

INNOVATIVE SOLUTIONS & SUPPORT INC
Form 10-Q
February 10, 2017
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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 December 31, 2016

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 No. 000-31157

INNOVATIVE SOLUTIONS AND SUPPORT, INC.

(Exact name of registrant as specified in its charter)

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PENNSYLVANIA
(State or Other Jurisdiction
of Incorporation or Organization)

23-2507402
(I.R.S. Employer
Identification No.)

720 Pennsylvania Drive, Exton, Pennsylvania
(Address of Principal Executive Offices)

19341
(Zip Code)

(610) 646-9800

(Registrant's Telephone Number, Including Area Code)

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 Website, 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.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

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

As of January 31, 2017, there were 16,783,129 shares of the Registrant's Common Stock, with par value of \$.001 per share, outstanding.

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	December 31, 2016 (unaudited)	September 30, 2016
<u>ASSETS</u>		
Current assets		
Cash and cash equivalents	\$ 18,161,147	\$ 18,767,661
Accounts receivable, net	3,786,980	4,511,091
Unbilled receivables, net	1,604,069	1,597,672
Inventories	4,198,432	3,645,828
Prepaid expenses and other current assets	1,222,595	847,207
Total current assets	28,973,223	29,369,459
Property and equipment, net	6,901,566	6,962,562
Other assets	156,948	156,948
Total assets	\$ 36,031,737	\$ 36,488,969
<u>LIABILITIES AND SHAREHOLDERS' EQUITY</u>		
Current liabilities		
Accounts payable	\$ 1,713,616	\$ 1,503,771
Accrued expenses	2,246,154	1,889,908
Deferred revenue	351,229	179,585
Total current liabilities	4,310,999	3,573,264
Non-current deferred income taxes	67,708	67,701
Total liabilities	4,378,707	3,640,965
Commitments and contingencies (See Note 6)		
Shareholders' equity		
Preferred stock, 10,000,000 shares authorized, \$.001 par value, of which 200,000 shares are authorized as Class A Convertible stock. No shares issued and outstanding at December 31, 2016 and September 30, 2016	\$	\$
	18,813	18,813

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Common stock, \$.001 par value: 75,000,000 shares
authorized, 18,812,465 issued at December 31, 2016 and
September 30, 2016

Additional paid-in capital	51,392,159	51,392,159
Retained earnings	1,610,595	2,805,569
Treasury stock, at cost, 2,096,451 shares at December 31, 2016 and September 30, 2016	(21,368,537)	(21,368,537)
Total shareholders' equity	31,653,030	32,848,004
Total liabilities and shareholders' equity	\$ 36,031,737	\$ 36,488,969

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended December 31,	
	2016	2015
Sales:		
Product	\$ 3,475,171	\$ 5,940,410
Engineering development contracts	348,876	643,168
Returns and allowances	(458,181)	
Total net sales	3,365,866	6,583,578
Cost of sales:		
Product	1,740,703	2,908,957
Engineering development contracts	87,349	358,810
Total cost of sales	1,828,052	3,267,767
Gross profit	1,537,814	3,315,811
Operating expenses:		
Research and development	1,085,988	931,600
Selling, general and administrative	2,047,121	2,692,944
Total operating expenses	3,133,109	3,624,544
Operating loss	(1,595,295)	(308,733)
Interest income	9,876	7,025
Other income	19,114	32,410
Loss before income taxes	(1,566,305)	(269,298)
Income tax benefit	(371,331)	(53,860)
Net loss	\$ (1,194,974)	\$ (215,438)
Net loss per common share:		
Basic	\$ (0.07)	\$ (0.01)
Diluted	\$ (0.07)	\$ (0.01)
Weighted average shares outstanding:		
Basic	16,716,014	16,909,638
Diluted	16,716,014	16,909,638

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	For the Three Months Ended December 31,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (1,194,974)	\$ (215,438)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	108,336	113,770
Share-based compensation expense:		
Stock options		55,496
Gain on disposal of property and equipment		(563)
Deferred income taxes	7	
(Increase) decrease in:		
Accounts receivable	724,111	(2,951,983)
Unbilled receivables, net	(6,397)	1,233,885
Inventories	(552,604)	73,406
Prepaid expenses and other current assets	(375,388)	293,373
Increase (decrease) in:		
Accounts payable	209,845	1,134,837
Accrued expenses	356,246	338,475
Income taxes payable/receivable		
Deferred revenue	171,644	(18,302)
Net cash (used in) provided by operating activities	(559,174)	56,956
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(47,340)	(66,067)
Proceeds from the sale of property and equipment		563
Net cash (used in) investing activities	(47,340)	(65,504)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net cash provided by financing activities		
Net decrease in cash and cash equivalents	(606,514)	(8,548)
Cash and cash equivalents, beginning of year	18,767,661	16,282,039
Cash and cash equivalents, end of period	\$ 18,161,147	\$ 16,273,491

The accompanying notes are an integral part of these statements.

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INNOVATIVE SOLUTIONS AND SUPPORT, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Summary of Significant Accounting Policies

Description of the Company

Innovative Solutions and Support, Inc. (the Company or IS&S) was incorporated in Pennsylvania on February 12, 1988. The Company operates in one business segment as a systems integrator that designs, manufactures, sells, and services air data equipment, engine display systems, standby equipment, primary flight guidance, and cockpit display systems for retrofit applications and original equipment manufacturers (OEMs). The Company supplies integrated Flight Management Systems (FMS), Flat Panel Display Systems (FPDS), Integrated Standby Units (ISU) and advanced Global Positioning System (GPS) receivers that enable reduced carbon footprint navigation.

The Company has continued to position itself as a system integrator, which capability provides the Company with the potential to generate more substantive orders over a broader product base. The strategy, as both a manufacturer and integrator, is designed to leverage the latest technologies developed for the computer and telecommunications industries into advanced and cost-effective solutions for the general aviation, commercial air transport, United States Department of Defense (DoD)/governmental, and foreign military markets. This approach, combined with the Company's industry experience, is designed to enable IS&S to develop high-quality products and systems, to reduce product time to market, and to achieve cost advantages over products offered by its competitors. Customers include commercial air transport carriers and corporate/general aviation companies, the DoD and its commercial contractors, aircraft operators, aircraft modification centers, foreign militaries, and various OEMs.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements are presented pursuant to the rules and regulations of the United States Securities and Exchange Commission (the SEC) in accordance with the disclosure requirements for the quarterly report on Form 10-Q and, therefore, do not include all of the information and footnotes required by generally accepted accounting principles in the United States (GAAP) for complete annual financial statements. In the opinion of Company management, the unaudited condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) necessary to state fairly the results for the interim periods presented. The condensed consolidated balance sheet as of September 30, 2016 is derived from the audited financial statements of the Company. Operating results for the three months ended December 31, 2016 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2017. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes of the Company included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2016.

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The Company's condensed consolidated financial statements include the accounts of its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The Company prepares its condensed consolidated financial statements in conformity with GAAP, which requires management to make estimates and assumptions that affect reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities, as of the date of the financial statements and the reported amounts of net sales and expenses during the reporting period. Estimates are used in accounting for, among other items, long term contracts, allowance for doubtful accounts, inventory obsolescence, product warranty cost liabilities, income taxes, engineering and material costs on Engineering Development Contracts (EDC) programs, percentage-of-completion on EDC, recoverability of long-lived assets, stock-based compensation expense self-insurance reserves, and contingencies. Actual results could differ materially from those estimates.

Cash and Cash Equivalents

Highly liquid investments, purchased with an original maturity of three months or less, are classified as cash equivalents. Cash equivalents at December 31, 2016 and September 30, 2016 consist of funds invested in money market funds with financial institutions.

Property and Equipment

Property and equipment are stated at cost. Depreciation is provided using an accelerated method over the estimated useful lives of the assets (the lesser of three to seven years or over the lease term), except for the manufacturing facility and the corporate airplane. The building is being depreciated on a straight-line basis over 39 years. During the three months ended December 31, 2016, no depreciation was provided for the airplane because it had been depreciated to its estimated salvage value. Major additions and improvements are capitalized, while maintenance and repairs that do not improve or extend the life of assets are charged to expense as incurred.

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Fair Value of Financial Instruments

The net carrying amounts of cash and cash equivalents, accounts receivable, and accounts payable approximate their fair value because of the short-term nature of these instruments. For financial assets and liabilities measured at fair value on a recurring basis, fair value is the price the Company would receive to sell an asset or pay to transfer a liability in an orderly transaction with a market participant at the measurement date. A three-level fair value hierarchy prioritizes the inputs used to measure fair value as follows:

Level 1 Unadjusted quoted prices that are available in active markets for the identical assets or liabilities at the measurement date.

Level 2 Other observable inputs available at the measurement date, other than quoted prices included in Level 1, either directly or indirectly, including:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets in non-active markets;
- Inputs other than quoted prices that are observable for the asset or liability; and
- Inputs that are derived principally from or corroborated by other observable market data.

Level 3 Unobservable inputs that cannot be corroborated by observable market data and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management's estimates of market participant assumptions.

The following table sets forth by level within the fair value hierarchy the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2016 and September 30, 2016, according to the valuation techniques the Company used to determine their fair values.

	Fair Value Measurement on December 31, 2016		
	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets			
Cash and cash equivalents:			
Money market funds	\$ 17,427,465	\$	\$

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Fair Value Measurement on September 30, 2016

	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets			
Cash and cash equivalents:			
Money market funds	\$ 17,424,641	\$	\$

Long-Lived Assets

The Company assesses the impairment of long-lived assets in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 360-10, *Property, Plant and Equipment*. This statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances, known as triggering events, indicate the carrying amount of an asset may not be recoverable. In addition, long-lived assets to be disposed of should be reported at the lower of the carrying amount or fair value less cost to sell. The Company considers historical performance and future estimated results in its evaluation of potential impairment and then compares the carrying amount of the asset to estimated future cash flows expected to result from use of the asset. If the carrying amount of the asset exceeds the estimated expected undiscounted future cash flows, the Company measures the amount of the impairment by comparing the carrying amount of the asset to its fair value. The estimation of fair value is generally measured by discounting expected future cash flows. No impairment triggering events occurred during the three months ended December 31, 2016 or 2015.

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Revenue Recognition

The Company enters into sales arrangements with customers that, in general, provide for the Company to design, develop, manufacture and deliver air data equipment, large flat-panel display systems, and advanced monitoring systems that measure and display critical flight information, including data relative to aircraft separation, airspeed, altitude, and engine and fuel data measurements. The Company's sales arrangements may include multiple deliverables as defined in FASB ASC Topic 605-25 *Multiple-Element Arrangements* (ASC Topic 605-25), which typically include design and engineering services and the production and delivery of the flat panel display and related components. The Company includes any design and engineering services elements in EDC sales and any functional upgrade and product elements in product sales on the accompanying consolidated statements of income.

To the extent that an arrangement contains software elements that are essential to the functionality of tangible products sold in the arrangement, the Company recognizes revenue for the deliverables in accordance with the guidance included in FASB Accounting Update 2009-14, *Revenue Arrangements That Include Software Elements* (ASU 2009-14); and FASB Accounting Standards Update 2009-13, *Multiple-Deliverable Revenue Arrangements*-a consensus of the FASB Emerging Issues Task Force (ASU 2009-13); and FASB ASC Topic 605, *Revenue Recognition* (ASC Topic 605).

To the extent that an arrangement contains software components, which include functional upgrades that are sold on a standalone basis and which the Company has deemed outside the scope of the exception defined by ASU 2009-14, the Company recognizes software revenue in accordance with ASC Topic 985, *Software* (ASC Topic 985).

Multiple Element Arrangements -

The Company identifies all goods and/or services that are to be delivered separately under such a sales arrangement and allocates sales to each deliverable (if more than one) based on that deliverable's selling price. The Company considers the appropriate recognition method for each deliverable. The Company's multiple element arrangements can include defined design and development activities, functional upgrades, and product sales.

The Company utilizes the selling price hierarchy that has been established by FASB ASU 2009-13, which requires that the selling price for each deliverable be based on vendor-specific objective evidence if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific objective evidence nor third-party evidence is available. To the extent that an arrangement includes a deliverable for which estimated selling price is used, the Company determines the best estimate of selling price by applying the same pricing policies and methodologies that would be used to determine the price to sell the deliverable on a standalone basis.

To the extent that an arrangement contains defined design and EDC activities as an identified deliverable in addition to products (resulting in a multiple element arrangement), the Company recognizes as EDC sales amounts earned during the design and development phase of the contract following the guidance included in FASB ASC Topic 605-35, *Construction-Type and Production-Type Contracts* (ASC Topic 605-35). To the extent that multiple element arrangements include product sales, sales are generally recognized once revenue recognition criteria for the product deliverables have been met based on the provisions of ASC Topic 605. The Company includes any design and engineering services elements in EDC sales and any functional upgrade and product elements in product sales on the accompanying consolidated statements of

income.

Single Element Arrangements -

Products

To the extent that a single element arrangement provides for product sales and repairs, the Company recognizes revenue when revenue recognition criteria for the product deliverable have been met based on the provisions of ASC Topic 605. In addition, the Company receives orders for equipment and parts, and recognizes revenue at either the shipping point or upon receipt by the customer. Prior to the quarter ended December 31, 2016, the Company had not experienced significant returns of its products. During January 2017, the Company commenced negotiations with a customer to reconfigure their avionics system. In connection with those negotiations, the Company agreed to allow the return of products previously sold and, accordingly, net sales and net accounts receivable reflect reductions of \$0.5 million for the value of products returned by the customer.

The Company offers its customers extended warranties for additional fees, which it records as deferred revenue and recognizes as sales on a straight-line basis over the warranty periods.

Engineering Development Contracts

The Company may enter into contracts to perform specified design and EDC services related to its products. The Company recognizes revenue from these arrangements as EDC revenue, following the guidance included in ASC Topic 605-35, and considers the nature of these contracts (including term, size of contract, and level of effort) when determining the appropriate accounting treatment for a particular contract. For contracts that are long-term in nature, the Company believes that the use of the percentage-of-completion method is appropriate as the Company has the ability to make reasonably dependable estimates of the extent of progress

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towards completion, contract revenues, and contract costs. In certain circumstances, the Company uses the completed contract method for other contracts. Sales and profit margins under the percentage-of-completion method are recorded based on the ratio of actual costs incurred to total estimated costs expected to be incurred related to the contract under the cost-to-cost method.

The percentage-of-completion method of accounting requires the Company to estimate the profit margin for each individual contract, and to apply that profit margin on a uniform basis as sales are recorded under the contract. The estimation of profit margins requires the Company to make projections of the total sales to be generated and the total costs that will be incurred under a contract. The projections require the Company to make numerous assumptions and estimates relating to items such as the complexity of design and related development costs, performance of subcontractors, availability and cost of materials, engineering productivity and cost, overhead, and capital costs. Contracts sometimes include purchase options for additional quantities and customer change orders for additional or revised product functionality. Sales and costs related to profitable purchase options are included in the Company's estimates only when the options are exercised, while sales and costs related to unprofitable purchase options are included in the Company's estimates when exercise is determined to be probable. Sales related to change orders are included in profit estimates only if they can be estimated reliably and collectability is reasonably assured. Purchase options and change orders are accounted for either as an integral part of the original contract or separately, depending upon the nature and value of the item. Anticipated losses on contracts are recognized in full in the period in which losses become probable and estimable.

The Company reviews estimates of profit margins for contracts on a quarterly basis. Changes in these underlying estimates because of either revisions in sales and cost estimates or the exercise of contract options may result in profit margins being recognized unevenly over a contract because such changes are accounted for on a cumulative basis in the period in which estimates are revised. Significant changes in estimates related to accounting for long-term contracts may have a material effect on the Company's results of income in the period in which the revised estimate is made. Cumulative catch-up adjustments (loss contracts) resulting from changes in estimates are disclosed in the notes to the consolidated financial statements of the Company.

Customer Service Revenue

The Company enters into sales arrangements with customers for the repair or upgrade of its various products that are not under warranty. The Company's customer service revenue and cost of sales for the three months ended December 31, 2016 and 2015 respectively are as follows:

	For the Three Months Ended December 31,	
	2016	2015
Customer Service Sales	\$ 703,732	\$ 697,890
Customer Service Cost of Sales	342,439	283,239
Gross Profit	\$ 361,293	\$ 414,651

Income Taxes

Income taxes are recorded in accordance with ASC Topic 740, Income Taxes (ASC Topic 740), which utilizes a balance sheet approach to provide for income taxes. Under this method, the Company recognizes deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of the Company's assets, liabilities, and expected benefits of utilizing net operating losses (NOL) and tax credit carry-forwards. The impact on deferred taxes of changes in tax rates and laws, if any, are applied to the years during which temporary

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differences are expected to be settled, and are reflected in the consolidated financial statements in the period of enactment. At the end of each interim and year-end reporting period, the Company prepares an estimate of the annual effective income tax rate and applies that annual effective income tax rate to ordinary year-to-date pre-tax income for the interim period. Specific tax items discrete to a particular quarter are recorded in income tax expense for that quarter. The estimated annual effective tax rate used in providing for income taxes on a year-to-date basis may change in subsequent periods.

Deferred tax assets are reduced by a valuation allowance if, based on the consideration of all available evidence, it is more likely than not that some portion of the deferred tax asset will not be realized. Significant weight is given to evidence that can be objectively verified, and significant management judgment is required in determining any valuation allowance recorded against net deferred tax assets. The Company evaluates deferred income taxes on a quarterly basis to determine if a valuation allowance is required by considering available evidence. Deferred tax assets are recognized when expected future taxable income is sufficient to allow the related tax benefits to reduce taxes that would otherwise be payable. The sources of taxable income that may be available to realize the benefit of deferred tax assets are future reversals of existing taxable temporary differences, future taxable income exclusive of reversing temporary differences and credit carryforwards, taxable income in carryback years, and tax planning strategies which are both prudent and feasible. The Company's current balance of the deferred tax valuation allowance is recorded against the majority of the federal and state deferred tax assets. The remaining amount of the deferred tax assets recognized are attributable to tax planning

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strategies and the ability to carryback federal tax losses to claim a tax refund. The Company will continue to assess all available evidence during future periods to evaluate any changes to the realization of its deferred tax assets. If the Company were to determine that it would be able to realize additional federal or state deferred tax assets in the future, it would make an adjustment to the valuation allowance which would reduce the provision for income taxes.

The accounting for uncertainty in income taxes requires a more likely than not threshold for financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. The Company records a liability for the difference between the (i) benefit recognized and measured for financial statement purposes and (ii) the tax position taken or expected to be taken on the Company's tax return. To the extent that the Company's assessment of such tax positions changes, the change in estimate is recorded in the period in which the determination is made. The Company has elected to record any interest or penalties associated with uncertain tax positions as income tax expense.

The Company files a consolidated United States federal income tax return. The Company prepares and files tax returns based on the interpretation of tax laws and regulations, and records estimates based on these judgments and interpretations. In the normal course of business, the tax returns are subject to examination by various taxing authorities. Such examinations may result in future tax and interest assessments by these taxing authorities, and the Company records a liability when it is probable that there will be an assessment. The Company adjusts the estimates periodically as a result of ongoing examinations by and settlements with the various taxing authorities, and changes in tax laws, regulations and precedent. The consolidated tax provision of any given year includes adjustments to prior years' income tax accruals that are considered appropriate, and any related estimated interest. Management believes that it has made adequate accruals for income taxes. Differences between estimated and actual amounts determined upon ultimate resolution, individually or in the aggregate, are not expected to have a material effect on the Company's consolidated financial position, but could possibly be material to its consolidated results of operations or cash flow of any one period.

Engineering Development

The Company invests a large percentage of its sales on engineering development, both research and development (R&D) and EDC. At December 31, 2016, approximately 35% of the Company's employees were engineers engaged in various engineering development projects. Total engineering development expense is comprised of both internally funded R&D and product development and design charges related to specific customer contracts. Engineering development expense consists primarily of payroll-related expenses of employees engaged in EDC projects, engineering related product materials and equipment, and subcontracting costs. R&D charges incurred for product design, product enhancements, and future product development are expensed as incurred. Product development and design charges related to specific customer contracts are charged to cost of sales-EDC based on the method of contract accounting (either percentage-of-completion or completed contract) applicable to such contracts.

Treasury Stock

Treasury stock is recorded at acquisition cost. Gains and losses on disposition are recorded as increases or decreases to additional paid-in capital with losses in excess of previously recorded gains charged directly to retained earnings. When treasury shares are retired and returned to authorized but unissued status, the carrying value in excess of par is allocated to additional paid-in capital and retained earnings on a pro rata basis.

Comprehensive Income

Pursuant to FASB ASC Topic 220, *Comprehensive Income* (ASC Topic 220), the Company is required to classify items of other comprehensive income by their nature in the balance sheet and to display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of its condensed consolidated balance sheets. For the three months ended December 31, 2016 and 2015, respectively, comprehensive income consisted of net income only, and there were no items of other comprehensive income for any of the periods presented.

Share-Based Compensation

The Company accounts for share-based compensation under FASB ASC Topic 505-50, *Equity-Based Payments to Non-Employees* (ASC Topic 505-50), and ASC Topic 718, *Stock Compensation* (ASC Topic 718), which require the Company to measure the cost of employee or non-employee director services received in exchange for an award of equity instruments based on the grant-date fair value of the award using an option pricing model. The Company recognizes such cost over the period during which an employee or non-employee director is required to provide service in exchange for the award.

Warranty

The Company offers warranties on some products of various lengths, however the standard warranty is twenty-four months. At the time of shipment, the Company establishes a reserve for estimated costs of warranties based on its best estimate of the amounts necessary to settle future and existing claims using historical data on products sold as of the balance sheet date. The length of the

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warranty period, the product's failure rates, and the customer's usage affect warranty cost. If actual warranty costs differ from the Company's estimated amounts, future results of operations could be affected adversely. Warranty cost is recorded as cost of sales, and the reserve balance recorded as an accrued expense. While the Company maintains product quality programs and processes, its warranty obligation is affected by product failure rates and the related corrective costs. If actual product failure rates and/or corrective costs differ from the estimates, the Company revises estimated warranty liability accordingly.

Self-Insurance Reserves

Since January 1, 2014, the Company has self-insured a significant portion of its employee medical insurance. The Company maintains a stop-loss insurance policy that limits its losses both on a per employee basis and an aggregate basis. Liabilities associated with the risks that are retained by the Company are estimated based upon actuarial assumptions such as historical claims experience, demographic factors and other actuarial assumptions. The Company estimated the total medical claims incurred but not reported and the Company believes that it has adequate reserves for these claims at December 31, 2016. However, the actual value of such claims could be significantly affected if future occurrences and claims differ from these assumptions. At December 31, 2016 and September 30, 2016, the estimated liability for medical claims incurred but not reported was \$49,400 and \$52,600 respectively. The Company has recorded the excess of funded premiums over estimated claims incurred but not reported of \$269,000 and \$253,000 as a current asset in the accompanying condensed consolidated balance sheets as of December 31, 2016 and September 30, 2016, respectively.

Concentrations

Major Customers and Products

For the three months ended December 31, 2016, three customers, Sierra Nevada Corporation (Sierra Nevada), Pilatus Aircraft Limited (Pilatus) and the DoD accounted for 32%, 18% and 11% of net sales, respectively. For the three months ended December 31, 2015, three customers, DHL Aviation Services (DHL), ABX Air (ABX) and the DoD accounted for 23%, 18% and 12% of net sales, respectively.

Major Suppliers

The Company buys several of its components from sole source suppliers. Although there are a limited number of suppliers of particular components, management believes other suppliers could provide similar components on comparable terms.

For the three months ended December 31, 2016, the Company had two suppliers that were individually responsible for greater than 10% of the Company's total inventory related purchases. For the three months ended December 31, 2015, the Company had one supplier that was individually responsible for greater than 10% of the Company's total inventory related purchases.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentration of credit risk consist principally of cash balances and accounts receivable. The Company invests its excess cash where preservation of principal is the primary consideration. Cash balances are maintained with two major banks. Balances on deposit with certain money market accounts and operating accounts may exceed the Federal Deposit Insurance Corporation (FDIC) limits. The Company s customer base consists principally of companies within the aviation industry. The Company requests advance payments and/or letters of credit from customers that it considers to be credit risks.

The Company had allowances for doubtful accounts for unbilled receivables in the amount of \$3.6 million related to the Delta contract as of both December 31, 2016 and September 30, 2016 (See Unbilled Receivables below under Note 2. Supplemental Balance Sheet Disclosures).

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Recent Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). Under this guidance, an entity is required to recognize right-of-use assets and lease liabilities on its balance sheet and disclose key information about leasing arrangements. This guidance offers specific accounting guidance for lessees, and lessors, including with respect to sale and leaseback transactions. Lessees and lessors are required to disclose qualitative and quantitative information about leasing arrangements to enable a user of the financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. This guidance is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period, and requires a modified retrospective adoption, with early adoption permitted. The Company is currently evaluating the impacts of adoption of this guidance.

In November 2015, the FASB issued ASU 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes, which simplifies balance sheet presentation of deferred income taxes. Previous guidance required an entity to separate deferred income tax liabilities and assets into current and noncurrent amounts in a classified statement of financial position; however, the new guidance requires that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The updated standard is effective for the Company beginning October 1, 2017, with early adoption permitted as of the beginning of any interim or annual reporting period. The Company early adopted this standard retrospectively and reclassified its current deferred tax balances to noncurrent deferred tax for all periods presented. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

In July 2015, the FASB issued guidance regarding Simplifying the Measurement of Inventory. This guidance requires entities to measure most inventory at the lower of cost and net realizable value, thereby simplifying the current guidance under which an entity must measure inventory at the lower of cost or market (market in this context is defined as one of three different measures). The guidance will not apply to inventories that are measured by using either the last-in, first-out (LIFO) method or the retail inventory method (RIM). The guidance is effective for the Company beginning October 1, 2017. Early adoption is permitted. The Company is currently assessing the impact of this guidance on its financial statements disclosure.

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40) (ASU 2014-15). The objective of ASU 2014-15 is to define management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and provide related disclosures. Currently, GAAP does not provide guidance to evaluate whether there is substantial doubt regarding an organization's ability to continue as a going concern. This ASU provides guidance to an organization's management, with principles and definitions to reduce diversity in the timing and content of financial statement disclosures commonly provided by organizations. ASU 2014-15 is effective for periods ending after December 15, 2016 and interim periods within annual periods beginning after December 15, 2016. Early adoption is permitted.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (ASC Topic 606) (ASU 2014-09). ASU 2014-09 will supersede existing revenue recognition guidance and require revenue to be recognized when promised goods or services are transferred to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standards were scheduled to be effective for reporting periods beginning after December 15, 2016, and early adoption is not permitted. However, on July 9, 2015, the FASB decided to delay the effective date of the new revenue standard by one year, but reporting entities may choose to adopt the standard as of the original effective date. Additionally, during 2016, the FASB issued ASU Nos. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Gross versus Net), ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, and ASU 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients, all of which should be adopted concurrent with ASU 2014-09. Adoption of the new rules could affect the timing of revenue recognition for certain transactions. The guidance permits two implementation approaches, one requiring retrospective application of the new standard with restatement of prior years and one requiring retrospective

application of the new standard with the cumulative effect of applying the new standard as of the date of initial application recognized and disclosure of results under old standards. The FASB has recently issued an Exposure Draft of a proposed ASU that would delay by one year the effective date of this standard. The Company is currently evaluating the impacts of adoption and the implementation approach to be used.

As new accounting pronouncements are issued, we will adopt those that are applicable under the circumstances.

2. Supplemental Balance Sheet Disclosures

Unbilled Receivables

Unbilled receivables principally represent sales recorded under the percentage-of-completion method of accounting that have not been billed to customers in accordance with applicable contract terms. Unbilled receivables, net of progress payments and an impairment of \$3.6 million related to the Delta contract were \$1.6 million at December 31, 2016 and September 30, 2016.

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Significant changes in estimates related to accounting for long-term contracts under the percentage-of-completion method may have a material effect on the Company's results of operations in the period in which the revised estimates are made. Cumulative catch-up adjustments resulting from changes in estimates increased operating income by \$154,000 for the three months ended December 31, 2016. Cumulative catch-up adjustments resulting from changes in estimates decreased operating income by \$46,000 for the three months ended December 31, 2015.

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market, net of write-downs for excess and obsolete inventory, and consist of the following:

	December 31, 2016	September 30, 2016
Raw materials	\$ 3,173,982	\$ 2,966,891
Work-in-process	688,537	500,869
Finished goods	335,913	178,068
	\$ 4,198,432	\$ 3,645,828

Prepaid expenses and other current assets

Prepaid expenses and other current assets consist of the following:

	December 31, 2016	September 30, 2016
Prepaid insurance	\$ 498,139	\$ 386,212
Income tax refund receivable	479,726	106,932
Other	244,730	354,063
	\$ 1,222,595	\$ 847,207

Property and equipment

Property and equipment, net consists of the following:

December 31, 2016	September 30, 2016
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Land	\$	1,021,245	\$	1,021,245
Computer equipment		2,224,772		2,208,398
Corporate airplane		3,194,571		3,194,571
Furniture and office equipment		1,052,284		1,052,284
Manufacturing facility		5,733,313		5,733,313
Equipment		5,466,915		5,435,949
		18,693,100		18,645,760
Less: accumulated depreciation and amortization		(11,791,534)		(11,683,198)
	\$	6,901,566	\$	6,962,562

Depreciation and amortization related to property and equipment was approximately \$108,000 and \$114,000 for the three months ended December 31, 2016 and 2015, respectively. The corporate airplane is utilized primarily in support of product development and has been depreciated to its estimated salvage value.

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Other assets consist of the following:

	December 31, 2016	September 30, 2016
Intangible assets, net of accumulated amortization of \$529,037 at December 31, 2016 and September 30, 2016	\$ 71,200	\$ 71,200
Other non-current assets	85,748	85,748
	\$ 156,948	\$ 156,948

Intangible assets consist of licensing and certification rights which are amortized over a defined number of units. No impairment charges were recorded in the three months ended December 31, 2016 and 2015.

There was no amortization expense for the three months ended December 31, 2016 and 2015. The timing of future amortization expense is not determinable because the intangible assets are being amortized over a defined number of units.

Accrued expenses

Accrued expenses consist of the following:

	December 31, 2016	September 30, 2016
Warranty	\$ 1,025,442	\$ 1,009,368
Salary, benefits and payroll taxes	375,418	267,323
Professional fees	408,528	308,905
Other, including losses on contracts	436,766	304,312
	\$ 2,246,154	\$ 1,889,908

Other accrued expense at December 31, 2016 and September 30, 2016 includes \$0.0 million and \$0.1 million of EDC program costs, respectively.

Warranty cost and accrual information for the three months ended December 31, 2016 is highlighted below:

**Three Months Ending
December 31, 2016**

Warranty accrual, beginning of period	\$	1,009,368
Accrued expense		66,970
Warranty cost		(50,896)
Warranty accrual, end of period	\$	1,025,442

3. Income Taxes

The income tax benefit for the three months ended December 31, 2016 was \$371,000 as compared to an income tax benefit of \$54,000 for the three month ended December 31, 2015.

The effective tax rate for the three months ended December 31, 2016 was 23.7%. The effective tax rate for the three months ended December 31, 2016 differs from the statutory rate primarily due to a change in the valuation allowance in the current period.

The effective tax rate for the three months ended December 31, 2015 was 20%. The effective tax rate for the three months ended December 31, 2015 differs from the statutory rate due to a limitation in the amount of tax benefit that may be realized.

In the period ended June 30, 2015, a valuation allowance was recorded on the majority of the Company's federal and state deferred tax assets, net of liabilities, due to the uncertainty on the Company's ability to generate sufficient future taxable income to realize such deferred tax assets. The remaining amount of deferred tax assets recognized were attributable to tax planning strategies. The Company will continue to maintain the balance of the valuation allowance until an appropriate level of profitability is sustained to warrant a conclusion that it is no longer more likely than not that a portion of these net deferred tax assets will not be realized in future periods.

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4. Shareholders Equity and Share-based Payments

At December 31, 2016, the Company's Amended and Restated Articles of Incorporation provides the Company authority to issue 75,000,000 shares of common stock and 10,000,000 shares of preferred stock.

Share-based compensation

The Company accounts for share-based compensation under the provisions of ASC Topic 505-50 and ASC Topic 718 by using the fair value method for expensing stock options and stock awards.

Total share-based compensation expense was approximately \$0 and \$55,000 for the three months ended December 31, 2016 and 2015, respectively. The income tax effect recognized as a credit to additional paid-in capital related to share-based compensation arrangements was \$0 for the three months ended December 31, 2016 and 2015. Compensation expense related to share-based awards is recorded as a component of general and administrative expense.

The Company has three share-based compensation plans, the 1998 Stock Option Plan (the 1998 Plan), the 2003 Restricted Stock Plan (the Restricted Plan) and the 2009 Stock-Based Incentive Compensation Plan (the 2009 Plan), each of which the shareholders approved. The 1998 Plan expired on November 13, 2008. The last awards under the Restricted Plan were made in 2010, and no further shares remain to be awarded under the Restricted Plan.

1998 Stock Option Plan

The 1998 Plan allowed the granting of incentive and nonqualified stock options to employees, officers, directors and independent contractors, and consultants. No stock options were granted to independent contractors or consultants under this plan. Incentive stock options granted under the 1998 Plan have exercise prices that are at least equal to the fair value of the common stock on the grant date. Nonqualified stock options granted under the plan have exercise prices that are less than, equal to or greater than the fair value of the common stock on the date of grant. The Company reserved 3,389,000 shares of common stock for awards under the plan. On November 13, 2008, the 1998 Plan expired and no additional shares were granted under the 1998 Plan after that date.

Total compensation expense associated with stock option awards to employees under the 1998 Plan was \$0 for December 31, 2016 and December 31, 2015.

2009 Stock-Based Incentive Compensation Plan

The 2009 Plan authorizes the grant of stock appreciation rights, restricted stock, options, RSUs and other equity-based awards (collectively referred to as Awards). Options granted under the 2009 Plan may be either incentive stock options as defined in section 422 of the Internal Revenue Code of 1986, as amended (the Code), or nonqualified stock options, as determined by the Compensation Committee of the Company s Board of Directors (the Compensation Committee).

Subject to an adjustment necessary upon a stock dividend, recapitalization, forward split or reverse split, reorganization, merger, consolidation, spin-off, combination, repurchase or share exchange, extraordinary or unusual cash distribution, or other similar corporate transaction or event, the maximum number of shares of common stock available for Awards under the 2009 Plan shall be 1,200,000, all of which may be issued pursuant to Awards of incentive stock options. In addition, the Plan provides that no more than 300,000 shares of common stock per year may be awarded to any employee as a performance-based Award under Section 162(m) of the Code. At December 31, 2016 there were 257,264 shares of common stock available for awards under the plan.

If any Award is forfeited, or if any option terminates, expires or lapses without being exercised, the related shares of common stock subject to such Award will again be available for future grant. Any shares tendered by a participant in payment of the exercise price of an option or the tax liability with respect to an Award (including, in any case, shares withheld from any such Award) will not be available for future grant under the 2009 Plan. If there is any change in the Company s corporate capitalization, the Compensation Committee must proportionately and equitably adjust the number and kind of shares of common stock which may be issued in connection with future Awards, the number and type of shares of common stock covered by Awards then outstanding under the 2009 Plan, the number and type of shares of common stock available under the 2009 Plan, the exercise or grant price of any Award, or if deemed appropriate, make provision for a cash payment with respect to any outstanding Award, provided that no adjustment may be made that would adversely affect the status of any Award that is intended to be a performance-based Award under Section 162(m) of the Code, unless otherwise determined by the Compensation Committee. In addition, the Compensation Committee may make adjustments in the terms and conditions of any Awards, including any performance goals, in recognition of unusual or nonrecurring events affecting the Company or any subsidiary, or in response to changes in applicable laws, regulations or accounting principles, provided that no adjustment may be made that would adversely affect the status of any Award that is intended to be a performance-based Award under Section 162(m) of the Code, unless otherwise determined by the Compensation Committee.

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On April 17, 2014, the Board of Directors resolved to revise the valuation date and the timing of the issuance of the awards of non-vested shares of common stock to each eligible non-employee director under the 2009 Plan. Effective January 1, 2015, the awards had a fair market value of \$40,000 each at the close of business on the first business day after January 1 of each calendar year and will be issued on the first business day of the next year. If any non-employee director resigns from the Board of Directors prior to December 31 of such calendar year, the Company will issue to such non-employee director a pro-rata number of shares through the date of resignation.

Total compensation expense related to Options issued to employees under the 2009 Plan was approximately \$0 and \$55,000 for the three months ended December 31, 2016 and 2015, respectively. The expense under the 2009 Plan related to shares issued to non-employee members of the Company's Board of Directors as compensation was \$0 for the three months ended December 31, 2016 and 2015. Total compensation expense associated with the 2009 Plan was \$0 and \$55,000 for the three months ended December 31, 2016 and 2015, respectively.

Restricted Stock Units

During fiscal 2016, the Company's Board of Directors (the Board) approved grants of RSUs to the non-employee directors on the Board as compensation for their services during calendar year 2016. Under the terms of the awards, at the conclusion of the vesting period on January 2, 2017, the grants of RSUs were settled in shares of the Company's common stock at a rate of one share of stock for each unit. Directors that did not serve for the entirety of calendar year 2016 received a pro rata portion of such award for time served. As of December 31, 2016, there were 67,115 unvested restricted stock units outstanding under the 2009 Plan, all of which were issued during the fiscal year ended September 30, 2016.

Stock repurchase program

On April 14, 2016, the Company's Board of Directors approved the extension of the Company's share repurchase program which allowed the Company to acquire up to 250,000 shares of its outstanding common stock for one year beginning May 1, 2016. Under the share repurchase program, the Company was permitted to purchase shares of its common stock through open market transactions, in privately negotiated block purchases, or in other private transactions (either solicited or unsolicited). The timing and amount of repurchase transactions under this program was subject to market conditions, and corporate and regulatory considerations. The Company was also permitted to discontinue or suspend the program at any time. The Company funding for this program was derived from available corporate funds, including cash on hand and cash flows from operations. During the year ended September 30, 2016, the Company purchased 250,000 shares of its common stock under the program. The aggregate cost of the shares purchased was \$724,776 at an average cost per share of \$2.90. As of December 31, 2016, no shares are available to be purchased under the program.

Table of Contents**5. Earnings Per Share**

	Three Months Ended December 31,	
	2016	2015
Numerator:		
Net income (loss)	\$ (1,194,974)	\$ (215,438)
Denominator:		
Basic weighted average shares	16,716,014	16,909,638
Dilutive effect of share-based awards		
Diluted weighted average shares	16,716,014	16,909,638
Earnings per common share:		
Basic EPS	\$ (0.07)	\$ (0.01)
Diluted EPS	\$ (0.07)	\$ (0.01)

Earnings per share (EPS) are calculated pursuant to FASB ASC Topic 260, *Earnings Per Share* (ASC Topic 260). Basic EPS excludes potentially dilutive securities and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted EPS is computed assuming the conversion or exercise of all dilutive securities such as employee stock options.

The number of incremental shares from the assumed exercise of stock options is calculated by using the treasury stock method. As of December 31, 2016 and 2015, there were 586,834 and 611,168 options to purchase common stock outstanding, respectively. The average outstanding diluted shares calculation excludes options with an exercise price that exceeds the average market price of shares during the period.

For the three months ended December 31, 2016 and 2015, respectively, 587,341 and 645,081 diluted weighted average- shares outstanding were excluded from the computation of diluted EPS because the effect would be anti-dilutive.

6. Contingencies

The Company previously announced that Delta Airlines (Delta) purported to terminate its contract with the Company to develop, manufacture and install new cockpit displays and certain navigation capabilities on Delta 's fleet of approximately 182 MD88 and MD90 aircraft. The Company initiated and engaged in a non-binding mediation with Delta on February 25, 2015. The mediation session did not resolve the dispute. On February 25, 2015, the Company filed a complaint against Delta in the United States District Court for the Eastern District of Pennsylvania for breach of contract. The Company has alleged in the case, captioned Innovative Solutions & Support, Inc. v. Delta Airlines, Inc. E.D. Pa. Civ. No. 15-959, that Delta 's purported termination of the contract was wrongful and in breach of the terms of the contract, and is seeking monetary damages. On March 20, 2015, Delta answered the Company 's complaint and filed counterclaims against the Company for breach of contract and breach of the duty of good faith and fair dealing, also seeking monetary damages. The parties have completed discovery and have each filed motions for summary judgment. On January 23, 2017, the Court denied both the Company 's and Delta 's motions for summary judgment. Pre-trial settlement conferences were held on December 16, 2016 and January 12, 2017 and the parties continue to discuss settlement. The outcome of the Delta matter is not determinable at this time. The Company had \$3.6 million of unbilled receivables and \$0.2 million of inventory on its balance sheet relating to the Delta program at September 30, 2016 both of which are fully reserved.

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These forward looking statements are based largely on current expectations and projections about future events and trends affecting the business, are not guarantees of future performance, and involve a number of risks, uncertainties and assumptions that are difficult to predict. In this report, the words anticipates, believes, may, will, estimates, continues, anticipates, intends, forecasts, expects, plans, could, should, would, is likely and similar expressions, as they relate to the business or to its management, are intended to identify forward looking statements, but they are not exclusive means of identifying them. Unless the context otherwise requires, all references herein to IS&S, the Registrant, the Company, we, us or our are to Innovative Solutions and Support, Inc. and its consolidated subsidiaries.

The forward looking statements in this report are only predictions, and actual events or results may differ materially. In evaluating such statements, a number of risks, uncertainties and other factors could cause actual results, performance, financial condition, cash flows, prospects and opportunities to differ materially from those expressed in, or implied by, the forward looking statements. These risks, uncertainties and other factors include those set forth in Item 1A (Risk Factors) of this Annual Report on Form 10-K and the following factors:

- *market acceptance of the Company's flat panel display systems, or COCKPIT/IP® or other planned products or product enhancements;*
- *continued market acceptance of the Company's air data systems and products;*
- *the competitive environment and new product offerings from competitors;*
- *difficulties in developing and producing the Company's COCKPIT/IP® Flat Panel Display System or other planned products or product enhancements;*
- *the deferral or termination of programs or contracts for convenience by customers;*
- *the availability of government funding;*
- *the impact of general economic trends on the Company's business;*
- *the ability to gain regulatory approval of products in a timely manner;*
- *delays in receiving components from third party suppliers;*
- *the bankruptcy or insolvency of one or more key customers;*
- *protection of intellectual property rights;*

- *failure to retain/recruit key personnel;*
- *a cyber security incident;*
- *the ability to service the international market;*
- *risks related to our self-insurance program;*
- *potential future acquisitions; and*
- *other factors disclosed from time to time in the Company's filings with the United States Securities and Exchange Commission (the SEC).*

Except as expressly required by the federal securities laws, the Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise after the date of this report. Results of operations in any past period should not be considered indicative of the results to be expected for future periods. Fluctuations in operating results may result in fluctuations in the price of the Company's common stock.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this Form 10-Q. The Company does not undertake any obligation to release publicly any revisions to these forward-looking statements to reflect events, circumstances, or changes in expectations after the date of this Form 10-Q, or to reflect the occurrence of unanticipated events. The forward-looking statements in this document are intended to be subject to the safe harbor protection provided by Sections 27A of the Securities Act of 1933, as amended (the Securities Act) and 21E of the Exchange Act.

*Investors should also be aware that while the Company, from time to time, communicates with securities analysts, it is against its policy to disclose any material non-public information or other confidential commercial information. Accordingly, shareholders should not assume that the Company agrees with any statement or report issued by any analyst irrespective of the content of the statement or report. Furthermore, the Company has a policy against issuing or confirming financial forecasts or projections issued by others. Thus, to the extent that reports issued by securities analysts contain any projections, forecasts or opinions, such reports are **not** the responsibility of the Company.*

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Company Overview

Innovative Solutions and Support, Inc. (the Company or IS&S) was incorporated in Pennsylvania on February 12, 1988. The Company operates in one business segment as a systems integrator that designs, develops, manufactures, sells, and services air data equipment, engine display systems, standby equipment, primary flight guidance, and cockpit display systems for retrofit applications and original equipment manufacturers (OEMs). The Company supplies integrated Flight Management Systems (FMS), Flat Panel Display Systems (FPDS), Integrated Standby Units (ISU) and advanced Global Positioning System (GPS) receivers that enable reduced carbon footprint navigation.

The Company has continued to position itself as a system integrator, which capability provides the Company with the potential to generate more substantive orders over a broader product base. The strategy, as both a manufacturer and integrator, is designed to leverage the latest technologies developed for the computer and telecommunications industries into advanced and cost-effective solutions for the general aviation, commercial air transport, United States Department of Defense (DoD)/governmental, and foreign military markets. This approach, combined with the Company's industry experience, is designed to enable IS&S to develop high-quality products and systems, to reduce product time to market, and to achieve cost advantages over products offered by its competitors.

For several years the Company has been working with advances in technology to provide pilots with more information to enhance both the safety and efficiency of flying, and has developed its COCKPIT/IP® Cockpit Information Portal (CIP) product line that incorporates proprietary technology, low cost, reduced power consumption, decreased weight, and increased functionality. The Company believes the CIP product line is suited to address market demand that will be driven by regulatory mandates, new technologies, and the high cost of maintaining aging/obsolete equipment on airplanes that have been in service for up to fifty years. The Company has also incorporated Electronic Flight Bag (EFB) functionality, such as charting and mapping systems, in its FPDS product line.

More recently, the Company has developed an FMS that combines the savings long associated with in flight fuel optimization in enroute flight management combined with the precision of satellite-based navigation required to comply with the regulatory environments of both domestic and international markets. The Company believes that the FMS coupled with its FPDS product line is well suited to address market demand driven by further regulatory mandates, new technologies, and the high cost of maintaining aging and obsolete equipment on aircraft that will be in service for up to fifty years. The shift in the regulatory and technological environment is illustrated by the dramatic increase in the number of Space Based Augmentation System (SBAS) or Wide Area Augmentation System (WAAS) approach qualified airports, particularly as realized through Localizer Performance with Vertical guidance (LPV) navigation procedures. Aircraft equipped with the Company's FMS and FPDS product line (equipped with a SBAS/WAAS/LPV enabled navigator) will be qualified to land at such airports and to comply with upcoming Federal Aviation Administration (FAA) mandates for Required Navigation Performance (RNP) and Automatic Dependent Surveillance-Broadcast (ADS-B) navigation, a fact which IS&S believes will further increase the demand for the Company's products. The Company's FMS/FPDS product line is designed for new production and retrofit applications into general aviation, commercial air transport and military transport aircraft. In addition, the Company offers an innovative ISU, integrating the full functionality of the primary and navigation displays into a small backup-powered unit. This ISU builds on the Company's legacy air data computer to form a complete next-generation cockpit display and navigation upgrade offering to the commercial and military markets.

IS&S sells to both the OEM and retrofit market. Customers include various OEMs, commercial air transport carriers and corporate/general aviation companies, DoD and its commercial contractors, aircraft operators, aircraft modification centers and foreign militaries. Occasionally, IS&S sells its products directly to DoD; however, the Company sells its products primarily to commercial customers for end use in DoD programs. Sales to defense contractors are generally made on commercial terms, although some of the termination and other provisions of government contracts are applicable to these contracts.

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Customers have been and may continue to be affected by the uncertain economic conditions that currently exist both in the United States and abroad. Such conditions may cause customers to curtail or delay their spending on both new and existing aircraft. Factors that can impact general economic conditions and the level of spending by customers include, but are not limited to, general levels of consumer spending, increases in fuel and energy costs, conditions in the real estate and mortgage markets, labor and healthcare costs, access to credit, consumer confidence, and other macroeconomic factors that affect spending behavior. In addition, the Budget Control Act of 2011 (the Budget Act) triggered substantial, automatic reductions in both defense and discretionary spending. The automatic across-the-board sequestration cuts are in addition to reductions already reflected in defense funding over a ten-year period. Furthermore, spending by government agencies may be reduced in the future if tax revenues decline. If customers curtail or delay their spending or are forced to declare bankruptcy or liquidate their operations because of adverse economic conditions, the Company's revenues and results of operations would be affected adversely. However, the Company believes that, in an uncertain economic environment, customers that may have otherwise elected to purchase newly manufactured aircraft may be interested instead in retrofitting existing aircraft as a cost-effective alternative, thereby creating a market opportunity for IS&S.

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Cost of sales related to product sales is comprised of material components and third-party avionics purchased from suppliers, direct labor, and overhead costs. Many of the components are standard, although certain parts are manufactured to meet IS&S specifications. The overhead portion of cost of sales is comprised primarily of salaries and benefits, building occupancy costs, supplies, and outside service costs related to production, purchasing, material control, and quality control. Cost of sales includes warranty costs.

Cost of sales related to engineering development contracts (EDC) sales is comprised of engineering labor, consulting services, and other costs associated with specific design and development projects. These costs are incurred pursuant to contractual arrangements and are accounted for typically as contract costs within cost of sales with the reimbursement accounted for as a sale in accordance with the percentage-of-completion method of accounting. Company funded research and development (R&D) expenditures relate to internally-funded efforts towards the development of new products and the improvement of existing products. These costs are expensed as incurred and reported as R&D expenses. The Company intends to continue investing in the development of new products that complement current product offerings and to expense associated R&D costs as they are incurred.

Selling, general and administrative expenses consist of sales, marketing, business development, professional services, salaries and benefits for executive and administrative personnel, facility costs, recruiting, legal, accounting, bad debt expense and other general corporate expenses.

Critical Accounting Policies and Estimates

The discussion and analysis of financial condition and consolidated results of operations are based upon the Company's condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. The preparation of these condensed consolidated financial statements requires estimates and assumptions that affect the reported amounts of assets, liabilities, sales and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, IS&S management evaluates its estimates based upon historical experience and various other assumptions that it believes to be reasonable in the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The Company believes that its critical accounting policies affect its more significant estimates and judgments used in the preparation of its consolidated financial statements. The Annual Report on Form 10-K for the fiscal year ended September 30, 2016 contains a discussion of these critical accounting policies. There have been no significant changes in the Company's critical accounting policies since September 30, 2016. See also Note 1 to the unaudited condensed consolidated financial statements for the three month period ending December 31, 2016 as set forth herein.

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**RESULTS OF OPERATIONS FOR THE THREE AND MONTHS ENDED
December 31, 2016 AND 2015**

The following table sets forth the statement of operations data expressed as a percentage of total net sales for the periods indicated (some items may not add due to rounding):

	Three Months Ended December 31,	
	2016	2015
Net sales:		
Product	89.6%	90.2%
Engineering development contracts	10.4%	9.8%
Total net sales	100.0%	100.0%
Cost of sales:		
Product	51.7%	44.2%
Engineering development contracts	2.6%	5.4%
Total cost of sales	54.3%	49.6%
Gross profit	45.7%	50.4%
Operating expenses:		
Research and development	32.3%	14.2%
Selling, general and administrative	60.8%	40.9%
Total operating expenses	93.1%	55.1%
Operating (loss) income	(47.4)%	(4.7)%
Interest income	0.3%	0.1%
Other income	0.5%	0.5%
(Loss) income before income taxes	(46.6)%	(4.1)%
Income tax (benefit)	(11.0)%	(0.8)%
Net (loss) income	(35.6)%	(3.3)%

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Three Months Ended December 31, 2016 Compared to the Three Months Ended December 31, 2015

Net sales. Net sales were \$3.4 million for the three months ended December 31, 2016 compared to \$6.6 million for the three months ended December 31, 2015, a decrease of 49%. Product sales decreased \$2.9 million in the three months ended December 31, 2016 compared to the three months ended December 31, 2015, and EDC sales decreased \$0.3 million from the same period in the prior year. Product sales decreased from the same period in the prior year primarily because of decreased shipments of displays for retrofit programs to commercial transport customers, the DoD and commercial subcontractors. Additionally, in January 2017, the Company offered our customer an updated and simplified version of a system originally sold to them that provides LPV capability. As the result the Company accepted the return of certain equipment and recognized a \$0.5 million reduction in net sales for the quarter ended December 31, 2016. The decrease in EDC sales was primarily the result of less revenue being recognized from EDC projects awarded in prior years as these projects are nearing completion and they have not been replaced by new EDC projects.

Cost of sales. Cost of sales decreased \$1.4 million, or 44%, to \$1.8 million, or 54.3% of net sales, in the three months ended December 31, 2016, compared to \$3.3 million, or 49.7% of net sales, in the three months ended December 31, 2015. The decrease in cost of sales was primarily the result of a decrease in product sales volume for the three months ended December 31, 2016 compared to the three months ended December 31, 2015. The Company's overall gross margin was 45.7% and 50.3% for the quarters ended December 31, 2016 and 2015, respectively. This decrease in overall gross margin primarily reflects a lower product gross margin primarily the result of reduced coverage of fixed costs due to lower sales volume.

Research and development. R&D expense increased by \$0.2 million to \$1.1 million for the three month periods ended December 31, 2016 versus \$0.9 million for the three months ended December 31, 2015. R&D expense represented 32.3% and 14.2% of net sales in such periods, respectively. The increase in R&D expense as a percentage of net sales resulted primarily from a higher proportion of efforts focused upon internal projects rather than EDC programs, whose costs are reflected in cost of sales rather than as R&D expense, and lower sales volumes.

Selling, general, and administrative. Selling, general and administrative expense decreased by \$0.7 million to \$2.0 million in the three months ended December 31, 2016 from \$2.7 million in the three months ended December 31, 2015. The decrease in selling, general, and administrative expense in the three month period was primarily the result of lower legal fees related to the litigation arising from the purported termination of the Delta contract as compared to the three months ended December 31, 2015. As a percentage of net sales, selling, general and administrative expenses increased to 60.8% of net sales in the three months ended December 31, 2016 from 40.9% of net sales in the three months ended December 31, 2015, which is reflective of the lower sales volumes.

Interest income. Interest income increased to \$10,000 in the three months ended December 31, 2016 from \$7,000 in the three months ended December 31, 2015, mainly a result of higher average cash balances as of December 31, 2016.

Other income. Other income was \$19,000 in the three months ended December 31, 2016 and \$32,000 for the three months ended December 31, 2015. Other income is mainly composed of royalties earned during each of the quarters ended December 31, 2016 and December 31, 2015.

Income tax expense. The income tax benefit for the three months ended December 31, 2016 was \$371,000 compared to tax benefit of \$54,000 for the three months ended December 31, 2015. The effective tax rate for the three months ended December 31, 2016 was 23.7% and differs from the statutory rate primarily due to the change in the valuation allowance in the current period.

The effective tax rate benefit for the three months ended December 31, 2015 was 20.0% and differs from the statutory rate due to the limitation in the amount of tax benefit that may be realized.

Net (loss) income. The Company reported a net loss for the three months ended December 31, 2016 of \$1.2 million compared to net loss of \$0.2 million for the three months ended December 31, 2015. On a diluted basis, the loss per share was \$0.07 for the three months ended December 31, 2016 compared to loss per share of \$0.01 for the three months ended December 31, 2015.

Table of Contents**Liquidity and Capital Resources**

The following table highlights key financial measurements of the Company:

	December 31, 2016	September 30, 2016
Cash and cash equivalents	\$ 18,161,147	\$ 18,767,661
Accounts receivable	3,786,980	4,511,091
Current assets	28,973,223	29,369,459
Current liabilities	4,310,999	3,573,264
Deferred revenue	351,229	179,585
Total debt and other non-current liabilities (1)	67,708	67,701
Quick ratio (2)	5.09	6.51
Current ratio (3)	6.69	8.22

	Three Months Ended December 31,	
	2016	2015
Cash flow activities:		
Net cash (used in) provided by operating activities	\$ (559,174)	\$ 56,956
Net cash (used in) investing activities	(47,340)	(65,504)
Net cash (used in) provided by financing activities		

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- (1) Excludes deferred revenue
- (2) The sum of cash and cash equivalents plus accounts receivable, divided by current liabilities
- (3) Current assets divided by current liabilities

The Company's principal source of liquidity has been from cash flows generated from current year operations and cash accumulated from prior years' operations. Cash is used principally to finance inventory, accounts receivable, unbilled receivables, and payroll, which are all collectively leveraged to execute the Company's growth strategies and to return value to its shareholders.

Operating activities

The cash used in operating activities during the three months ended December 31, 2016 mainly funded a loss of \$1.2 million and an increase in inventory of \$0.6 million, and was partially offset by a decrease of accounts receivable of \$0.7 million, an increase in accrued expenses of \$0.4

million and an increase in accounts payable of \$0.2 million.

Cash generated by operating activities for the three months ended December 31, 2015 resulted primarily from the net effect of decreases of prepaid expenses and other current assets of \$0.3 million, unbilled receivables of \$1.2 million, which principally represent sales recorded under the percentage-of-completion method of accounting that have been billed to customers in accordance with applicable EDC terms, and an increase to accounts payable and accrued expenses of \$1.5 million. These increases were offset by an increase of accounts receivable of \$3.0 million.

Investing activities

Cash used in investing activities was \$0 and \$0.1 million for the three months ended December 31, 2016 and 2015, respectively, and consisted primarily of the purchase of production and laboratory test equipment.

Financing activities

Net cash used by financing activities was \$0 for each of the three months ended December 31, 2016 and 2015.

Summary

Future capital requirements depend upon numerous factors, including market acceptance of the Company's products, the timing and rate of expansion of business, acquisitions, joint ventures, and other factors. IS&S has experienced increases in expenditures since its inception and anticipates that expenditures will continue in the foreseeable future. The Company believes that its cash and cash equivalents will provide sufficient capital to fund operations for at least the next twelve months. However, IS&S may need to develop and introduce new or enhanced products, respond to competitive pressures, invest in or acquire businesses or technologies, or respond to unanticipated requirements or developments. If insufficient funds are available, the Company may not be able to introduce new products or compete effectively.

Table of Contents**Backlog**

Backlog activity for the three months ended December 31, 2016 (in thousands):

	Three Months Ended December 31, 2016	
Backlog, beginning of period	\$	4,569
Bookings, net		5,276
Recognized in revenue		(3,824)
Backlog, end of period	\$	6,021

At December 31, 2016 and September 30, 2016, the Company's backlog was \$6.0 million and \$4.6 million, respectively. Backlog represents the value of contracts and purchase orders received, less sales recognized to date on those contracts and purchase orders. The \$1.4 million increase in backlog was the result of \$5.3 million in net new business orders, offset by \$3.8 million of sales recognized for the three months ended December 31, 2016. At December 31, 2016, none of the Company's backlog was expected to be filled beyond fiscal 2017. To the extent new business orders do not continue to equal or exceed sales recognized in the future from the Company's existing backlog, future operating results may be impacted negatively.

Off-Balance Sheet Arrangements

IS&S has no relationships with unconsolidated entities or financial partnerships, such as Special Purpose Entities or Variable Interest Entities, established for the purpose of facilitating off-balance sheet arrangements or other limited purposes.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's operations are exposed to market risks primarily as a result of changes in interest rates. The Company does not use derivative financial instruments for speculative or trading purposes. The Company's exposure to market risk for changes in interest rates relates to its cash equivalents. The Company's cash equivalents consist of funds invested in money market accounts, which bear interest at a variable rate. The Company does not participate in interest rate hedging. Cash balances are maintained with two major banks. Balances on deposit with certain money market accounts and operating accounts may exceed the Federal Deposit Insurance Corporation (FDIC) limits. A change in interest rates earned on the cash equivalents would impact interest income and cash flows, but would not impact the fair market value of the related underlying instruments. Assuming that the balances during the three months ended December 31, 2016 were to remain constant and the Company did not act to alter the existing interest rate sensitivity, a hypothetical 1% increase in variable interest rates would have affected interest income by approximately \$46,000 with a resulting impact on cash flows of approximately \$46,000 for the three months ended December 31, 2016.

Item 4. Controls and Procedures

(a) We carried out an evaluation under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act), as of December 31, 2016. Based on that evaluation, our chief executive officer and chief financial officer concluded that these controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is i) recorded, processed, summarized, and reported, within the time periods specified in the rules and forms of the Securities and Exchange Commission and ii) accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(b) Management's annual report on internal control over financial reporting as previously disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2016.

(c) There were no changes in the Company's internal control over financial reporting identified in connection with the evaluation of such controls that occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

In the ordinary course of business, IS&S is at times subject to various legal proceedings and claims. Except as set forth below, the Company does not believe any such matters that are currently pending will, individually or in the aggregate, have a material effect on the results of operations or financial position.

The Company previously announced that Delta Airlines (Delta) purported to terminate its contract with the Company to develop, manufacture and install new cockpit displays and certain navigation capabilities on Delta s fleet of approximately 182 MD88 and MD90 aircraft. The Company initiated and engaged in a non-binding mediation with Delta on February 25, 2015. The mediation session did not resolve the dispute. On February 25, 2015, the Company filed a complaint against Delta in the United States District Court for the Eastern District of Pennsylvania for breach of contract. The Company has alleged in the case, captioned Innovative Solutions & Support, Inc. v. Delta Airlines, Inc. E.D. Pa. Civ. No. 15-959, that Delta s purported termination of the contract was wrongful and in breach of the terms of the contract, and is seeking monetary damages. On March 20, 2015, Delta answered the Company s complaint and filed counterclaims against the Company for breach of contract and breach of the duty of good faith and fair dealing, also seeking monetary damages. The parties have completed discovery and have each filed motions for summary judgment. On January 23, 2017, the Court denied both the Company s and Delta s motions for summary judgment. Pre-trial settlement conferences were held on December 16, 2016 and January 12, 2017 and the parties continue to discuss settlement. The outcome of the Delta matter is not determinable at this time.

Item 1A. Risk Factors

There are no material changes to the risk factors described under Item 1A of the Company s Form 10-K for the year ended September 30, 2016.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

(a) Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) (2)

31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) (2)

32.1 Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (2)

101.INS XBRL Instance Document (1)

101.SCH XBRL Taxonomy Extension Scheme Document (1)

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document (1)

101.DEF XBRL Taxonomy Extension Definition Linkbase Document (1)

101.LAB XBRL Taxonomy Extension Label Linkbase Document (1)

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document (1)

(1) Filed herewith

(2) Furnished herewith

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SIGNATURE

Pursuant to 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.

INNOVATIVE SOLUTIONS AND SUPPORT, INC.

Date: February 10, 2017

By:

/s/ RELLAND WINAND
RELLAND WINAND
CHIEF FINANCIAL OFFICER