying values to the estimated fair value of the reporting unit or asset group in which they reside. When evaluating intangible assets for potential impairment, we first compare the carrying value of the asset to the asset's estimated future cash flows (undiscounted and without interest charges). If the estimated undiscounted cash flows are less than the carrying value of the asset, we calculate an impairment loss. The impairment loss calculation compares the carrying value of the asset to the asset's estimated fair value. At both September 30, 2013 and December 31, 2012, we determined there was no impairment of intangible assets.

*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 C: Inventories

Inventories consisted of the following (in thousands):

	<u>September 30, 2013</u>	<u>December 31, 2012</u>
Components	\$ 3,189	\$ 3,001
Finished goods	1,306	1,484
	<u>\$ 4,495</u>	<u>\$ 4,485</u>

Note D: Intangible Assets

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

	<b>September 30, 2013</b>			<b>Weighted Average Useful Life (in Years)</b>
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Value</b>	
Developed technology	\$ 7,490	\$ (4,145)	\$ 3,345	3.8
Trade names	3,267	(2,045)	1,222	4.8
Other intangible assets	1,839	(933)	906	4.8
Software development costs	714	—	714	—
Total	<u>\$ 13,310</u>	<u>\$ (7,123)</u>	<u>\$ 6,187</u>	4.2

	<b>December 31, 2012</b>			<b>Weighted Average Useful Life (in Years)</b>
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Value</b>	
Developed technology	\$ 7,490	\$ (3,480)	\$ 4,010	4.6
Trade names	3,267	(1,853)	1,414	5.8
Other intangible assets	1,840	(775)	1,065	5.2
Total	<u>\$ 12,597</u>	<u>\$ (6,108)</u>	<u>\$ 6,489</u>	4.9

#### Note E: Credit Facilities

We have a revolving line of credit and had term loans with Associated Bank, National Association (“Associated Bank”), that were initially entered into as of May 1, 2008. Our current revolving line of credit agreement (“Credit Agreement”) with Associated Bank provides up to \$5.0 million of credit. The Credit Agreement expires in May 2014 and bears interest at an annual rate equal to the greater of (a) 4.5% or (b) LIBOR plus 2.75%. Any advances are secured by inventories, accounts receivable and equipment. We are subject to certain financial covenants under the Credit Agreement, including minimum debt service coverage ratios, minimum cash flow coverage ratios and financial measures. At September 30, 2013, we had no borrowings under the Credit Agreement, and we were in compliance with all financial covenants.

#### Note F: Warranties

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

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

	<b>Nine-Month Periods Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>
Beginning balance	\$ 520	\$ 423
Warranty provisions	209	109
Warranty claims	(550)	(26)
Adjustments to preexisting warranties	467	(151)
Ending balance	<u>\$ 646</u>	<u>\$ 355</u>

#### Note G: Stock-Based Compensation

We compensate officers, directors and key employees with stock-based compensation under two stock 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 six to ten years. 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 September 30, 2013 and 2012 was \$63,000 and \$3,500, respectively. Stock-based compensation expense included in general and administrative expense for the nine-month periods ended September 30, 2013 and 2012 was \$149,000 and \$186,000, respectively. At September 30, 2013, a total of 200,750 shares were available for grant under these plans.

#### *Stock Options*

A summary of the option activity for the first nine months of 2013 is as follows:

	<b>Number of Shares</b>	<b>Weighted Average Exercise Price Per Share</b>	<b>Weighted Average Remaining Contractual Term (in years)</b>	<b>Aggregate Intrinsic Value</b>
Options outstanding at December 31, 2012	398,893	\$ 7.95	5.6	\$ 13,080
Granted	84,000	\$ 6.81	3.8	\$ 24,540
Exercised	(2,333)	\$ 3.65	—	\$ 8,632
Forfeited or expired	<u>(135,810)</u>	\$ 10.14	—	\$ —
Options outstanding at September 30, 2013	<u>344,750</u>	\$ 6.81	6.4	\$ 316,508
Options exercisable at September 30, 2013	<u>129,008</u>	\$ 8.25	3.0	\$ 61,725

There were no options exercised during the three-month period ended September 30, 2013. The total intrinsic value of options exercised was \$20,570 during the three-month period ended September 30, 2012. The total intrinsic value of options exercised was \$8,049 and \$207,790 during the nine-month periods ended September 30, 2013 and 2012, respectively. As of September 30, 2013, there was \$531,000 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 3.2 years.

#### *Stock Awards*

We issue stock awards as a portion of the annual retainer for each director on a quarterly basis. The stock awards are fully vested at the time of issuance. Compensation expense related to stock awards is determined on the grant date based on the publicly quoted fair market value of our common stock and is charged to earnings on the grant date. During the quarter ended September 30, 2013, there were stock awards issued for 2,640 shares with a weighted-average grant date fair value of \$7.10. For the nine months ended September 30, 2013, there were stock awards issued for 9,750 shares with a weighted-average grant date fair value of \$5.77.

## Note H: Earnings (Loss) per Common Share

Basic earnings per share are computed by dividing net earnings by the daily weighted average number of common shares outstanding during the applicable periods. Diluted earnings per share include the potentially dilutive effect of common shares issued in connection with outstanding stock-based compensation options and grants using the treasury stock method. Under the treasury stock method, shares associated with certain 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 128,137 and 456,759 weighted common shares have been excluded from the diluted weighted shares outstanding for the three-month periods ended September 30, 2013 and 2012, respectively, and 170,759 and 528,613 weighted common shares have been excluded from the diluted weighted shares outstanding for the nine month periods ended September 30, 2013 and 2012, respectively. The potentially dilutive effect of common shares issued in connection with outstanding stock options is determined based on net income (loss). A reconciliation of these amounts is as follows:

	Three-Month Periods Ended September 30,		Nine-Month Periods Ended September 30,	
	2013	2012	2013	2012
Numerator:				
Net income (loss)	\$ (1,935)	\$ 989	\$ (5,133)	\$ (3,337)
Denominator:				
Weighted average common shares outstanding	4,970	4,904	4,949	4,878
Dilutive potential common shares	—	60	—	—
Shares used in diluted net income (loss) per common share calculations	<u>4,970</u>	<u>4,964</u>	<u>4,949</u>	<u>4,878</u>
Basic net income (loss) per common share	<u>\$ (0.39)</u>	<u>\$ 0.20</u>	<u>\$ (1.04)</u>	<u>\$ (0.68)</u>
Diluted net income (loss) per common share	<u>\$ (0.39)</u>	<u>\$ 0.20</u>	<u>\$ (1.04)</u>	<u>\$ (0.68)</u>

## Note I: Segment Information

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

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

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

	Three Months Ended September 30,							
	Intersection		Highway		LPR		Total	
	2013	2012	2013	2012	2013	2012	2013	2012
Revenue	\$ 3,586	\$ 4,980	\$ 2,794	\$ 1,056	\$ 1,361	\$ 1,141	\$ 7,741	\$ 7,177
Gross profit	3,058	4,440	1,238	469	501	407	4,797	5,316
Amortization of intangible assets	—	—	122	192	206	217	328	409
Intangible assets	—	—	1,778	1,603	4,409	5,306	6,187	6,909

	Nine Months Ended September 30,							
	Intersection		Highway		LPR		Total	
	2013	2012	2013	2012	2013	2012	2013	2012
Revenue	\$ 10,293	\$ 12,021	\$ 4,409	\$ 2,430	\$ 5,122	\$ 3,691	\$ 19,824	\$ 18,142
Gross profit	8,963	10,686	1,669	1,058	2,681	1,905	13,313	13,649
Goodwill impairment	—	—	—	1,372	—	1,803	—	3,175
Amortization of intangible assets	—	—	367	576	642	651	1,009	1,227
Intangible assets	—	—	1,778	1,603	4,409	5,306	6,187	6,909

#### Note J: Other Assets

In January 2013, we acquired a minority interest in the shares of common stock of Municipal Parking Services, Inc. (MPS) for an aggregate purchase price of \$300,000. The investment is accounted for under the cost method and is included in Other Assets on our condensed consolidated balance sheets. In April 2013, the Chief Executive Officer of MPS was appointed to our Board of Directors.

#### Note K: 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 generally accepted accounting principles in the United States, 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 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.

##### *Investigation Matter*

As previously disclosed, Polish authorities are conducting an investigation into violations of Polish law related to tenders in the City of Łódź, Poland. In December 2012, the regional prosecutor charged two employees of Image Sensing Systems Europe Limited SP.Z.O.O., our Polish subsidiary (“ISS Poland”), with, among other things, criminal violations of Polish tender and corruption law related to a project in Łódź. Neither the Company nor any of our subsidiaries has been charged with any offense. A Special Subcommittee of our Audit Committee comprised solely of independent directors has retained independent counsel and accounting advisors to conduct an investigation focusing on possible violations of Company policy, internal controls, and laws, including the Foreign Corrupt Practices Act, the U.K. Anti-Bribery Act and Polish law. This investigation is ongoing, and we have voluntarily disclosed this matter to the Securities and Exchange Commission and the Department of Justice.

We are cooperating with the Polish prosecutor and intend to cooperate with any other governmental investigation into these matters. We have taken remedial actions, including ending the employment of the two Polish employees, and we are assessing and implementing enhancements to our internal policies, procedures and controls. We cannot predict the

outcome of this matter at this time or whether it will have a material adverse impact on our business prospects, financial condition, operating results or cash flows.

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

### Overview

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

Autoscope video and radar systems are sold to distributors and end users of traffic management products in North America, the Caribbean and Latin America by Econolite Control Products, Inc. (“Econolite”), our exclusive licensee in these regions. We sell Autoscope LPR systems to distributors and end users in North America. We sell all of our systems to distributors and end users in Europe and Asia through our European and Hong Kong subsidiaries, respectively. The majority of our sales are to end users that are funded by government agencies responsible for traffic management or law enforcement.

### *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 has increased the ability of our primary end users to implement our products; and
- general increases in the cost-effectiveness of electronics, which make our products more affordable for end users.

We believe our continued growth primarily depends upon:

- continued adoption and governmental funding of intelligent transportation systems (“ITS”) and other automated applications for traffic control, safety and enforcement in developed countries;
- a propensity by traffic engineers to implement lower cost technology-based solutions rather than civil engineering solutions such as widening roadways;
- countries in the developing world adopting above-ground detection technology, such as video or radar, instead of in-pavement loop technology to manage traffic;
- the adoption of automatic license plate recognition for law enforcement and homeland security applications in metropolitan areas;
- the use of CED to provide solutions to security/surveillance and environmental issues associated with increasing automobile use in metropolitan areas; and
- 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 difficult 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 negatively affect our revenue.

### ***Key Financial Terms and Metrics***

*Revenue.* We derive revenue from two sources: (1) royalties received from Econolite for its sales of the Autoscope video and radar systems in North America, the Caribbean and Latin America and (2) revenue received from our direct sales of Autoscope LPR systems in North America, the Caribbean and Latin America and all of our systems in Europe and Asia. We calculate the royalties using a profit sharing model where the gross profits on sales of product made through Econolite are shared equally with Econolite. This royalty arrangement has the benefit of decreasing our cost of revenues and our selling, marketing and product support expenses because these costs and expenses are borne primarily by Econolite. Although this royalty model has a positive impact on our gross margin, it also negatively impacts our total revenue, which would be higher if all the sales made by Econolite were made directly by us. The royalty arrangement is exclusive under a long-term agreement.

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

*Operating Expenses.* Our operating expenses fall into three primary 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. General and administrative expenses reflect 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 direct costs regarding the investigation relating to ISS Poland, impairment charges, restructuring costs and non-cash expense for intangible asset amortization.

*Non-GAAP Operating Measure.* We use non-GAAP net income to analyze our business. Non-GAAP net income excludes the impact, net of tax, of the investigation matter, restructuring charges, goodwill impairment charges and amortizing the intangible assets and expenses related to acquisitions, including any earn-out adjustments. Management believes that this non-GAAP operating measure, when shown in conjunction with GAAP measures, facilitates the comparison of our current operating results to historical operating results. We use this non-GAAP information to evaluate short-term and long-term operating trends in our core operations. Further, we believe that this non-GAAP measure improves management's and investors' ability to compare our financial performance with other companies in the technology industry. 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 loss to non-GAAP net loss are as follows (dollars in thousands, except per share amounts):

	Three-Month Periods Ended		Nine-Month Periods Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
GAAP net income (loss)	\$ (1,935)	\$ 989	\$ (5,133)	\$ (3,337)
Adjustments to reconcile to non-GAAP net income (loss)				
Investigation matter	476	—	3,214	—
Amortization of intangible assets	328	409	1,009	1,227
Goodwill impairment	—	—	—	3,175
Restructuring charges	—	—	—	430
Impact on income taxes on above items	85	(567)	(1,053)	(760)
Non-GAAP net income (loss)	<u>\$ (1,046)</u>	<u>\$ 831</u>	<u>\$ (1,963)</u>	<u>\$ 735</u>
GAAP diluted earnings (loss) per share	\$ (0.39)	\$ 0.20	\$ (1.04)	\$ (0.68)
Non-GAAP diluted earnings (loss) per share	\$ (0.21)	\$ 0.17	\$ (0.40)	\$ 0.15

*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 have a significant large project component, resulting in a varying revenue stream. Accordingly, we believe that quarter-to-quarter comparisons of our financial results should not be relied upon as an indication of our future performance. No assurance can be given that we will be able to achieve or maintain profitability on a quarterly or annual basis in the future.

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

Financial information by reportable segment for the three- and nine-month periods ended September 30, 2013 and 2012 is summarized as follows (in thousands):

	Three Months Ended September 30,							
	Intersection		Highway		LPR		Total	
	2013	2012	2013	2012	2013	2012	2013	2012
Revenue	\$ 3,586	\$ 4,980	\$ 2,794	\$ 1,056	\$ 1,361	\$ 1,141	\$ 7,741	\$ 7,177
Gross profit	3,058	4,440	1,238	469	501	407	4,797	5,316
Amortization of								
intangible assets	—	—	122	192	206	217	328	409
Intangible assets	—	—	1,778	1,603	4,409	5,306	6,187	6,909

	Nine Months Ended September 30,							
	Intersection		Highway		LPR		Total	
	2013	2012	2013	2012	2013	2012	2013	2012
Revenue	\$ 10,293	\$ 12,021	\$ 4,409	\$ 2,430	\$ 5,122	\$ 3,691	\$ 19,824	\$ 18,142
Gross profit	8,963	10,686	1,669	1,058	2,681	1,905	13,313	13,649
Goodwill impairment	—	—	—	1,372	—	1,803	—	3,175
Amortization of intangible assets	—	—	367	576	642	651	1,009	1,227
Intangible assets	—	—	1,778	1,603	4,409	5,306	6,187	6,909

## Results of Operations

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

	Three-Month Periods Ended		Quarter Over Quarter Change
	September 30,		
	2013	2012	
Product sales	56.1 %	47.4 %	27.6 %
Royalties	43.9	52.6	(9.9)
Total revenue	100.0	100.0	7.9
Gross profit - product sales	32.2	45.3	(9.4)
Gross profit - royalties	100.0	100.0	(9.9)
Selling, marketing and product support	36.1	21.8	78.2
General and administrative	18.9	21.3	(4.4)
Research and development	21.3	13.3	73.1
Investigation matter	6.1	—	—
Amortization of intangible assets	4.2	5.7	(19.8)
Income (loss) from operations	(24.7)	11.9	(324.1)
Income tax expense (benefit)	0.3	(1.8)	(116.7)
Net income (loss)	(25.0)	13.8	(295.7)

  

	Nine-Month Periods Ended		Period Over Period Change
	September 30,		
	2013	2012	
Product sales	53.8 %	49.5 %	18.6 %
Royalties	46.2	50.5	0.1
Total revenue	100.0	100.0	9.3
Gross profit - product sales	38.9	50.0	(7.7)
Gross profit - royalties	100.0	100.0	0.1
Selling, marketing and product support	38.1	28.9	44.1
General and administrative	22.3	22.4	8.7
Research and development	20.9	17.9	27.7
Investigation matter	16.2	—	—
Amortization of intangible assets	5.1	6.8	(17.8)
Restructuring charges	—	2.4	—
Goodwill impairment	—	17.5	—
Loss from operations	(35.4)	(20.6)	88.0
Income tax benefit	(9.5)	(2.0)	411.4
Net loss	(25.9)	(18.4)	53.8

Total revenue increased to \$7.7 million in the three-month period ended September 30, 2013 from \$7.2 million in the same period in 2012, an increase of 7.9%, and to \$19.8 million in the first nine months of 2013 from \$18.1 million in

the same period in 2012, an increase of 9.3%. Royalties decreased to \$3.4 million in the third quarter of 2013 from \$3.8 million in the third quarter of 2012, a decrease of 9.9%. Royalties were \$9.2 million in the first nine months of both 2013 and 2012. Product sales increased to \$4.3 million in the third quarter of 2013 from \$3.4 million in the same period in 2012, an increase of 27.6%, and they increased to \$10.7 million in the first nine months of 2013 from \$9.0 million in the same period in 2012, an increase of 18.6%. The decrease in royalty income from the same quarter in the prior year was mainly due to a decrease in sales volume. The increases in product sales in both the third quarter and first nine months of 2013 were mainly due to higher sales volume in Europe and Asia.

Revenue for the Intersection segment decreased in the three-month period ended September 30, 2013 to \$3.6 million from \$5.0 million in the three-month period ended September 30, 2012 and in the first nine months of 2013 to \$10.3 million from \$12.0 million in the first nine months of 2012 and is reflective of lower sales volume internationally combined with lower royalties.

Revenue for the Highway segment increased in the three-month period ended September 30, 2013 to \$2.8 million in 2012 from \$1.1 million in the same period in 2012 and increased in the first nine months of 2013 to \$4.4 million from \$2.4 million in the first nine months of 2012. Autoscope radar product sales and royalties were \$2.5 million and \$309,000, respectively, in the three month period ended September 30, 2013 and \$3.4 million and \$981,000, respectively, in the nine-month period ended September 30, 2013. The increase in revenue for the Highway segment is primarily due to the higher volume of radar products sold to end customers in Europe.

Revenue for the LPR segment increased in the three-month period ended September 30, 2013 to \$1.4 million from \$1.1 million in the three-month period ended September 30, 2012 and increased in the first nine months of 2013 to \$5.1 million from \$3.7 million in the same period in 2012. The increase in revenue for the LPR segment over the same quarter in the prior year is due to higher sales volumes in Europe.

Gross margins for product sales decreased to 32.2% in the three months ended September 30, 2013 from 45.3% in the same period in 2012 and decreased to 38.9% in the first nine months of 2013 from 50.0% in the same period in 2012. Margins were lower as a result of product mix and product pricing. Gross margins on royalty income remained consistent at 100% in each of the periods ended September 30, 2013 and 2012. We anticipate that gross margins for our product sales will be higher in the remainder of 2013 as compared to the first nine months of the year, while we expect royalty gross margins will remain at 100%.

Selling, marketing and product support expense increased to \$2.8 million, or 36.1% of total revenue, in the three months ended September 30, 2013 from \$1.6 million, or 21.8% of total revenue, in the third quarter of 2012, and to \$7.5 million, or 38.1% of total revenue, in the first nine months of 2013 from \$5.2 million, or 28.9% of total revenue, in the first nine months of 2012. Our selling, marketing and product support expense increased mainly due to our investments in additional sales and marketing resources. We anticipate that annual selling, marketing and product support expense will increase in both terms of dollar amount and a percentage of revenue in 2013 as compared to 2012.

General and administrative expenses were \$1.5 million in the three months ended September 30, 2013 and 2012. General and administrative expenses as a percentage of revenue decreased to 18.9% in the third quarter of 2013 from 21.3% in the third quarter of 2012. General and administrative expenses increased to \$4.4 million, or 22.3% of total revenue, in the first nine months of 2013 from \$4.1 million, or 22.4% of total revenue, in the first nine months of 2012. General and administrative expenses increased in 2013 mainly due to severance costs related to the separation from former employees. We anticipate that annual general and administrative expenses will increase in dollar amount and decrease as a percentage of revenue in 2013 as compared to 2012.

Research and development expense increased to \$1.7 million, or 21.3% of total revenue, in the three months ended September 30, 2013 from \$1.0 million, or 13.3% of total revenue, in the third quarter of 2012, and to \$4.1 million, or 20.9% of total revenue, in the first nine months of 2013 from \$3.2 million, or 17.9% of total revenue, in the first nine months of 2012. The increase was mainly related to the increased expenditures on new projects, acceleration of previously existing projects and other product developments. We anticipate that annual research and development expense will increase in terms of dollar amount in 2013 as compared to 2012.

The Company has incurred legal and other professional fees related to the investigation and remediation actions described in Note K of our Notes to the Condensed Consolidated Financial Statements set forth elsewhere in this Quarterly Report on Form 10-Q. The Company's direct costs related to the investigation were approximately \$328,000 for the three months ended September 30, 2013 and \$3.2 million for the nine months ended September 30, 2013. The Company is unable to determine the likely outcome or range of loss, if any, from the investigation, or predict with certainty the timeline for resolution of the investigation.

Amortization of intangibles expense was \$328,000 in the third quarter of 2013 and \$1.0 million in the first nine months of 2013 and reflects the amortization of intangible assets obtained in acquisitions. Assuming there are no changes to our intangible assets, we anticipate amortization expense will be \$1.4 million for all of 2013.

We recognized goodwill impairment in the second quarter of 2012 of \$3.2 million that was triggered by a significant decline in our market capitalization as of September 30, 2012.

Other income was \$1,000 in the third quarter of 2013, and we recorded other expense of \$1,000 in first nine months of 2013, as compared to other income of \$3,000 and \$27,000, respectively, in the same periods in 2012.

Income tax expense of \$22,000, or 1.2% of our pretax loss, was recorded for the three months ended September 30, 2013, compared to an income tax benefit of \$132,000, or 15.4% of pretax income, for the three months ended September 30, 2012. An income tax benefit of \$1.9 million, or 26.9% of our pretax loss, was recorded for the nine months ended September 30, 2013, compared to an income tax benefit of \$369,000, or 10.0% of our pretax loss, for the nine months ended September 30, 2012. The income tax rate increased in 2013 mainly due to the impact the investigation costs had on the results of the first three quarters of 2013. We expect the effective rate in 2013 to be below 36%.

### **Liquidity and Capital Resources**

At September 30, 2013, we had \$3.7 million in cash and cash equivalents and \$3.9 million in short-term investments, compared to \$8.3 million in cash and cash equivalents and \$4.8 million in short-term investments at December 31, 2012. 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 \$4.4 million in the first nine months of 2013, compared to cash provided by operating activities of \$3.2 million in the same period in 2012. The primary reason for the decrease in cash was the loss for the year offset in part by the collection of outstanding receivables and the conversion of inventory. We anticipate that average receivable collection days in 2013 will improve from 2012 but that the improvement will not have a material impact on our liquidity.

Net cash used in investing activities was \$382,000 for the first nine months of 2013, compared to cash used in investing activities of \$1.4 million in the first nine months of 2012. Our planned additions of property and equipment are discretionary, and we do not expect them to exceed historical levels in 2013.

We have a revolving line of credit and had term loans with Associated Bank, National Association (“Associated Bank”), that were initially entered into as of May 1, 2008. Our current revolving line of credit agreement (“Credit Agreement”) with Associated Bank provides up to \$5.0 million of credit. The Credit Agreement expires in May 2014 and bears interest at an annual rate equal to the greater of (a) 4.5% or (b) LIBOR plus 2.75%. Any advances are secured by inventories, accounts receivable and equipment. We are subject to certain financial covenants under the Credit Agreement, including minimum debt service coverage ratios, minimum cash flow coverage ratios and financial measures. At September 30, 2013, we had no borrowings under the Credit Agreement, and we were in compliance with all financial covenants.

We believe that cash and cash equivalents on hand at September 30, 2013, 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, 2012. The accounting policies used in preparing our interim

Condensed Consolidated Financial Statements as of and for the three months and nine months ended September 30, 2013 set forth elsewhere in this Quarterly Report on Form 10-Q are the same as those described in our Annual Report on Form 10-K.

Cautionary Statement:

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange of 1934, as amended. Forward-looking statements represent our expectations or beliefs concerning future events and can be identified by the use of forward-looking words such as “expects,” “believes,” “may,” “will,” “should,” “intends,” “plans,” “estimates,” or “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 increased international presence;
- our failure to secure adequate protection for our intellectual property rights;
- our inability to develop new applications and product enhancements;
- 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, 2012.

### 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 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 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 report, 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.

## 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, 2012. 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 September 30, 2013:

Exhibit Number	Description
31.1	Certification of 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 Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.2	Certification of 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 September 30, 2013, 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).



## 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: November 6, 2013

By: /s/ Kris B. Tufto

Kris B. Tufto  
President and Chief Executive Officer  
(principal executive officer)

Dated: November 6, 2013

By: /s/ Dale E. Parker

Dale E. Parker  
Chief Financial Officer  
(principal financial and accounting officer)

## EXHIBIT INDEX

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**CERTIFICATION PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Kris B. Tufto, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Image Sensing Systems, Inc. for its fiscal quarter ended September 30, 2013;

2. Based on my knowledge, this 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 report;

3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

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

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 6, 2013

/s/ Kris B. Tufto  
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Name: Kris B. Tufto  
Title: President and Chief Executive Officer

**CERTIFICATION PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Dale E. Parker, certify that:

6. I have reviewed this Quarterly Report on Form 10-Q of Image Sensing Systems, Inc. for its fiscal quarter ended September 30, 2013;

7. Based on my knowledge, this 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 report;

8. Based on my knowledge, the financial statements, and other financial information included in this 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 report;

9. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

10. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 6, 2013

/s/ Dale E. Parker

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Name: Dale E. Parker

Title: Chief Financial Officer

**CERTIFICATION PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Image Sensing Systems, Inc. (the “Company”) on Form 10-Q for the period ended September 30, 2013, as filed with the Securities and Exchange Commission (the “Report”), I, Kris B. Tufto, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Kris B. Tufto

Kris B. Tufto

President and Chief Executive Officer

November 6, 2013

**CERTIFICATION PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Image Sensing Systems, Inc. (the "Company") on Form 10-Q for the period ended September 30, 2013, as filed with the Securities and Exchange Commission (the "Report"), I, Dale E. Parker, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Dale E. Parker

Dale E. Parker  
Chief Financial Officer  
November 6, 2013