

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

FORM 10-Q

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

For the quarterly period ended June 30, 2014

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 August 1, 2014

Common Stock, \$0.01 par value per share

4,984,151 shares

IMAGE SENSING SYSTEMS, INC.

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## PART I. FINANCIAL INFORMATION

### Item 1. Financial Statements

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

	<b>June 30,</b>	<b>December 31,</b>
	<b>2014</b>	<b>2013</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 2,576	\$ 3,564
Marketable securities	—	2,639
Accounts receivable, net of allowance for doubtful accounts of \$870 and \$1,173, respectively	4,986	5,252
Inventories	3,569	3,589
Prepaid expenses and other current assets	1,231	1,414
Total current assets	12,362	16,458
Property and equipment:		
Furniture and fixtures	620	620
Leasehold improvements	522	511
Equipment	4,116	3,988
	5,258	5,119
Accumulated depreciation	4,352	4,094
	906	1,025
Deferred income taxes	139	139
Intangible assets, net	5,763	6,463
Other assets	300	300
<b>TOTAL ASSETS</b>	<b>\$ 19,470</b>	<b>\$ 24,385</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 3,210	\$ 2,409
Accrued compensation	707	1,202
Warranty and other current liabilities	1,640	1,959
Total current liabilities	5,557	5,570
Deferred income taxes	180	175
Other long-term liabilities	107	126
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, 4,984,151 and 4,974,847 issued and outstanding, respectively	49	49
Additional paid-in capital	23,463	23,276
Accumulated other comprehensive income	819	604
Retained earnings	(10,705)	(5,415)
Total shareholders' equity	13,626	18,514
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 19,470</b>	<b>\$ 24,385</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		Six-Month Periods Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Revenue:				
Product sales	\$ 2,651	\$ 4,271	\$ 4,549	\$ 6,316
Royalties	3,287	3,197	5,711	5,766
	<u>5,938</u>	<u>7,468</u>	<u>10,260</u>	<u>12,082</u>
Cost of revenue:				
Product sales	1,675	2,505	2,880	3,567
	<u>1,675</u>	<u>2,505</u>	<u>2,880</u>	<u>3,567</u>
Gross profit	<u>4,263</u>	<u>4,963</u>	<u>7,380</u>	<u>8,515</u>
Operating expenses:				
Selling, marketing and product support	2,471	2,703	5,191	4,753
General and administrative	1,498	1,592	2,870	2,962
Research and development	1,423	1,356	3,239	2,487
Investigation matter	36	1,129	152	2,738
Restructuring	—	—	460	—
Amortization of intangible assets	393	340	782	681
	<u>5,821</u>	<u>7,120</u>	<u>12,694</u>	<u>13,621</u>
Loss from operations	<u>(1,558)</u>	<u>(2,157)</u>	<u>(5,314)</u>	<u>(5,106)</u>
Other income (expense), net	15	(4)	14	(2)
Loss before income taxes	<u>(1,543)</u>	<u>(2,161)</u>	<u>(5,300)</u>	<u>(5,108)</u>
Income tax benefit	(10)	(415)	(10)	(1,909)
Net loss	<u>\$ (1,533)</u>	<u>\$ (1,746)</u>	<u>\$ (5,290)</u>	<u>\$ (3,199)</u>
Net loss per share:				
Basic	<u>\$ (0.31)</u>	<u>\$ (0.35)</u>	<u>\$ (1.06)</u>	<u>\$ (0.65)</u>
Diluted	<u>\$ (0.31)</u>	<u>\$ (0.35)</u>	<u>\$ (1.06)</u>	<u>\$ (0.65)</u>
Weighted average number of common shares outstanding:				
Basic	<u>4,980</u>	<u>4,967</u>	<u>4,978</u>	<u>4,939</u>
Diluted	<u>4,980</u>	<u>4,967</u>	<u>4,978</u>	<u>4,939</u>

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

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

	Three-Month Periods Ended		Six-Month Periods Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Loss before income taxes	\$ (1,533)	\$ (1,746)	\$ (5,290)	\$ (3,199)
Other comprehensive income (loss):				
Foreign currency translation adjustment	184	104	215	(306)
Comprehensive loss	<u>\$ (1,349)</u>	<u>\$ (1,642)</u>	<u>\$ (5,075)</u>	<u>\$ (3,505)</u>

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

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

	Six-Month Periods Ended	
	June 30,	
	2014	2013
<b>Operating activities:</b>		
Net loss	\$ (5,290)	\$ (3,199)
Adjustments to reconcile net loss to net cash provided by (used for) operating activities:		
Depreciation	298	432
Amortization	782	681
Stock-based compensation	186	86
Changes in operating assets and liabilities:		
Accounts receivable, net	266	(538)
Inventories	20	(371)
Prepaid expenses and current assets	173	(1,901)
Accounts payable	801	788
Accrued expenses and other liabilities	(820)	1,183
Net cash used for operating activities	(3,584)	(2,839)
<b>Investing activities:</b>		
Sales and maturities of marketable securities	2,639	3,289
Purchases of marketable securities	—	(2,867)
Purchases of property and equipment	(196)	(239)
Purchase of other investments	—	(300)
Capitalized software development costs	(42)	(459)
Net cash provided by (used for) investing activities	2,401	(576)
<b>Financing activities:</b>		
Proceeds from exercise of stock options	—	9
Net cash provided by financing activities	—	9
Effect of exchange rate on changes on cash	195	(185)
Decrease in cash and cash equivalents	(988)	(3,591)
Cash and cash equivalents at beginning of period	3,564	8,334
Cash and cash equivalents at end of period	\$ 2,576	\$ 4,743

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

IMAGE SENSING SYSTEMS, INC.  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)  
June 30, 2014

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 six-month periods ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. The accompanying condensed consolidated financial statements of the Company should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013 as filed with the SEC.

**Summary of Significant Accounting Policies**

The Company believes that of its significant accounting policies, the following are particularly important to the portrayal of the Company's results of operations and financial position and may require the application of a higher level of judgment by the Company's management and, as a result, are subject to an inherent degree of uncertainty.

*Revenue Recognition*

We recognize revenue on a sales arrangement when it is realized or realizable and earned, which occurs when all of the following criteria have been met: persuasive evidence of an arrangement exists; delivery and title transfer have occurred or services have been rendered; the sales price is fixed and determinable; collectability is reasonably assured; and all significant obligations to the customer have been fulfilled.

Certain sales may contain multiple elements for revenue recognition purposes. We consider each deliverable that provides value to the customer on a standalone basis as a separable element. Separable elements in these arrangements may include the hardware, software, installation services, training and support. We initially allocate consideration to each separable element using the relative selling price method. Selling prices are determined by us based on either vendor-specific objective evidence (“VSOE”) (the actual selling prices of similar products and services sold on a standalone basis) or, in the absence of VSOE, our best estimate of the selling price. Factors considered by us in determining estimated selling prices for applicable elements generally include overall economic conditions, customer demand, costs incurred by us to provide the deliverable, as well as our historical pricing practices. Under these arrangements, revenue associated with each delivered element is recognized in an amount equal to the lesser of the consideration initially allocated to the delivered element or the amount for which payment is not deemed contingent upon future delivery of other elements in the arrangement. Under arrangements where special acceptance protocols exist, installation services and training may not be considered separable. Under those circumstances, revenue for the entire arrangement is recognized upon the completion of installation, training and fulfillment of any other significant obligations specific to the terms of the arrangement. Arrangements that do not contain any separable elements are typically recognized when the products are shipped and title has transferred to the customer.

Revenue from arrangements for services such as maintenance, repair, consulting and technical support are recognized either as the service is performed or ratably over the defined contractual period for service maintenance contracts.

Econolite Control Products, Inc. (Econolite) is our licensee that sells certain of our products in the United States, Mexico, Canada and the Caribbean. The royalty of approximately 50% of the gross profit on licensed products is recognized when the products are shipped or delivered by Econolite to its customers.

We record provisions against sales revenue for estimated returns and allowances in the period when the related revenue is recorded based on historical sales returns and changes in end user demand.

Revenue is recorded net of taxes collected from customers that are remitted to governmental authorities, with the collected taxes recorded as current liabilities until remitted to the relevant government authority.

#### *Inventories*

Inventories are primarily electronic components and finished goods and are valued at the lower of cost or market on the first-in, first-out accounting method.

#### *Income Taxes*

We record a tax provision for the anticipated tax consequences of the reported results of operations. Deferred tax assets and liabilities are measured using the currently enacted tax rates that apply to taxable income in effect for the years in which those deferred tax assets and liabilities are expected to be realized or settled. We record a valuation allowance to reduce deferred tax assets to the amount that is believed more likely than not to be realized. We believe it is more likely than not that forecasted income, including income that may be generated as a result of certain tax planning strategies, together with the tax effects of the deferred tax liabilities, will be sufficient to fully recover the remaining net realizable value of deferred tax assets. In the event that all or part of the net deferred tax assets are determined not to be realizable in the future, an adjustment to the valuation allowance would be charged to earnings in the period such determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with management's expectations could have a material impact on our financial condition and operating results. We recognize penalties and interest expense related to unrecognized tax benefits in income tax expense.

#### *Intangible Assets*

Intangible assets with finite lives are amortized on a straight-line basis over the expected period to be benefited by future cash flows and reviewed for impairment. At both June 30, 2014 and December 31, 2013, we determined there was no impairment of intangible assets. At both June 30, 2014 and December 31, 2013, there were no indefinite-lived intangible assets.

We capitalize certain software development costs related to software to be sold, leased, or otherwise marketed. Capitalized software development costs include purchased materials and services and other costs associated with the development of new products and services. Software development costs are expensed as incurred until technological feasibility has been established, at which time future costs incurred are capitalized until the product is available for general release to the public. A certain amount of judgment and estimation is required to assess when technological feasibility is established, as well as the ongoing assessment of the recoverability of capitalized costs. In evaluating the recoverability of capitalized software costs, the Company compares expected product performance, utilizing forecasted revenue amounts, to the total costs incurred to date and estimates of additional costs to be incurred. If revised forecasted product revenue is less than, and/or revised forecasted costs are greater than, the previously forecasted amounts, the net realizable value may be lower than previously estimated, which could result in the recognition of an impairment charge in the period in which such a determination is made.

We reached technological feasibility for certain software products and, as a result, capitalized \$42,000 of software development costs during the three months ended June 30, 2014 and have capitalized a total \$909,000 of software development costs through the period ended June 30, 2014. 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: Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers." ASU 2014-09 provides new guidance related to how an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, ASU 2014-09 specifies new accounting for costs associated with obtaining or fulfilling contracts with customers and expands the required disclosures related to revenue and cash flows from contracts with customers. This new guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, and can be adopted either retrospectively to each prior reporting period presented or as a cumulative-effect adjustment as of the date of adoption, with early application not permitted. The Company is currently determining its implementation approach and assessing the impact of ASU 2014-09 on the condensed consolidated financial statements.



## Note C: Fair Value Measurements 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 and market value of our available-for-sale securities by major security type were as follows (in thousands):

	December 31, 2013			
	Level 1	Level 2	Level 3	Total
Bank certificates of deposit	\$ —	\$ 2,639	\$ —	\$ 2,639
	<u>\$ —</u>	<u>\$ 2,639</u>	<u>\$ —</u>	<u>\$ 2,639</u>

We evaluate impairment at each reporting period for securities where the fair value of the investment is less than its cost. Unrealized gains and losses on our available-for-sale investments are primarily attributable to general changes in interest rates and market conditions. The aggregate unrealized gain or loss on available-for-sale investments was immaterial as of December 31, 2013.

Classification of available-for-sale investments as current or noncurrent is dependent upon our intended holding period, the security's maturity date, or both. 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 December 31, 2013.

Proceeds from maturities or sales of available-for-sale securities were \$2.6 million for the six month period ended June 30, 2014, and \$2.2 million and \$3.3 million for the three and six month periods ended June 30, 2013, respectively. There were no proceeds from maturities or sales of available-for-sale securities during the three month period ended June 30, 2014. Realized gains and losses are determined using the specific identification method. Realized gains and losses related to sales of available-for-sale investments during the three and six month periods ended June 30, 2014 and June 30, 2013 were immaterial and included in other income (expense), net.

### *Nonfinancial Assets Measured at Fair Value on a Nonrecurring Basis*

Our intangible assets and other long-lived assets are nonfinancial assets that were acquired either as part of a business combination, individually or with a group of other assets. These nonfinancial assets were initially, and have historically been, measured and recognized at amounts equal to the fair value determined as of the date of acquisition.

### *Financial Instruments not Measured at Fair Value*

Certain of our financial instruments are not measured at fair value and are recorded at carrying amounts approximating fair value, based on their short-term nature or variable interest rate. These financial instruments include cash and cash equivalents, accounts receivable, accounts payable and other current assets and liabilities.

#### Note D: Inventories

Inventories consisted of the following (in thousands):

	<b>June 30, 2014</b>	<b>December 31, 2013</b>
Components	\$ 2,691	\$ 2,797
Finished goods	878	792
	<u>\$ 3,569</u>	<u>\$ 3,589</u>

#### Note E: Intangible Assets

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

	<b>June 30, 2014</b>			
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Value</b>	<b>Weighted Average Useful Life (in Years)</b>
Developed technology	\$ 8,174	\$ (5,150)	\$ 3,024	3.1
Trade names	3,267	(2,238)	1,029	4.0
Other intangible costs	1,929	(1,128)	801	2.7
Software development costs	909	—	909	
Total	<u>\$ 14,279</u>	<u>\$ (8,516)</u>	<u>\$ 5,763</u>	3.1

	<b>December 31, 2013</b>			
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Value</b>	<b>Weighted Average Useful Life (in Years)</b>
Developed technology	\$ 8,152	\$ (4,587)	\$ 3,566	3.6
Trade names	3,267	(2,110)	1,157	4.5
Other intangible assets	1,874	(1,001)	873	3.1
Software development costs	867	—	867	
Total	<u>\$ 14,160</u>	<u>\$ (7,698)</u>	<u>\$ 6,463</u>	3.5

#### Note F: Credit Facilities

On May 12, 2014, the Company entered into a revolving line of credit with Alliance Bank. This revolving line of credit agreement and related documents (collectively, "Alliance Credit Agreement") with Alliance Bank provide up to \$5.0 million of credit. The Alliance Credit Agreement expires in May 2015 and bears interest at a fixed annual rate of 3.95%. Any advances are secured by inventories, accounts receivable, cash, marketable securities, and equipment. We are subject to certain covenants under the Alliance Credit Agreement. At June 30, 2014 we had no borrowings under the Alliance Credit Agreement, and we were in compliance with all financial covenants.

Prior to May 12, 2014, we had a revolving line of credit with Associated Bank, National Association ("Associated Bank") that was initially entered into as of May 1, 2008. We requested, and Associated Bank granted, a termination to the Credit Agreement effective on May 12, 2014 in connection with the revolving line of credit from Alliance Bank described above.

### Note G: Warranties

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

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

	<b>Six-Month Periods Ended</b>	
	<b>June 30,</b>	
	<b>2014</b>	<b>2013</b>
Beginning balance	\$ 934	\$ 520
Warranty provisions	53	144
Warranty claims	(173)	(306)
Adjustments to preexisting warranties	(81)	103
Ending balance	<u>\$ 733</u>	<u>\$ 461</u>

### Note H: Stock-Based Compensation

We compensate officers, directors and key employees with stock-based compensation under 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.

Performance stock options are time based; however, the final number of awards earned and the related compensation expense is adjusted up or down as of the last day of the performance period to the extent the performance target is met. The actual number of shares that will ultimately vest ranges from 90% to 100% of the targeted amount if the minimum performance target is achieved. For performance stock awards granted in 2014, the performance target is revenue. We evaluate the likelihood of meeting the performance target at each reporting period and adjust compensation expense, on a cumulative basis, based on the expected achievement of each performance target.

Compensation expense, net of estimated forfeitures, is recognized ratably over the vesting period. Stock-based compensation expense included in general and administrative expense for the three-month periods ended June 30, 2014 and 2013 was \$99,000 and \$31,000, respectively. Stock-based compensation expense included in general and administrative expense for the six-month periods ended June 30, 2014 and 2013 was \$186,000 and \$86,000, respectively. At June 30, 2014, a total of 443,113 shares were available for grant under these plans.

### Stock Options

A summary of the option activity for the first six months of 2014 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, 2013	339,750	\$ 6.73	6.9	\$ 9,000
Granted	167,500	\$ 4.92	9.7	\$ 4,650
Exercised	—	\$ -	--	\$ -
Expired	—	\$ -	--	\$ -
Forfeited	<u>(27,562)</u>	\$ 5.66	--	\$ 325
Options outstanding at June 30, 2014	<u>479,688</u>	\$ 6.16	7.6	\$ -
Options exercisable at June 30, 2014	<u>144,938</u>	\$ 7.61	4.9	\$ -

There were no options exercised during the three and six month periods ended June 30, 2014. The total intrinsic value of options exercised was \$8,632 during the three and six month periods ended June 30, 2013. As of June 30, 2014, there was \$655,000 of total unrecognized compensation cost related to non-vested stock options. The weighted average period over which the compensation cost is expected to be recognized is 2.8 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 June 30, 2014, there were stock awards issued for 5,593 shares with a weighted-average grant date fair value of \$3.91. For the six months ended June 30, 2014, there were stock awards issued for 9,304 shares with a weighted-average grant date fair value of \$4.36.

### Note I: Loss per Common Share

Net loss per share is computed by dividing net loss by the daily weighted average number of common shares outstanding during the applicable periods. Diluted net loss per share includes the potentially dilutive effect of common shares subject to outstanding stock options using the treasury stock method. Under the treasury stock method, shares subject to certain outstanding stock options have been excluded from the diluted weighted average shares outstanding calculation because the exercise of those options would lead to a net reduction in common shares outstanding. As a result, stock options to acquire 343,000 and 108,000 weighted common shares have been excluded from the diluted weighted shares outstanding for the three-month periods ended June 30, 2014 and 2013, respectively, and 337,000 and 168,000 weighted common shares have been excluded from the diluted weighted shares outstanding for the six month periods ended June 30, 2014 and 2013, respectively. The potentially dilutive effect of common shares subject to certain outstanding stock options is determined based on net loss. A reconciliation of these amounts is as follows:

	Three-Month Periods Ended		Six-Month Periods Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Numerator:				
Net loss	\$ (1,533)	\$ (1,746)	\$ (5,290)	\$ (3,199)
Denominator:				
Weighted average common shares outstanding	4,980	4,967	4,978	4,939
Dilutive potential common shares	—	—	—	—
Shares used in diluted net loss per common share calculations	4,980	4,967	4,978	4,939
Basic net loss per common share	\$ (0.31)	\$ (0.35)	\$ (1.06)	\$ (0.65)
Diluted net loss per common share	\$ (0.31)	\$ (0.35)	\$ (1.06)	\$ (0.65)

#### Note J: 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 June 30,							
	Intersection		Highway		LPR		Total	
	2014	2013	2014	2013	2014	2013	2014	2013
Revenue	\$ 3,625	\$ 3,765	\$ 1,094	\$ 842	\$ 1,219	\$ 2,861	\$ 5,938	\$ 7,468
Gross profit	3,242	3,171	488	108	533	1,684	4,263	4,963
Amortization of intangible assets	—	—	121	122	272	218	393	340
Intangible assets	—	—	698	1,644	5,065	4,562	5,763	6,206
	Six Months Ended June 30,							
	Intersection		Highway		LPR		Total	
	2014	2013	2014	2013	2014	2013	2014	2013
Revenue	\$ 5,808	\$ 6,707	\$ 2,169	\$ 1,615	\$ 2,283	\$ 3,760	\$ 10,260	\$ 12,082
Gross profit	5,347	5,905	1,166	431	867	2,179	7,380	8,515
Amortization of intangible assets	—	—	244	245	538	436	782	681
Intangible assets	—	—	698	1,644	5,065	4,562	5,763	6,206

#### Note K: Restructuring

In the first quarter of 2014, the Company implemented restructuring plans to improve our financial performance in Europe. These plans included the closure of our office in Poland. Because of these actions, restructuring charges of approximately \$460,000 were recorded related primarily to facilities and employee terminations.

The following table shows the restructuring activity for 2014 (in thousands):

	<b>Termination Benefits</b>	<b>Facility Costs and Contract Termination</b>	<b>Total</b>
Balance at January 1, 2014	\$ -	\$ -	\$ -
Charges	60	400	460
Payments/settlements	(45)	(177)	(222)
Balance at March 31, 2014	<u>\$ 15</u>	<u>\$ 223</u>	<u>\$ 238</u>
Charges	-	-	-
Payments/settlements	(15)	(223)	(238)
Balance at June 30, 2014	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

#### Note L: 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 M: Commitments and Contingencies

##### *Litigation*

We are involved from time to time in various legal proceedings arising in the ordinary course of our business, including primarily commercial, product liability, employment and intellectual property claims. In accordance with GAAP, we record a liability in our Consolidated Financial Statements with respect to any of these matters when it is both probable that a liability has been incurred and the amount of the liability can be reasonably estimated. With respect to any currently pending legal proceedings, we have not established an estimated range of reasonably possible additional losses either because we believe that we have valid defenses to claims asserted against us or the proceeding has not advanced to a stage of discovery that would enable us to establish an estimate. We currently do not expect the outcome of these matters to have a material effect on our consolidated results of operations, financial position or cash flows. Litigation, however, is inherently unpredictable, and it is possible that the ultimate outcome of one or more claims asserted against us could adversely impact our results of operations, financial position or cash flows. We expense legal costs as incurred.

##### *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.

#### Note N: Subsequent Events

On July 1, 2014, the Company amended its Manufacturing, Distributing and Technology License Agreement with Econolite. As of July 14, 2014, the marketing, manufacturing and distribution of the Autoscope® radar product line in the United States, Mexico, Canada and the Caribbean transitioned from Econolite to the Company. Econolite will continue to manufacture, market and distribute the Company's Autoscope® video detection products in these geographic territories under the agreements.

## 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 toll managers and law enforcement officials to read license plates for various safety, security, access and enforcement LPR applications.

Autoscope® video are sold to distributors and end users of traffic management products in the United States, Mexico, Canada and the Caribbean and Latin America by Econolite Control Products, Inc. ("Econolite"), our exclusive licensee in these regions. From July 24, 2012 until July 14, 2014, our Autoscope® radar systems also were sold by Econolite in these geographic areas under the same arrangement. As described elsewhere in this Quarterly Report on Form 10-Q, effective July 14, 2014, the marketing, manufacturing and distribution of the Autoscope® radar product line in the United States, Mexico, Canada and the Caribbean transitioned from Econolite to the Company. We sell LPR systems to distributors and end users in the United States, Canada and Mexico. We sell all of our systems to distributors and end users in Europe and Asia through our subsidiaries. The majority of our sales are to end users that are funded by government agencies responsible for traffic management or traffic law enforcement.

## ***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 LPR 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 sales of the Autoscope® video and Autoscope® radar (July 24, 2012 until July 14, 2014) systems in the United States, Mexico, Canada and the Caribbean and Latin America and (2) revenue received from the direct sales of our Autoscope® radar (before July 24, 2012) and LPR systems in the United States, Mexico, Canada and the Caribbean and all of our systems in Europe and Asia. Royalties are calculated using a profit sharing model where the gross profits on sales of product made through Econolite are shared equally with Econolite. This royalty arrangement has the benefit of decreasing our cost of revenues and our selling, marketing and product support expenses because these costs and expenses are borne primarily by Econolite. Although this royalty model has a positive impact on our gross margin, it also negatively impacts our total revenue, which would be higher if all the sales made by Econolite were made directly by us. The royalty arrangement is exclusive under a long-term agreement.

*Cost of Revenue.* There is no cost of revenue related to royalties, as virtually all manufacturing, warranty and related costs are incurred by Econolite. Cost of revenue related to product sales consists primarily of the amount charged by our third party contractors to manufacture hardware platforms, which is influenced mainly by the cost of electronic components. The cost of revenue also includes logistics costs, estimated expenses for product warranties, restructuring



costs and inventory reserves. The key metric that we follow is achieving certain gross margin percentages on product sales by geographic region and to a lesser extent by product line.

*Operating Expenses.* Our operating expenses fall into three categories: (1) selling, marketing and product support; (2) general and administrative; and (3) research and development. Selling, marketing and product support expenses consist of various costs related to sales and support of our products, including salaries, benefits and commissions paid to our personnel; commissions paid to third parties; travel, trade show and advertising costs; second-tier technical support for Econolite; and general product support, where applicable. General and administrative expenses consist of certain corporate and administrative functions that support the development and sales of our products and provide an infrastructure to support future growth. These expenses include management, supervisory and staff salaries and benefits, legal and auditing fees, travel, rent and costs associated with being a public company, such as board of director fees, listing fees and annual reporting expenses. Research and development expenses consist mainly of salaries and benefits for our engineers and third party costs for consulting and prototyping. We measure all operating expenses against our annually approved budget, which is developed with achieving a certain operating margin as a key focus. Also included in operating expenses are restructuring costs and non-cash expense for intangible asset amortization.

*Non-GAAP Operating Measure.* We provide certain non-GAAP financial information as supplemental information to financial measures calculated and presented in accordance with GAAP (Generally Accepted Accounting Principles in the United States). This non-GAAP information excludes the impact of amortizing intangible assets and may exclude other non-recurring items. Management believes that this presentation facilitates the comparison of our current operating results to historical operating results. Management uses this non-GAAP information to evaluate short-term and long-term operating trends in our core operations. Non-GAAP information is not prepared in accordance with GAAP and should not be considered a substitute for or an alternative to GAAP financial measures and may not be computed the same as similarly titled measures used by other companies.

Reconciliations of GAAP net loss to non-GAAP net loss are as follows (dollars in thousands, except per share amounts):

	<b>Three-Month Periods Ended</b>		<b>Six-Month Periods Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Loss from operations	\$ (1,558)	\$ (2,157)	\$ (5,314)	\$ (5,106)
Amortization of intangible assets	393	340	782	681
Investigation matter	36	1,129	152	2,738
Restructuring charges	—	—	460	—
Non-GAAP loss from operations	<u>\$ (1,129)</u>	<u>\$ (688)</u>	<u>\$ (3,920)</u>	<u>\$ (1,687)</u>

*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 six month periods ended June 30, 2014 and 2013 is summarized as follows (in thousands):

	Three Months Ended June 30,							
	Intersection		Highway		LPR		Total	
	2014	2013	2014	2013	2014	2013	2014	2013
Revenue	\$ 3,625	\$ 3,765	\$ 1,094	\$ 842	\$ 1,219	\$ 2,861	\$ 5,938	\$ 7,468
Gross profit	3,242	3,171	488	108	533	1,684	4,263	4,963
Amortization of intangible assets	—	—	121	122	272	218	393	340
Intangible assets	—	—	698	1,644	5,065	4,562	5,763	6,206

	Six Months Ended June 30,							
	Intersection		Highway		LPR		Total	
	2014	2013	2014	2013	2014	2013	2014	2013
Revenue	\$ 5,808	\$ 6,707	\$ 2,169	\$ 1,615	\$ 2,283	\$ 3,760	\$ 10,260	\$ 12,082
Gross profit	5,347	5,905	1,166	431	867	2,179	7,380	8,515
Amortization of intangible assets	—	—	244	245	538	436	782	681
Intangible assets	—	—	698	1,644	5,065	4,562	5,763	6,206

## 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.

	<u>Three-Months ended June 30,</u>		<u>Quarter Over Quarter Change</u>
	<u>2014</u>	<u>2013</u>	
	Product sales	44.6 %	57.2 %
Royalties	55.4	42.8	2.8
Total revenue	100.0	100.0	(20.5)
Gross profit - product sales	36.8	41.3	(44.7)
Gross profit - royalties	100.0	100.0	2.8
Selling, marketing and product support	41.6	36.2	(8.6)
General and administrative	25.2	21.3	(5.9)
Research and development	24.0	18.2	4.9
Investigation matter	0.6	15.1	(96.8)
Amortization of intangible assets	6.6	4.6	15.6
Loss from operations	(26.2)	(28.9)	(27.8)
Income tax benefit	(0.2)	(5.6)	(97.6)
Net loss	(25.8)	(23.4)	(12.2)

  

	<u>Six-Months ended June 30,</u>		<u>Period Over Period Change</u>
	<u>2014</u>	<u>2013</u>	
	Product sales	44.3 %	52.3 %
Royalties	55.7	47.7	(1.0)
Total revenue	100.0	100.0	(15.1)
Gross profit - product sales	36.7	43.5	(39.3)
Gross profit - royalties	100.0	100.0	(1.0)
Selling, marketing and product support	50.6	39.3	9.2
General and administrative	28.0	24.5	(3.1)
Research and development	31.6	20.6	30.2
Investigation matter	1.5	22.7	(94.4)
Restructuring	4.5	—	—
Amortization of intangible assets	7.6	5.6	14.8
Loss from operations	(51.8)	(42.3)	4.1
Income tax benefit	(0.1)	(15.8)	(99.5)
Net loss	(51.6)	(26.5)	65.4

Total revenue decreased to \$5.9 million in the three month period ended June 30, 2014 from \$7.5 million in the same period in 2013, a decrease of 20.5%, and to \$10.3 million in the first half of 2014 from \$12.1 million in the same period in 2013, a decrease of 15.1%. Royalties increased to \$3.3 million in the second quarter of 2014 from \$3.2 million in the second quarter of 2013, an increase of 2.8% and they decreased to \$5.7 million in the first half of 2014 from \$5.8 million in the same period in 2013, a decrease of 1.0%. The decrease in royalties was the result of a decrease in Autoscope® video royalties slightly offset by an increase in Autoscope® radar royalties. Autoscope® video royalties were lower in the three months ended June 30, 2014 compared to the three months ended June 30, 2013 as a result of lower unit volume. Product sales decreased to \$2.7 million in the second quarter of 2014 from \$4.3 million in the second quarter of 2013, a decrease of 37.9%, and decreased to \$4.5 million in the first half of 2014 from \$6.3 million in the first half of 2013, a decrease of 28.0%. The decrease in product sales was mainly due to lower sales volume in

Europe slightly offset by higher sales volume in Asia. The decrease in European sales volume was primarily the result of the Polish office closure and the transition of operations to other jurisdictions.

Revenue for the Intersection segment decreased to \$3.6 million in the three-month period ended June 30, 2014 from \$3.8 million in the three-month period ended June 30, 2013, a decrease of 3.7%. Revenue for the Intersection segment decreased to \$5.8 million in the first six months of 2014 from \$6.7 million in the first half of 2013, a decrease of 13.4%. The decrease in revenue for the Intersection segment was mainly due to lower sales volume in Europe.

Revenue for the Highway segment increased to \$1.1 million in the second quarter of 2014 from \$842,000 in the second quarter of 2013, an increase of 30.0% and increased in the first half of 2014 to \$2.2 million from \$1.6 million in the first half of 2013, an increase of 34.3%. The increase in revenue for the Highway segment was due mainly to higher sales volume worldwide.

Revenue for the LPR segment decreased to \$1.2 million in the period ended June 30, 2014 from \$2.9 million in the period ended June 30, 2013, a decrease of 57.4%, and decreased to \$2.3 million in the six month period ended June 30, 2014 from \$3.8 million in the same period in 2013, a decrease of 39.3%. The decrease in revenue for the LPR segment in 2014 over 2013 is due to lower sales volumes in North America and Europe.

Gross profit for product sales decreased to 36.8% in the quarter ended June 30, 2014 from 41.3% in the quarter ended June 30, 2013 and decreased to 36.7% in the first half of 2014 from 43.5% in the first half of 2013. Gross profit for the LPR product line have historically been lower than gross profit for the Intersection and Highway product lines and therefore the mix of the product lines sold in any given period can result in varying gross profit. Generally, lower sales volumes of Highway or LPR products will reduce gross profit because of fixed manufacturing costs for these products. Additionally, the geographic sales mix of our product sales can influence margins, as product sold in some jurisdictions have lower margins. We anticipate that gross profit for our product sales will be higher in 2014 as compared to 2013, while we expect royalty gross profit will be 100% in 2014.

Selling, marketing and product support expense decreased to \$2.5 million or 41.6% of total revenue in the three months ended June 30, 2014 from \$2.7 million or 36.2% of total revenue in the three months ended June 30, 2013 and increased to \$5.2 million or 50.6% of total revenue in the first half of 2014 from \$4.8 million or 39.3% of total revenue in the first half of 2013. Our selling, marketing and product support expense increased in the first half of 2014 mainly due to our investments in additional sales and marketing resources. We anticipate that annual selling, marketing and product support expense will increase in dollar amount in 2014 as compared to 2013.

General and administrative expense decreased to \$1.5 million or 25.2% of total revenue for the second quarter of 2014 from \$1.6 million or 21.3% of total revenue in the second quarter of 2013 and to \$2.9 million or 28.0% of total revenue in the first half of 2014 from \$3.0 million or 24.5% of total revenue in the first half of 2013. We anticipate that annual general and administrative expenses for 2014 will approximate the expenses of 2013.

Research and development expense was to \$1.4 million or 24.0% of total revenue in the three months ended June 30, 2014 and \$1.4 million or 18.2% of total revenue in the same period in 2013, and it increased to \$3.2 million or 31.6% of total revenue in the first half of 2014 from \$2.5 million or 20.6% of total revenue in the first half of 2013. The increase in the first half of 2014 was mainly related to the increased expenditures on new research and development projects, the acceleration of previously existing projects and other product developments.

In the first quarter of 2014, we implemented restructuring plans to improve our financial performance in Europe. These plans included the closure of our office in Poland. Because of these actions, restructuring charges of approximately \$460,000 were recorded in the first quarter of 2014 related primarily to facilities and employee terminations.

Amortization of intangibles was \$393,000 in the second quarter of 2014 and \$782,000 in the first half of 2014 compared to \$340,000 in the second quarter of 2013 and \$681,000 in the first half of 2013. This reflects the amortization of intangible assets acquired in acquisitions. Assuming there are no changes to our intangible assets, we anticipate amortization expense will be approximately \$1.8 million in 2014.

We recorded an income tax benefit of \$10,000 for the three and six months ended June 30, 2014, compared to income tax benefit of \$415,000 and \$1.9 million for the three and six months ended June 30, 2013. Certain jurisdictions have net operating loss carry forwards. The benefits of these net operating loss carryforwards are uncertain and, as a result, the Company is not recording the related tax benefits.

### **Liquidity and Capital Resources**

At June 30, 2014, we had \$2.6 million in cash and cash equivalents and no marketable securities compared to \$3.6 million in cash and cash equivalents and \$2.6 million in marketable securities at December 31, 2013. 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 \$3.6 million in the first six months of 2014 compared to cash used in operating activities of \$2.8 million in the same period in 2013. The primary reason for the decrease in cash was the loss for the first six months of 2014 offset in part by the collection of outstanding receivables and the conversion of inventory. We anticipate that average receivable collection days in 2014 will improve from 2013 but that the improvement will not have a material impact on our liquidity.

Net cash provided by investing activities was \$2.4 million for the first half of 2014 compared to cash used in investing activities of \$576,000 in the first half of 2013. Our planned additions of property and equipment are discretionary, and we do not expect them to exceed historical levels in 2014.

On May 12, 2014, the Company entered into a revolving line of credit with Alliance Bank. This revolving line of credit agreement and related documents (collectively, "Alliance Credit Agreement") with Alliance Bank provide up to \$5.0 million of credit. The Alliance Credit Agreement expires in May 2015 and bears interest at a fixed annual rate of 3.95%. Any advances are secured by inventories, accounts receivable, cash, marketable securities, and equipment. We are subject to certain covenants under the Alliance Credit Agreement. At June 30, 2014, we had no borrowings under the Alliance Credit Agreement, and we were in compliance with all financial covenants.

Prior to May 12, 2014, we had a revolving line of credit with Associated Bank, National Association ("Associated Bank") that was initially entered into as of May 1, 2008. We requested, and Associated Bank granted, a termination to the Credit Agreement effective on May 12, 2014 in connection with the revolving line of credit from Alliance Bank described above.

We believe that cash and cash equivalents on hand at June 30, 2014, 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, 2013. The accounting policies used in preparing our interim Condensed Consolidated Financial Statements as of and for the three months and six months ended June 30, 2014 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, 2013.

### 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, 2013. 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

- (a) The fourth and fifth paragraphs under the caption “Liquidity and Capital Resources” set forth in “Item 2, Management’s Discussion and Analysis of Financial Condition and Results of Operations” elsewhere in this Report is hereby incorporated herein by reference.

### Item 6. Exhibits

The following exhibits are filed as part of this Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2014:

<u>Exhibit Number</u>	<u>Description</u>
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 June 30, 2014, formatted in XBRL (Extensible Business Reporting Language), (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the



**SIGNATURES**

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

Image Sensing Systems, Inc.

Dated: August 4, 2014

By: /s/ Kris B. Tufto

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

Dated: August 4, 2014

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 June 30, 2014;

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: August 4, 2014

/s/ Kris B. Tufto  
\_\_\_\_\_  
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:

1. I have reviewed this Quarterly Report on Form 10-Q of Image Sensing Systems, Inc. for its fiscal quarter ended June 30, 2014;

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: August 4, 2014

/s/ Dale E. Parker

\_\_\_\_\_  
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 June 30, 2014, 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

August 4, 2014

**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 June 30, 2014, 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  
August 4, 2014