**U.S. SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

# FORM 10-QSB

**[X] Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the quarterly period ended September 30, 2001**

[ ] Transition report under Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from __________ to __________

**Commission file number 1-12471**

# INTEGRATED SURGICAL SYSTEMS, INC.

(Name of Small Business Issuer in its Charter)

| | |
|---|---|
| **Delaware** | **68-0232575** |
| (State or Other Jurisdiction of Incorporation or Organization) | (IRS Employer Identification Number) |
| **1850 Research Park Drive, Davis, CA** | **95616-4884** |
| (Address of Principal Executive Offices) | (Zip Code) |

**(530) 792-2600**
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

| Title of each Class | Name of Each Exchange on Which Each Class is Registered |
|---|---|
| **Common Stock, $.01 Par Value** | **None** |
| **Common Stock Purchase Warrants** | **None** |

Securities registered pursuant to Section 12(g) of the Act:
**Not Applicable**
(Title of Class)

**ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS**
Check whether the issuer has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court. Yes [ ] No [ ]

**APPLICABLE ONLY TO CORPORATE REGISTRANTS**
On November 7, 2001 the issuer had 38,306,385 shares of common stock, $.01 par value, outstanding.

**INTEGRATED SURGICAL SYSTEMS, INC.**
**FORM 10-QSB**
**FOR THE QUARTER ENDED SEPTEMBER 30, 2001**

**TABLE OF CONTENTS**

## Part I. Financial Information

Item 1. Financial Statements (unaudited)

**Integrated Surgical Systems, Inc.**
**Consolidated Balance Sheet**
**September 30, 2001**
**(Unaudited)**

| | |
|---|---|
| **Assets** | |
| Current assets: | |
| Cash and cash equivalents | $ 471,219 |
| Accounts receivable less allowance for doubtful accounts of $115,022 | 1,881,083 |
| Inventory | 2,226,501 |
| Other current assets | 172,496 |
| Total current assets | 4,751,299 |
| | |
| Net property and equipment | 367,414 |
| Leased equipment, net | 355,405 |
| Intangible assets, net | 707,618 |
| Other assets | 10,603 |
| | $ 6,192,339 |
| | |
| **Liabilities and stockholders' equity** | |
| Current liabilities: | |
| Accounts payable | $ 1,448,467 |
| Accrued payroll and related expense | 467,784 |
| Accrued liabilities | 338,236 |
| Unearned income | 3,090,954 |
| Other current liabilities | 370,300 |
| Total current liabilities | 5,715,741 |
| | |
| Note payable | 89,482 |
| Commitments and contingencies | |
| | |
| Convertible preferred stock, $0.01 par value, 1,000,000 shares authorized; 364 shares issued and outstanding ($364,000 aggregate liquidation value) | 364,000 |
| | |
| Stockholders' equity: | |
| Common stock, $0.01 par value, 100,000,000 shares authorized; 36,931,385 shares issued and outstanding | 369,314 |
| Additional paid-in capital | 61,752,724 |
| Accumulated other comprehensive loss | (1,039,919) |
| Accumulated deficit | (61,059,003) |
| Total stockholders' equity | 23,116 |
| | $ 6,192,339 |

*See accompanying notes.*

**Integrated Surgical Systems, Inc.**
**Consolidated Statements of Operations**
**(Unaudited)**

| | Three months ended September 30, | |
|---|---|---|
| | **2001** | 2000 (Restated) |
| Net sales | **$ 2,734,660** | $ 2,400,689 |
| Cost of sales | **1,331,882** | 1,229,408 |
| | **1,402,778** | 1,171,281 |
| Operating expenses: | | |
| Selling, general and administrative | **1,004,258** | 1,475,842 |
| Research and development | **845,706** | 618,448 |
| Amortization of Intangibles | **209,760** | 209,760 |
| | **2,059,724** | 2,304,050 |
| Operating loss | **(656,946)** | (1,132,769) |
| Other income (expense), net | **166,532** | (455,993) |
| Net loss before preferred stock accretion | **(490,414)** | (1,588,762) |
| Preferred stock accretion | **(38,275)** | (411,029) |
| Net loss to common stockholders | **$ (528,689)** | $ (1,999,791) |
| Basic and diluted net loss per common share | **$ (0.01)** | $ (0.11) |
| Shares used in computing basic net loss per share | **36,878,894** | 17,927,065 |

*See accompanying notes.*

**Integrated Surgical Systems, Inc.**
**Consolidated Statements of Operations**
**(Unaudited)**

| | Nine months ended September 30, | |
|---|---|---|
| | **2001** | 2000 (Restated) |
| Net sales | **$ 6,760,633** | $ 5,380,622 |
| Cost of sales | **2,885,129** | 2,564,901 |
| | **3,875,504** | 2,815,721 |
| Operating expenses: | | |
| Selling, general and administrative | **3,185,214** | 3,454,188 |
| Research and development | **2,696,968** | 3,650,861 |
| Amortization of Intangibles | **629,280** | 629,280 |
| | **6,511,462** | 7,734,329 |
| Operating loss | **(2,635,958)** | (4,918,608) |
| Other income (expense), net | **(76,675)** | 299,536 |
| Loss before provision for income taxes | **(2,712,633)** | (4,619,072) |
| Provision for income taxes | **-** | 15,000 |
| Net loss before cumulative effect of accounting change | **(2,712,633)** | (4,634,072) |
| Cumulative effect of accounting change under SAB 101 | **-** | (581,907) |
| Net loss before preferred stock accretion | **(2,712,633)** | (5,215,979) |
| Preferred stock accretion | **(38,275)** | (3,609,845) |
| Net loss to common stockholders | **$ (2,750,908)** | $ (8,825,824) |
| Basic and diluted net loss per common share before cumulative effect of accounting change | **$ (0.08)** | $ (0.49) |
| Cumulative effect of accounting change under SAB 101 | **-** | (0.03) |
| Basic and diluted net loss per common share | **$ (0.08)** | $ (0.53) |
| Shares used in computing basic net loss per share | **35,304,598** | 16,803,453 |
| Pro forma amounts assuming the accounting change under SAB 101 is applied retroactively: | | |
| Net loss to common stockholders | **$ (2,750,908)** | $ 8,243,917) |
| Basic and diluted net loss per common share | **$ (0.08)** | $ (0.49) |

*See accompanying notes.*

**Integrated Surgical Systems, Inc.**
**Consolidated Statements Cash Flows (Unaudited)**
**Increase (Decrease) in Cash and Cash Equivalents**

| | Nine months ended September 30, 2001 | 2000 (Restated) |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net loss | **$(2,712,633)** | $ (5,215,979) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation | **259,513** | 399,981 |
| Amortization of intangible assets | **629,280** | 629,280 |
| Stock compensation | **58,289** | 236,058 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | **(1,050,108)** | (1,035,444) |
| Inventory | **1,758,783** | (630,332) |
| Other current assets | **150,368** | (129,810) |
| Accounts payable | **362,630** | (824,051) |
| Accrued payroll and related expenses | **45,569** | 19,706 |
| Accrued liabilities | **(63,652)** | 106,989 |
| Unearned income | **649,931** | 285,888 |
| Other current liabilities | **(282,560)** | 30,595 |
| Net cash used in operating activities | **(194,590)** | (6,127,119) |
| **Cash flows from investing activities:** | | |
| Principal payments received on sales-type lease | **58,311** | 221,492 |
| Purchases of property and equipment | **-** | (115,045) |
| Net cash provided by investing activities | **58,311** | 106,447 |
| **Cash flows from financing activities:** | | |
| Payments on bank loans | **(40,962)** | (49,036) |
| Proceeds from sale of preferred stock and warrants | **-** | 4,524,506 |
| Proceeds from sale of common stock and warrants | **632,000** | - |
| Proceeds from exercise of stock options | **-** | 31,501 |
| Redemption of preferred stock | **-** | (1,185,000) |
| Net cash provided by financing activities | **591,038** | 3,321,971 |
| Effect of exchange rate changes on cash and cash equivalents | **(259,862)** | 176,996 |
| Net increase (decrease) in cash and cash equivalents | **194,897** | (2,521,705) |
| Cash and cash equivalents at beginning of period | **276,322** | 2,918,016 |
| Cash and cash equivalents at end of period | **$ 471,219** | $ 396,311 |

*See accompanying notes.*

**Integrated Surgical Systems Inc.**
**Notes to Consolidated Financial Statements (unaudited)**
**September 30, 2001**

**1. Basis of presentation.** The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and the instructions to Form 10-QSB. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included.

Operating results for the nine month period ended September 30, 2001 are not necessarily indicative of the results that may be expected for the year ended December 31, 2001. For further information, refer to the consolidated financial statements and footnotes thereto included in the Integrated Surgical Systems, Inc. annual report on Form 10-KSB for the year ended December 31, 2000.

**2. Cumulative effect of change in accounting principle.** In December 1999, the Securities and Exchange Commission staff issued Staff Accounting Bulletin (SAB) No. 101, "Revenue Recognition in Financial Statements," and effective January 1, 2000, we changed our method of accounting for revenue recognition in accordance with SAB No. 101. Previously, we generally recognized revenue upon delivery of equipment to customers. The costs of installation and training were accrued in the same period revenue was recognized. Under the new accounting method adopted retroactively to January 1, 2000, we now recognize revenue upon completion of training and installation of the equipment at the end-user's site, except when the sales contract requires formal customer acceptance. Equipment sales with contractual customer acceptance provisions are recognized as revenue upon written notification of customer acceptance, which occurs after the completion of training and installation. Furthermore, due to business customs in Japan and our interpretation of Japanese law, all equipment sales to Japan are recognized upon customer acceptance, which occurs after the completion of training and installation. Revenue related to maintenance and service contracts is recognized ratably over the duration of the contracts. The cumulative effect of the change on prior years resulted in an increase in the consolidated loss of $581,907, which is included in the consolidated statement of operations for the year ended December 31, 2000. The effect of the change on the year ended December 31, 2000 was to decrease the consolidated loss before the cumulative effect of the accounting change by $581,907 ($0.03 per share).

For the three months ended March 31, 2000, we recognized $1,137,907 in revenue that was included in the cumulative effect adjustment as of January 1, 2000. The effect of that revenue and related cost of revenue of $556,000 in the first quarter was to reduce the consolidated loss by $581,907 during that period. The unaudited pro forma amounts presented in the statement of operations were calculated assuming the accounting change was made retroactively to prior periods.

**3. Inventories.** At September 30, 2001, the components of inventory were:

| | |
|---|---|
| Raw materials | $ 449,914 |
| Work-in-process | 664,876 |
| Finished goods | 982,341 |
| Deferred product development contract costs | 129,370 |
| | $2,226,501 |

**4. Stockholders' equity.** On September 21, 2001, 58,183 shares of common stock, with a fair value of $3,491, were issued to employees under our 2000 Long-Term Performance Plan as part of an employee bonus for 2000 performance.

On October 25, 2001 our board of directors approved a twelve month extension of the expiration date of all of our warrants to purchase common stock outstanding on October 25, 2001. The various warrant issues, the number of warrants outstanding, the number of shares of common stock which the warrants may purchase, the exercise price and the extended expiration date are listed below:

| Warrant | Number of Warrants | Number of Shares | Exercise Price | Extended Expiration Date |
|---|---|---|---|---|
| IBM | 2,206,479 | 2,206,479 | $0.0100 | December 31, 2006 |
| IPO public offering | 1,567,000 | 6,112,552 | $1.5400 | November 19, 2002 |
| IPO underwriters (1) | 339,250 | 1,323,344 | $1.5400 | November 19, 2002 |
| IPO underwriters (2) | 152,500 | 663,384 | $1.9000 | November 19, 2002 |
| Rickel & Associates, Inc. | 25,000 | 105,510 | $1.7800 | September 4, 2003 |
| EASDAQ underwriters | 150,000 | 654,680 | $1.9100 | November 21, 2003 |
| Series B Preferred | 12,500 | 12,500 | $2.7500 | March 25, 2003 |
| Series C Preferred | 9,375 | 9,375 | $2.1531 | June 9, 2003 |
| Series D Preferred | 25,000 | 25,000 | $3.4125 | June 29, 2003 |
| Series E Preferred | 37,500 | 37,500 | $4.3880 | July 29, 2003 |
| Series F Preferred | 125,000 | 125,000 | $2.3750 | February 7, 2004 |
| Series G Preferred | 63,000 | 63,000 | $1.8750 | May 29, 2004 |
| Series H Preferred (1) | 300,000 | 300,000 | $0.9344 | August 16, 2004 |
| Series H Preferred (2) | 250,000 | 250,000 | $1.0156 | August 16, 2004 |
| Series H Preferred (3) | 100,000 | 100,000 | $0.5000 | August 16, 2004 |
| Equity Line | 35,000 | 35,000 | $0.8590 | September 14, 2004 |
| ILTAG International Licensing Holding S.A.L. | 4,000,000 | 4,000,000 | $1.0270 | December 13, 2003 |
| | | 16,023,324 | | |

**5. Net loss per share.** At September 30, 2001, outstanding options to purchase 1,915,578 shares of common stock (with exercise prices ranging from $0.01 to $8.88), 9,397,604 outstanding warrants to purchase 16,023,324 shares of common stock (with exercise prices from $0.01 to $4.39), and 3,641,460 shares of common stock issuable upon conversion of Series G and H convertible preferred stock could potentially dilute basic earnings per share in the future and have not been included in the computation of diluted net loss per share because to do so would have been antidilutive for the periods presented. The exercise price and the ultimate number of shares of common stock issuable upon conversion of the warrants are subject to adjustments based upon the occurrence of certain future events.

**6. Accumulated other comprehensive loss.**

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | 2001 | 2000 (Restated) | 2001 | 2000 (Restated) |
| Net loss before preferred stock accretion | $ 490,414 | $1,588,762 | $2,712,633 | $5,215,979 |
| Other comprehensive loss: | | | | |
| Foreign currency translation | 87,588 | 24,298 | 503,506 | 77,941 |
| Comprehensive loss | $ 578,002 | $1,613,060 | $3,216,139 | $5,293,920 |

**7. Recent Accounting Pronouncements.** We adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," on January 1, 2001. This statement standardized the accounting for derivatives and hedging activities and requires that all derivatives be recognized in the statement of financial position as either assets or liabilities at fair value. Changes in the fair value of derivatives that do not meet the hedge accounting criteria are to be reported in earnings. The adoption of SFAS No. 133 on January 1, 2001 had no effect on our consolidated financial statements.

On June 29, 2001, the Financial Accounting Standards Board issued SFAS No. 141, “Business Combinations,” and SFAS No. 142, “Goodwill and Other Intangible Assets.” SFAS No. 141 eliminates the pooling-of-interests method of accounting for business combinations. Under statement No. 142, goodwill and indefinite lived intangible assets are no longer amortized but are reviewed annually, or more frequently if impairment indicators arise, for impairment. Intangible assets whose lives are not indefinite are amortized over their useful lives, and reviewed for impairment in accordance with SFAS No. 121. We have not yet determined the impact, if any, that SFAS Nos. 141 and 142 will have on our consolidated financial statements. We now evaluate our intangible assets in accordance with SFAS No. 121, and will adopt SFAS Nos. 141 and 142 on January 1, 2002.

Item 2. Management’s Discussion and Analysis

***Results of Operations***

Net revenue of $2,735,000 for the three months ended September 30, 2001 brings year-to-date 2001 revenue to $6,761,000, compared to $5,934,000 for the whole of calendar 2000. Revenue for six systems has been recognized through the third quarter of 2001 (including three in the three months ended September 30, 2001) against four systems in all of 2000.

Selling, general and administrative (“SG&A”) expense at $1,004,000 for the three months ended September 30, 2001 is $470,000 lower than for the same period of 2000—the result of cost containment efforts. SG&A rose slightly ($23,000) in the third quarter against the second quarter of 2001, as travel expense associated with our marketing efforts increased. During the first five months of 2000, most European selling expenses were transferred to an exclusive distributor. However, administrative cost reductions through 2001 led to a favorable SG&A comparison to year-to-date 2000, despite this offset.

Research and development (“R&D”) expenses for 2001 are lower than 2000 on a year-to-date basis due to cost-savings measures undertaken in 2000 in response to lowered sales projections. While the three months ended September 30, 2001 show a $227,000 increase in R&D expenses over the same period last year, significant resources were redirected from R&D to product development contracts in the third quarter of 2000, resulting in a decrease of approximately $492,000 in R&D expense.

Other income for the three month period ended September 30, 2001 included a transportation claim settlement of approximately $54,000. The other major component of other income, foreign currency exchange gain, was $108,000 as the dollar weakened slightly against European currencies in the third quarter in comparison to the first half of 2001. The major components of 2000 other income on a year-to-date basis were approximately $740,000 of licensing fees we received under an exclusive distribution agreement which was terminated in May 2000, offset by approximately $450,000 in foreign currency losses. There were no comparable licensing fees received in 2001, and foreign exchange losses were approximately $107,000 through the third quarter.

***Liquidity***

The report of our independent auditors on our 2000 consolidated financial statements included an explanatory paragraph indicating that there is substantial doubt with respect to the Company’s ability to continue as a going concern. Since inception, our expenses have exceeded our revenue, and operations have been funded primarily through the sale of equity securities. We believe, however, that we have begun to generate sales at a level sufficient to ensure our survival. Although we believe that our plan will be realized, there is no assurance that this will occur. The consolidated financial statements do not include any adjustments to reflect the uncertainties related to the recoverability and classification of assets or the amounts and classification of liabilities that may result from our inability to continue as a going concern.

Our cash balance at September 30, 2001 was $75,000 greater than at end of the third quarter of 2000, and has increased $195,000 from the balance at December 31, 2000 as systems sales have increased year-over-year. However, at September 30, 2001, our current liabilities exceeded our current assets, accounts payable contributed $363,000 to cash flow over the nine month period, and it has been difficult for us to meet our obligations as they become due.

Inventory provided approximately $882,000 to cash flow during the third quarter of 2001 and $1,759,000 during the nine months ended September 30, 2001, as systems were shipped from supplies already on hand. Unearned income, at $3,091,000, represented 53% of the our liabilities at June 30, 2001. Unearned income includes payments for systems sales on which revenue is not yet recognized, advance payment for service contracts which revenue is recognized ratably over the period of the contract and deposits on product development contracts. Accounts receivable have been our largest use of cash, $1,050,000, since December 31, 2000. Receivables have increased $905,000 from their second quarter 2001 level, as cash for 1.5 systems remained outstanding at the end of the quarter.

***Capital Resources***

On October 23, 2001 the OTC Bulletin Board began to offer quotations on our common stock. Between May 24 and October 22, 2001 quotes were available only through the pink sheets. While we believe that Bulletin Board coverage will make it easier for our shareholders to trade their common stock, our shares closed at $0.06 on October 31, making it unlikely that the equity markets will support fundraising activity at our historic level.

We have received proceeds of $742,000 through our Private Equity Line of Credit Agreement from its inception on November 2, 2000 through October 31, 2001, and through that date have $11,258,000 in additional credit on which to draw. However, the level of our current share price means that any use of the equity line of credit will cause significant dilution to our common shareholders.

**Part II. Other Information**

Item 6. Exhibits and Reports of Form 8-K

(a) Exhibits
None.

(b) Reports on Form 8-K
On October 30, 2001 we filed a Form 8-K concerning the extension of the expiration date of our outstanding warrants to purchase common stock.

**SIGNATURE**

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**INTEGRATED SURGICAL SYSTEMS, INC.**

By: /s/ PATRICIA PILZ
Patricia Pilz
(Principal Financial and Accounting Officer)

Dated: November 8, 2000